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American Institute of Certified Public Accountants

AICPA Technical Practice Aids

Volume 2

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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AS OF JUNE 1, 2009

AICPA Technical Practice Aids

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ARCHIVE—STATEMENTS OF POSITION ACCOUNTING

Introduction

The guidance included in this section has been codified into the Financial Accounting Standards Board (FASB) *Accounting Standards Codification*™ (ASC) effective July 1, 2009. However, these Statements of Position are included herein for archival purposes until further notice.

Disclaimer: The Statements of Position in this section have not been updated for certain recently issued FASB Statements, including FASB Statement No 157, *Fair Value Measurements*, and FASB Statement No. 165, *Subsequent Events*.

Statements of Position of the Accounting Standards Division present the conclusions of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. SAS No. 69 is effective for audits of financial statements for periods ending after March 15, 1992. An entity following an accounting treatment as of March 15, 1992, need not change to an accounting treatment specified in a Statement of Position whose effective date is before March 15, 1992. For Statements of Position whose effective date is subsequent to March 15, 1992, and for entities initially applying an accounting principle after March 15, 1992, the accounting treatment specified by that Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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STATEMENTS OF POSITION—ACCOUNTING

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Section 10,060

Statement of Position 75-2 Accounting Practices of Real Estate Investment Trusts

[Recommendation to Financial Accounting Standards Board]

AICPA **American Institute of Certified Public Accountants**
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

June 27, 1975

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on *Accounting Practices of Real Estate Investment Trusts*. It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate. The scope of the Statement is restricted to REITs, although it is acknowledged that the conclusions therein may also be appropriate for companies which are not REITs.

The Statement takes the position that the allowance for losses on loans and foreclosed properties should now be determined based on an evaluation of the recoverability of individual loans and properties and, in this evaluation, the principle of providing for all losses when they become evident should now require the inclusion of all holding costs, including interest, in determining such losses.

The individual evaluation of the loans and foreclosed properties should be made, according to the Statement, as of the close of all annual and interim stockholder reporting periods. This may well result in a need to increase or decrease the allowance for losses with a corresponding charge or credit to income. However, in the case of foreclosed property which the REIT elects to hold as a long-term investment, the Statement concludes that the net realizable value of such property at the date of foreclosure becomes its new basis, and subsequent increases in market values of such properties should generally not be recorded until the time of a later exchange transaction which confirms the amount of any increase.

The Statement also takes the position that recognition of interest revenue should be discontinued when it is not reasonable to expect that the revenue will be received and enumerates conditions which should now be regarded as establishing a presumption that the recording of interest should be discontinued.

Finally, the Statement concludes that commitment fees should be amortized over the combined commitment and loan period, and provides guidance with respect to appropriate accounting by a REIT for operating support from its adviser.

The Division would appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

STANLEY J. SCOTT
Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

Accounting Practices of Real Estate Investment Trusts[*]

Introduction

.01 Real estate investment trusts (REITs) have in recent years assumed an increasingly important role in the real estate industry. REITs are business trusts and are generally publicly-held. They employ equity capital, coupled with substantial amounts of debt financing, in making real estate loans and investments.

.02 A REIT, if it so elects, will not be required to pay Federal corporate income taxes (other than that on "tax preference" items) if, among other things, at least 90% of its taxable income, as defined, is distributed to its shareholders. This Statement, however, is not restricted to those REITs which have elected such tax treatment.

.03 The accounting problems discussed in this Statement of Position may also be encountered by other companies which are not REITs but which are engaged in the business of making loans on or investing in real estate. The conclusions in this Statement of Position may, therefore, also be appropriate for those companies. However, the accounting practices of companies which are not REITs are beyond the scope of this Statement of Position.

.04 REITs have engaged in a variety of lending and investing activities, some of which are listed below.

Construction loans are generally short-term first mortgage loans to finance the construction of residential, commercial or industrial properties. Interest revenue on such loans is usually accrued and added to the loan balance, which is paid from the proceeds of permanent financing.

Development loans are short-term first mortgage loans to finance site development costs. They are usually paid from proceeds of a construction loan.

Land acquisition loans are first mortgage loans to finance the acquisition (not the development) of sites.

[*] [Footnote deleted.]

Long and intermediate term loans are generally conventional mortgage loans to finance completed properties.

Purchase leasebacks consist of the simultaneous purchase and leaseback to the seller of real estate properties.

Equity investments in real estate are direct ownership interests, under a variety of forms, in improved or unimproved real estate.

Junior mortgage loans are real estate loans subject to the lien of a prior mortgage.

Wrap-around loans are junior mortgage loans to provide an owner with funds without disturbing a prior first mortgage loan which, for various reasons, is not liquidated.

Gap loans are junior mortgage loans to finance a temporary spread between amounts advanced and amounts committed under a prior first mortgage loan.

Warehousing loans are short-term loans secured by the pledge of mortgage loans.

.05 In connection with real estate loans, a REIT may issue a commitment, which is an agreement to make a mortgage loan in the future at specified terms.

.06 A REIT's financial success is often dependent upon external factors, among which are the operations of its contractor-borrowers, the availability to those contractors of long-term mortgage funds when projects are completed, and the general condition of the real estate industry. The success of the REIT is also dependent upon its ability to obtain financing at rates less than that earned on its portfolio of investments.

.07 Considerable attention has recently been given to the accounting practices of REITs, particularly those which relate to loans which are in default or may become in default. This Statement of Position addresses certain of those practices.

Losses From Loans

[.08–.29] [Effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,* effective for financial statements for fiscal years beginning after December 15, 1994, and December 15, 1995, respectively.][1–2]

Assets Affected by Troubled Debt Restructurings

[.29A–.29C] [Effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, effective for financial statements for fiscal years beginning after December 15, 1994, and December 15, 1995, respectively.]

Discontinuance of Interest Revenue Recognition

.30 While some REITs argue that recognition of interest revenue should never be discontinued, it seems clear that there is no sound basis in theory or

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[1–2] [Footnotes effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, effective for financial statements for fiscal years beginning after December 15, 1994, and December 15, 1995, respectively.]

practice for such a position, since it is well established in accounting that if sufficient doubt or uncertainty exists as to realization, recognition may not be appropriate.

.31 In practice, the recognition of interest revenue has usually been discontinued at one of the following points:

(1) When the amount of any final loss can be determined with a high degree of precision (e.g., upon final settlement).

(2) Upon the occurrence of certain specified events (e.g., interest or principal is a certain number of days past due, cost overruns are at a certain percentage, foreclosure proceedings are being initiated, etc.)

(3) When judgment—often involving an evaluation of total loan recoverability, including estimated recoverability from foreclosure and sale—indicates that any additional interest would not be realized.

.32 Postponing the discontinuance of interest recognition until a loss can be determined with a high degree of precision is in conflict with general practice and theory.

.33 A common practice is to discontinue the recognition of interest upon the occurrence of certain specified events. Its attractiveness lies in the ability to determine objectively if the criteria have been met and, as a result, it is presumed there would be a greater uniformity in the reported results of REITs following this practice.

.34 Opponents of this practice acknowledge that specific criteria may be useful in identifying potential problem loans but believe that arbitrary rules cannot be a substitute for management's judgment. It is argued that even though a loan may meet an established criterion for the discontinuance of interest recognition, it is still possible that the loan and the interest will ultimately be collected; thus, to discontinue recognition in such a situation is as incorrect as recognizing interest when it is clear it will not be collected.

.35 The Division believes that the recognition of interest revenue should be discontinued when it is not reasonable to expect that the revenue will be received. The Division also believes that certain conditions, such as any one of the following, should now be regarded as establishing a presumption (which may be overcome if other facts clearly refute the presumption) that the recording of interest should be discontinued.

(1) Payments of principal or interest are past due.

(2) The borrower is in default under the terms of the loan agreement.

(3) Foreclosure proceedings have been or are expected to be initiated.

(4) The credit-worthiness of the borrower is in doubt because of pending or actual bankruptcy proceedings, the filing of liens against his assets, etc.

(5) Cost overruns and/or delays in construction cast doubt on the economic viability of the project.

(6) The loan has been renegotiated.

These conditions may also be an indication that an allowance for losses should be provided.

.36 The Division supports the view that the discontinuance of interest revenue recognition is related to the question of realization and, consequently, such recognition should not be resumed, nor should unrecorded interest be recognized, until it is evident that the principal and interest will be collected.

.37 Some believe that even though the recognition of interest is discontinued, interest revenue should be "grossed up" with an offsetting charge to an expense account. They believe that this presentation will more clearly reflect the planned income from the portfolio as well as the deviations, in the form of provisions for possible losses, from that plan.

.38 Others maintain that since the interest recognition was discontinued because realization was doubtful, it would not be appropriate to include such amounts in interest revenue in the financial statements because such a presentation would contradict economic reality. The Division supports this view.

Commitment Fees

[.39–.46] [Effectively superseded by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, effective for lending and leasing transactions entered into and commitments granted in fiscal years beginning after December 15, 1987.][3]

Operating Support of the REIT by the Adviser

.47 Various methods are or have been employed by advisers to insure a certain return to the REIT for certain periods. Some of these methods are summarized below.

(1) Purchasing a loan or a property at an amount in excess of market value

(2) Forgiving indebtedness

(3) Reducing advisory fees

(4) Providing required compensating balances

(5) Making outright cash payments

.48 In situations of this type, few would challenge the need for disclosure of the nature of the relationship between the REIT and its adviser and the nature and amount of the transactions between them. The accounting for the transaction, however, is not quite as clear.

.49 Some believe that operating support given to a REIT by its adviser can be determined to be either income or a contribution to capital on the basis of the form of the transaction.

.50 Others hold that such support should always be accounted for as income since it is difficult, if not impossible, to distinguish items of income from capital contributions. In some cases, for example, determining what the terms of an "arms-length" transaction would be might pose significant problems. Distinguishing between the types of operating support would also pose problems—why, for example, should a loan purchased at more than market value by the adviser be viewed differently from a reduction in the advisory fee?

.51 The Division believes that in the present framework of generally accepted accounting principles, appropriate accounting by a REIT for operating support from its adviser would include the following:

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[3] [Footnote effectively superseded by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, effective for lending and leasing transactions entered into and commitments granted in fiscal years beginning after December 15, 1987.]

(1) Adjustment of any assets (or liabilities) which will be transferred between the companies to current market value as of the date of the transaction.

(2) Recognition, as income or as a reduction of advisory fees, of the operating support effectively obtained, with full disclosure of (*a*) the relationship between the parties and (*b*) the nature and amount of the transactions.

.52 The effect of such transactions, when material, should be reported separately in the income statement.

* * * * *

[.53] Appendix A: Illustration A

Purpose of Illustration

[Effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, effective for financial statements for fiscal years beginning after December 15, 1994, and December 15, 1995, and December 15, 1986, respectively.]

[.54] Appendix B: Illustration B

[Effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, effective for financial statements for fiscal years beginning after December 15, 1994, and December 15, 1995, and December 15, 1986, respectively.]

[.55] Appendix C: Present Value Factors

[Effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, effective for financial statements for fiscal years beginning after December 15, 1994, and December 15, 1995, and December 15, 1986, respectively.][*]

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[*] [Footnote effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, effective for financial statements for fiscal years beginning after December 15, 1994, December 15, 1995, and December 15, 1986, respectively.]

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Assistant Director
Accounting Standards

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Section 10,130

Statement of Position 76-3 Accounting Practices for Certain Employee Stock Ownership Plans

[Recommendation to the Financial Accounting Standards Board]

AICPA **American Institute of Certified Public Accountants**
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 20, 1976

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on *Accounting Practices for Certain Employee Stock Ownership Plans* (ESOPs). It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

The Statement deals primarily with accounting and reporting issues that have arisen with respect to those ESOPs that borrow funds from a bank or other lender to acquire shares of stock in the employer company or that issue notes to existing shareholders in exchange for shares of stock. However, certain conclusions in the Statement are also applicable to ESOPs that have not entered into such transactions.

The Statement's major recommendations are briefly summarized below:

- An obligation of an ESOP should be recorded as a liability in the financial statements of the employer when the obligation is covered by either a guarantee of the employer or a commitment by the employer to make future contributions to the ESOP sufficient to meet the debt service requirements.
- The offsetting debit to the liability recorded by the employer should be accounted for as a reduction of shareholders' equity.
- The liability recorded by the employer and the offsetting debit should both be reduced as the ESOP makes payments on the debt.

- The amount contributed or committed to be contributed to an ESOP with respect to a given year should be charged to expense by the employer; the compensation and interest elements of the contribution should be separately reported.
- All shares held by an ESOP should be treated as outstanding shares in the determination of earnings per share. Dividends paid on those shares should be charged to retained earnings.
- Any additional investment tax credit should be accounted for as a reduction of income tax expense in the year in which the contribution to the ESOP is charged to expense.

The Division would appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

Raymond C. Lauver
Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

Accounting Practices for Certain Employee Stock Ownership Plans

Introduction

.01 The Employee Retirement Income Security Act of 1974 describes an Employee Stock Ownership Plan (ESOP) as a qualified stock bonus plan, or a combination stock bonus and money purchase pension plan, designed to invest primarily in "qualifying employer securities."[1] Qualifying employer securities include the employer's stock and its other marketable obligations. The essential differences between an ESOP and other qualified stock bonus plans are that (*a*) an ESOP is permitted, in certain circumstances, to incur liabilities in the acquisition of employer securities and (*b*) the employer may be permitted to increase his maximum allowable investment tax credit by as much as an additional 1½% if that amount is contributed to an ESOP.

.02 In some cases, funds are borrowed from a bank or other lender by the ESOP and are used to acquire shares of stock in the employer company. The stock may be outstanding shares, treasury shares, or newly issued shares, and is held by the ESOP until it is distributed to the employees. (In some cases, an ESOP may issue notes to existing shareholders in exchange for qualifying employer securities.) The stock may be allocated to individual employees even though it may not be distributed to them until a future date. The debt of the ESOP is usually collateralized by a pledge of the stock and by either a guarantee of the employer or a commitment by the employer to make future contributions to the ESOP sufficient to meet the debt service requirements. The employer company makes annual contributions to the ESOP that are deductible for tax purposes, subject to the limitations of the Internal Revenue Code. Cash contributions and dividends received are used by the ESOP to:

(*a*) Satisfy the annual amortization of the outstanding debt principal.

(*b*) Satisfy the annual interest costs on such debt.

(*c*) Obtain short-term investments to provide for liquidity.

(*d*) Pay other expenses.

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[1] Employee Retirement Income Security Act of 1974, Title II, Subtitle B, Section 2003.

(*e*) Acquire additional shares of the employer company's stock, to the extent of the excess, if any, over that required by (*a*) through (*d*) above.

.03 Several accounting and reporting issues have arisen with respect to those ESOPs that borrow funds from a bank or other lender to acquire shares of stock in the employer company, or that issue notes to existing shareholders in exchange for shares of stock.[2] These issues are being dealt with in practice in different ways. This Statement of Position has been issued because the Division believes it is desirable to narrow the range of alternative accounting practices in this area.

.04 Final regulations clarifying the rights and duties of the parties affected by an ESOP have not been issued by the Internal Revenue Service. Readers of this Statement of Position should also be cognizant of the content of such regulations, when they are issued.

Accounting for an Obligation of an ESOP Guaranteed by the Employer

Recording an ESOPs Obligation in the Employer's Financial Statements

.05 The Division believes that an obligation of an ESOP should be recorded as a liability in the financial statements of the employer when the obligation is covered by either a guarantee of the employer or a commitment by the employer to make future contributions to the ESOP sufficient to meet the debt service requirements. The employer's guarantee or commitment is, in substance, the assumption of the ESOP's debt and the related obligation to reduce that debt. The employer has assumed these obligations either (*a*) to buy back its own shares (in the case where the ESOP uses the loan proceeds to acquire previously outstanding shares) or (*b*) to finance additional working capital or other fund needs (in the case where the ESOP uses the loan proceeds to acquire previously unissued or treasury shares from the employer).

.06 It does not follow from the above that assets held by an ESOP should be included in the financial statements of the employer. Ownership of these assets rests in the employees, not in the employer.

Recording the Offsetting Debit to the Recorded Liability

.07 The Division believes that the offsetting debit to the liability recorded by the employer should be accounted for as a reduction of shareholders' equity. Therefore, when new shares are issued to the ESOP by the employer, an increase in shareholders' equity should be reported only as the debt that financed that increase is reduced. (The offsetting debit in shareholders' equity in this case is akin to the unearned compensation discussed in APB Opinion No. 25, paragraph 14.) When outstanding shares, as opposed to unissued shares, are acquired by the ESOP, shareholders' equity should similarly be reduced by the offsetting debit until the debt is repaid.

Reducing the Recorded Liability

.08 The Division believes that the liability recorded by the employer should be reduced as the ESOP makes payments on the debt. The liability is

[2] This Statement of Position does not deal directly with ESOPs that might invest in qualifying employer securities other than equity securities.

initially recorded because the guarantee or commitment is in substance the employer's debt. Therefore, it should not be reduced until payments are actually made. Similarly, the amount reported as a reduction of shareholders' equity should be reduced only when the ESOP makes payments on the debt. These two accounts should move symmetrically.

Measuring Compensation Expense

.09 The Division believes that the amount contributed or committed to be contributed to an ESOP with respect to a given year should be the measure of the amount to be charged to expense by the employer.[3] Such contributions measure the amount of expense irrevocably incurred whether or not they are used concurrently to reduce the debt guaranteed by the employer.

.10 Since the debt of the ESOP is, in substance, the employer's debt, the Division believes that the employer should report separately the compensation element and the interest element of the annual contribution, and should disclose the related interest rate and debt terms in the footnotes to the financial statements. However, a significant minority within the Division believes that the entire annual contribution should be reported as compensation expense.

Reporting Dividends Paid and Earnings Per Share

.11 The Division believes that all shares held by an ESOP should be treated as outstanding shares in the determination of earnings per share. An ESOP is a legal entity holding shares issued by the employer, whether or not those shares have been allocated to employee accounts.

.12 Dividends paid on shares held by an ESOP should be charged to retained earnings. Such dividends should not be included at any time in compensation expense.

.13 A minority within the Division believes that when trust debt proceeds are transferred to the employer corporation, a transaction of a predominantly financing nature has occurred. The minority believes that shares should be considered outstanding for earnings per share calculations only to the extent that they become constructively unencumbered by repayments of debt principal. To do otherwise, according to this minority view, would result in an inconsistent and initially excessive effect on earnings per share in that the total number of shares purchased by the ESOP would be immediately included in the calculation of earnings per share, even though the related compensation expense would be spread over a period of time on the basis of the employer's contribution to the trust. Consistent with this position, the minority would also charge dividends to retained earnings only to the extent that trust shares are unencumbered. Any remaining balance would be reported as additional compensation expense in the period the dividends were declared.

Other Matters

Investment Tax Credit

.14 The Division believes that the additional investment tax credit should be accounted for (to the extent that it is available and utilized) as a reduction of income tax expense in the same year in which the contribution to the ESOP

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[3] This conclusion is also applicable to ESOPs that have not borrowed funds from a bank or other lender (or issued notes to existing shareholders) to acquire shares of stock in the employer company.

is charged to expense, irrespective of the accounting for the normal investment tax credit on property acquisitions.[4] This additional credit arises from the contribution to the ESOP, not solely from the property acquisitions of the employer.[5]

Applicability of APB Opinion No. 11

[.15] [Effectively superseded by FASB Statement No. 109, *Accounting for Income Taxes*, effective for fiscal years beginning after December 15, 1992.][6]

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[4] See footnote 3.

[5] See also Section 101(c) of the Revenue Act of 1971.

[6] [Footnote effectively superseded by FASB Statement No. 109, *Accounting for Income Taxes*, effective for fiscal years beginning after December 15, 1992.]

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Section 10,240

Statement of Position 78-9 Accounting for Investments in Real Estate Ventures

[Proposal to Financial Accounting Standards Board]

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 29, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, *Accounting for Investments in Real Estate Ventures*, has been prepared on behalf of the division by the AICPA Committee on Real Estate Accounting and approved by the AICPA Accounting Standards Executive Committee.

The statement presents the division's recommendations on accounting for investments in real estate ventures (corporate joint ventures, general and limited partnerships, and undivided interests). The recommendations are primarily an application of the existing authoritative accounting literature to the specialized accounting problems related to such investments and are intended to narrow the range of alternative practices.

Representatives of the division are available to discuss this proposal with you or your staff at your convenience.

Sincerely,

Arthur R. Wyatt
Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

[The next page is 78,553.]

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

SOP 78-9 is amended by FASB Staff Position SOP 78-9-1*, Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5*. FASB Staff Position 78-9-1 is effective: for general partners of all new partnerships formed, and for existing partnerships for which the partnership agreements are modified, after June 29, 2005; for general partners in all other partnerships, no later than the beginning of first reporting period in fiscal years beginning after December 15, 2005.

Accounting for Investments in Real Estate Ventures

Introduction

.01 Ownership of real estate or real estate development projects by two or more entities may take several forms. The most common forms are as follows:

a. *A corporate joint venture*—a corporation owned and operated by a small group of ventures to accomplish a mutually beneficial venture or project, as described in paragraph 3 of APB Opinion 18, *The Equity Method of Accounting for Investments in Common Stock*.

b. *A general partnership*—an association in which each partner has unlimited liability.

c. *A limited partnership*—an association in which one or more general partners have unlimited liability and one or more partners have limited liability. A limited partnership is usually managed by the general partner or partners, subject to limitations, if any, imposed by the partnership agreement.

d. *An undivided interest*—an ownership arrangement in which two or more parties jointly own property, and title is held individually to the extent of each party's interest.

In this statement of position, the terms *real estate venture* and *venture* apply to all of the ownership arrangements described in this paragraph.

.02 These forms of ownership differ in legal form and economic substance, and the authoritative accounting literature dealing with the specialized accounting problems related to such investments is limited. In practice, those accounting problems are dealt with in a variety of ways, and the division believes narrowing the range of those alternative practices is desirable.

.03 This statement of position presents the division's recommendations on accounting for investments in real estate ventures in financial statements prepared in conformity with generally accepted accounting principles. It does not apply to regulated investment companies and other entities that are required to account for investments at quoted market value or fair value.

The Applicability of the Equity Method of Accounting

Corporate Joint Ventures

.04 APB Opinion 18 requires investments in corporate joint ventures to be accounted for by the equity method and includes guidance for applying that method in the financial statements of the investor. That opinion applies to corporate joint ventures created to own or operate real estate projects.

.05 Paragraph 3 of APB Opinion 18 states that "an entity which is a subsidiary of one of the 'joint venturers' is not a corporate joint venture." A subsidiary, according to that opinion, refers to

> . . . a corporation which is controlled, directly or indirectly, by another corporation. The usual condition for control is ownership of a majority (over 50 percent) of the outstanding voting stock. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

Accordingly, an investment in a corporate subsidiary that is a real estate venture should be accounted for by the investor-parent using the principles applicable to investments in subsidiaries rather than those applicable to investments in corporate joint ventures. Minority shareholders in such a real estate venture should account for their investment using the principles applicable to investments in common stock set forth in APB Opinion 18 or in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

General Partnerships

.06 The staff of the American Institute of Certified Public Accountants issued an interpretation of APB Opinion 18 in November, 1971, which concludes that many of the provisions of APB Opinion 18 are appropriate in accounting for investments in certain unincorporated entities. The division believes that the principal difference, aside from income tax considerations, between corporate joint ventures and general partnerships is that the individual investors in general partnerships usually assume joint and several liability. The division believes, however, that the equity method enables noncontrolling investors in general partnerships to reflect the underlying nature of their investments in those ventures as well as it does for investors in corporate joint ventures. Accordingly, the division believes that investments in noncontrolled real estate general partnerships should be accounted for and reported under the equity method. This recommendation requires the one-line equity method of presentation in both the balance sheet and the statement of income.[1] Paragraph 19 of APB Opinion 18 should be used as a guide in applying the equity method. Investors in general partnerships should provide for income taxes on the profits accrued on their investment in the partnership regardless of the tax basis used in the partnership return. Differences between the investor's tax basis of the investment and the reported amount of the investment in the financial statements of the investor that will result in taxable or deductible amounts in future years (temporary differences) should

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[1] Pro rata consolidation is not appropriate except in the limited circumstances described in paragraph .11.

be accounted for in conformity with FASB Statement No. 109, *Accounting for Income Taxes*. [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.07 The division believes a general partnership that is controlled, directly or indirectly, by an investor is, in substance, a subsidiary of the investor. APB Opinion No. 18 states that the usual condition for control of a corporation is ownership of a majority (over 50 percent) of the outstanding voting stock. However, if partnership voting interests are not clearly indicated, a condition that would usually indicate control is ownership of a majority (over 50 percent) of the financial interests in profits or losses (see paragraph .25). The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other partners, or by court decree. On the other hand, the majority interest holder may not control the entity if one or more of the other partners have substantive participating rights that permit those other partners to effectively participate in significant decisions that would be expected to be made in the ordinary course of business. The determination of whether the rights of the other partners are substantive participating rights should be evaluated in accordance with the guidance for "substantive participating rights" in EITF Issue No. 04-5, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights*. If the other partners have substantive participating rights, the presumption of control by the majority interest holder is overcome. The division believes that a controlling investor should account for its investment under the principles of accounting applicable to investments in subsidiaries. Accordingly, intercompany profits and losses on assets remaining within the group should be eliminated. A noncontrolling investor in a general partnership should account for its investment by the equity method and should be guided by the provisions of paragraph 19 of APB Opinion No. 18 as amended. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 144. As amended, effective: for general partners of all new partnerships formed, and for existing partnerships for which the partnership agreements are modified, after June 29, 2005; for general partners in all other partnerships, no later than the beginning of first reporting period in fiscal years beginning after December 15, 2005, by FASB Staff Position SOP 78-9-1.]

Limited Partnerships

.08 The division believes that the accounting recommendations for use of the equity method of accounting for investments in general partnerships are generally appropriate for accounting by limited partners for their investments in limited partnerships. A limited partner's interest may be so minor that the limited partner may have virtually no influence over partnership operating and financial policies. Such a limited partner is, in substance, in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation, and, accordingly, accounting for the investment using the cost method may be appropriate. Under the cost method, income recognized by the investor is limited to distributions received, except that distributions that exceed the investor's share of earnings after the date of the investment are applied to reduce the carrying value of the investment. Differences between the investor's tax basis of the investment and the reported amount of the investment in the financial statements of the investor that will result in taxable or deductible amounts in future years (temporary differences) should be accounted for in conformity with FASB Statement No. 109, *Accounting for Income Taxes*. [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.09 The rights and obligations of the general partners in a limited partnership are different from those of the limited partners and, accordingly, the general partners should be presumed to control the limited partnership. However, the rights of the limited partners may overcome that presumption of control. The guidance in EITF Issue No. 04-5 should be used to determine whether the rights of the limited partners overcome the presumption of control by the general partners. If the presumption of control by the general partners is overcome by the rights of the limited partners, the general partners should apply the equity method of accounting to their interests. If the presumption of control by the general partners is not overcome by the rights of the limited partners and no single general partner controls the limited partnership, the general partners should apply the equity method of accounting to their interests. If the presumption of control is not overcome by the rights of the limited partners and a single general partner controls the limited partnership, that general partner should consolidate the limited partnership and apply the principles of accounting applicable for investments in subsidiaries. [As amended, effective: for general partners of all new partnerships formed, and for existing partnerships for which the partnership agreements are modified, after June 29, 2005; for general partners in all other partnerships, no later than the beginning of first reporting period in fiscal years beginning after December 15, 2005, by FASB Staff Position SOP 78-9-1.]

.10 The division believes that if the substance of the partnership arrangement is such that the general partners are not in control of the major operating and financial policies of the partnership, a limited partner may be in control. An example could be a limited partner holding over 50 percent of the total partnership interest. A controlling limited partner should be guided in accounting for its investment by the principles for investments in subsidiaries. Noncontrolling limited partners should account for their investments by the equity method and should be guided by the provisions of paragraph 19 of APB Opinion 18, as discussed in paragraphs .06 and .07, or by the cost method, as discussed in paragraph .08, as appropriate.

Undivided Interests

.11 In an interpretation of APB Opinion 18 issued by the staff of the American Institute of Certified Public Accountants in November, 1971, the staff concluded that most of the provisions of paragraph 19 of APB Opinion 18 generally would be appropriate in accounting for partnerships and unincorporated ventures, but that if

> . . . the investor-venturer owns an undivided interest in each asset and is proportionately (i.e., severally) liable for its share of each liability, the provisions of the equity method set forth in paragraph 19(c) of the Opinion may not apply in some industries. For example, where it is the established industry practice . . ., the investor-venturer may account in its financial statements for its *pro rata* share of the assets, liabilities, revenues, and expenses of the venture.

If real property owned by undivided interests is subject to joint control by the owners, the division believes that investor-venturers should not present their investments by accounting for their pro rata share of the assets, liabilities, revenues, and expenses of the ventures. Such property is subject to joint control if decisions regarding the financing, development, sale, or operations require the approval of two or more of the owners. Most real estate ventures with ownership in the form of undivided interests are subject to some level of joint control. Accordingly, the division believes that such investments should be presented in the same manner as investments in noncontrolled partnerships.

If, however, the approval of two or more of the owners is not required for decisions regarding the financing, development, sale, or operations of real estate owned and each investor is entitled to only its pro rata share of income, is responsible to pay only its pro rata share of expenses, and is severally liable only for indebtedness it incurs in connection with its interest in the property, the investment may be presented by recording the undivided interest in the assets, liabilities, revenue, and expenses of the venture.

General Matters

Disclosure

.12 The division believes that investors in real estate ventures should be guided by the provisions of paragraph 20 of APB Opinion 18 in determining the disclosures to be made in their financial statements.

Statement of Cash Flows

.13 FASB Statement No. 95, *Statement of Cash Flows*, governs the form and content of statements of cash flows. [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Investor Accounting for Losses

General

.14 Some investors have suggested that their equity in losses of a real estate venture need not be recorded under the equity method of accounting as long as the value of their investment has not been impaired; for example, if it is expected that the venture's assets can be sold for more than their carrying value. The division believes that investors should record their share of the real estate venture's losses, determined in conformity with generally accepted accounting principles, without regard to unrealized increases in the estimated fair value of the venture's assets.

Accounting for an Investor's Share of Losses in Excess of Its Investment, Including Loans and Advances

.15 The division believes that an investor that is liable for the obligations of the venture or is otherwise committed to provide additional financial support to the venture should record its equity in real estate venture losses in excess of its investment, including loans and advances.[2] The following are examples of such circumstances:

a. The investor has a legal obligation as a guarantor or general partner.

b. The investor has indicated a commitment, based on considerations such as business reputation, intercompany relationships, or credit standing, to provide additional financial support. Such a commitment might be indicated by previous support provided by the investor or statements by the investor to other investors or third parties of the investor's intention to provide support.

.16 An investor in a real estate venture should report its recorded share of losses in excess of its investment, including loans and advances, as a liability in its financial statements.

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[2] An investor, though not liable or otherwise committed to provide additional financial support, should provide for losses in excess of investment when the imminent return to profitable operations by the venture appears to be assured. For example, a material nonrecurring loss of an isolated nature, or start-up losses, may reduce an investment below zero through the underlying profitable pattern of an investee is unimpaired.

.17 If an investor does not recognize venture losses in excess of its investment, loans, and advances and the venture subsequently reports net income, the investor should resume applying the equity method only after its share of such net income equals the share of net losses not recognized during the period in which equity accounting was suspended.

.18 If it is probable that one or more investors cannot bear their share of losses, the remaining investors should record their proportionate shares of venture losses otherwise allocable to investors considered unable to bear their share of losses.[3] When the venture subsequently reports income, those remaining investors should record their proportionate share of the venture's net income otherwise allocable to investors considered unable to bear their share of losses until such income equals the excess losses they previously recorded. The division also believes that an investor who is deemed by other investors to be unable to bear its share of losses should continue to record its contractual share of losses unless it is relieved from the obligation to make payment by agreement or operation of law.

.19 The division believes that the accounting by an investor for losses otherwise allocable to other investors should be governed by the provisions of FASB Statement No. 5 relating to loss contingencies. Accordingly, the investor should record a proportionate share of the losses otherwise allocable to other investors if it is probable that they will not bear their share. In this connection, the division believes that each investor should look primarily to the fair value of the other investors' interests in the venture and the extent to which the venture's debt is nonrecourse in evaluating their ability and willingness to bear their allocable share of losses.[4] However, there may be satisfactory alternative evidence of an ability and willingness of other investors to bear their allocable share of losses. Such evidence might be, for example, that those investors previously made loans or contributions to support cash deficits, possess satisfactory financial standing (as may be evidenced by satisfactory credit ratings), or have provided adequately collateralized guarantees.

Loss in Value of an Investment, Including Loans and Advances, Other Than a Temporary Decline

.20 A loss in value of an investment other than a temporary decline should be recognized. Such a loss in value may be indicated, for example, by a decision by other investors to cease providing support or reduce their financial commitment to the venture. Loans and advances should be evaluated under FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*. [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Other Accounting Matters Related to the Use of the Equity Method

Eliminating Interentity Profits and Losses

.21 As noted elsewhere in this statement, APB Opinion 18 should be used as a guide when applying the equity method. Paragraph 19(*a*) of that opinion provides that, in applying the equity method, intercompany profits and losses should be eliminated until realized by the investor or investee as if the investee

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[3] This recommendation does not apply for real property jointly owned and operated as undivided interests in assets if the claims or liens of investor's creditors are limited to investors' respective interests in such property.

[4] An investor may not be able to apply the general rule to an investment in an undivided interest because the extent to which the interests of other investors are encumbered by liens may not be known.

company were consolidated. The division believes that intercompany profit should be eliminated by the investor in relation to the investor's ownership interest in the investee, except that an investor that controls the investee and enters into a transaction with the investee should eliminate all of the intercompany profit on assets remaining within the group.

.22 AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*,* sets out similar rules in paragraph 58:

> A sale of property in which the seller holds or acquires an equity interest in the buyer should result in recognizing only the part of the profit proportionate to the outside interest in the buyer. No profit should be recognized if the seller controls the buyer . . . until realized from transactions with outside parties through sale or operations of the property.

.23 The division believes that if a transaction with a real estate venture confirms that there has been a loss in the value of the asset sold that is other than temporary and that has not been recognized previously, the loss should be recognized on the books of the transferor.

Accounting Principles Used by the Venture

.24 In the real estate industry, the accounts of a venture may reflect accounting practices, such as those used to prepare tax basis data for investors, that vary from generally accepted accounting principles. If the financial statements of the investor are to be prepared in conformity with generally accepted accounting principles, such variances that are material should be eliminated in applying the equity method.

Allocation Ratios for the Determination of Investor Income

.25 Venture agreements may designate different allocations among the investors of the venture's (*a*) profits and losses, (*b*) specified costs and expenses, (*c*) distributions of cash from operations, and (*d*) distributions of cash proceeds from liquidation. Such agreements may also provide for changes in the allocations at specified times or on the occurrence of specified events. Accounting by the investors for their equity in the venture's earnings under such agreements requires careful consideration of substance over form and consideration of underlying values as discussed in paragraph .19. The division believes that in order to determine the investor's share of venture net income or loss, such agreements or arrangements should be analyzed to determine how an increase or decrease in net assets of the venture (determined in conformity with generally accepted accounting principles) will affect cash payments to the investor over the life of the venture and on its liquidation. The division believes that specified profit and loss allocation ratios should not be used to determine an investor's equity in venture earnings if the allocation of cash distributions and liquidating distributions are determined on some other basis. For example, if a venture agreement between two investors purports to allocate all depreciation expense to one investor and to allocate all other revenues and expenses equally, but further provides that irrespective of such allocations, distributions to the investors will be made simultaneously and divided equally between them, there is no substance to the purported allocation of depreciation expense.

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* The Financial Accounting Standards Board has extracted the specialized accounting and reporting principles and practices contained in this AICPA Accounting Guide, see FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

Accounting for a Difference Between the Carrying Amount of an Investment in a Real Estate Venture and the Underlying Equity in Net Assets

.26 Differences between the carrying amount of an investment in a real estate venture and the investor's equity in the underlying net assets recorded by the venture may arise, for example, from unrecognized profit on transfers of real estate to the venture or differences in accounting methods. In addition, differences may arise from the acquisition of an investment in a venture at a price different from the investor's share of the net assets as recorded on the books of the venture.

.27 Differences that arise from a business combination with a venture accounted for as a purchase should be accounted for in accordance with the provisions of FASB Statement No. 141, *Business Combinations*.[†] Paragraph 35 of FASB Statement No. 141 states that the acquiring entity should allocate the cost of an acquired entity to the assets acquired, including intangible assets, and liabilities assumed based on their estimated fair values at date of acquisition. [‡] The division believes that an excess of the cost of the investment acquired over the equity in the underlying net assets usually would be ascribed to the fair values of real property interest owned by the venture. However, any excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed should be recognized as goodwill and should not be amortized.[||] [Revised, March 2003, to reflect conforming changes necessary due to the issuance of FASB Statement Nos. 141 and 142.]

.28 Paragraph 19(b) of APB Opinion No. 18, as amended by paragraph 40 of FASB Statement No. 142, provides that the difference between the cost of an investment and the amount of the underlying equity in net assets of the investee "should affect the determination of the amount of the investor's share of earnings or losses of an investee as if the investee were a consolidated subsidiary." The differences, other than goodwill, should be recognized by the investor as an adjustment to the amount of the venturer's depreciation, cost of sales, or other expenses, as appropriate, in recording income or loss from the venture on the equity basis. Paragraph 40 of FASB Statement No. 142 states that the portion of the difference between the cost of an investment and the amount of underlying equity in net assets of an equity method investee that is recognized as goodwill (equity method goodwill) should not be amortized. However, equity method goodwill should not be tested for impairment in accordance with FASB Statement No. 142. Equity method investments should continue to be reviewed for impairment in accordance with paragraph 19(h) of APB Opinion No. 18, as amended by FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. [Revised, March 2003, to

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[†] FASB Statement No. 141, *Business Combinations*, supersedes APB Opinion 16. Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141 (revised 2007), *Business Combinations*, should be applied. [Footnote added, March 2003, to reflect conforming changes necessary due to the issuance of FASB Statement No. 141. Footnote revised, May 2008, due to the issuance of FASB Statement No. 141(R).]

[‡] Paragraphs 35–39 of FASB Statement No. 141 provide guidance on the recognition of assets, including intangible assets, and liabilities apart from goodwill. Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141 (revised 2007) should be applied. [Footnote added, March 2003, to reflect conforming changes necessary due to the issuance of FASB Statement No. 141. Footnote revised, May 2008, due to the issuance of FASB Statement No. 141(R).]

[||] Paragraphs 12–14 of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, provide guidance on intangible assets subject to amortization. [Footnote added, March 2003, to reflect conforming changes necessary due to the issuance of FASB Statement No. 142.]

reflect conforming changes necessary due to the issuance of FASB Statement No. 142. Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 144.]

Accounting by the Investor for Certain Transactions With a Real Estate Venture

Capital Contributions

.29 *Contribution of Cash.* If all investors contribute cash at the formation of the real estate venture, each investor should record its investment at the amount of the cash contributed.

.30 *Contribution of Real Estate.*The division believes an investor that contributes real estate to the capital of a real estate venture generally should record its investment in the venture at the investor's cost (less related depreciation and valuation allowances) of the real estate contributed, regardless of whether the other investors contribute cash, property, or services. The division believes that an investor should not recognize profit on a transaction that in economic substance is a contribution to the capital of an entity, because a contribution to the capital of an entity is not the culmination of the earnings process. The division understands, however, that some transactions, structured in the form of capital contributions, may in economic substance be sales. The recommendations in paragraph .36 of this statement on accounting for sales of real estate to a venture by an investor apply to those transactions. An example of such a transaction is one in which investor *A* contributes to a venture real estate with a fair value of $2,000 and investor *B* contributes cash in the amount of $1,000 which is immediately withdrawn by investor *A*, and, following such contributions and withdrawals, each investor has a 50 percent interest in the venture (the only asset of which is the real estate). Assuming investor *A* is not committed to reinvest the $1,000 in the venture, the substance of this transaction is a sale by investor *A* of a one-half interest in the real estate in exchange for cash. A minority of the division disagrees with the conclusion that an investor contributing real estate to a real estate venture should record its investment at the cost of the real estate contributed. They believe that profit recognition by such an investor to the extent of the other investors' interests in the profits and losses of the venture may be appropriate if the other investors contribute cash or other hard assets (such as marketable securities) for their interests and the investor contributing the real estate has no continuing involvement with the real estate that would require deferral of profit under the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*.[#] The majority of the division believes that unless the investor that contributes real estate to the venture withdraws cash (or other hard assets) and has no commitment to reinvest, such a transaction is not the culmination of an earnings process.

.31 An investor contributing property to a venture may obtain a disproportionately small interest in the venture based on a comparison of the carrying amount of the property with the cash contributed by the other investors. That situation might indicate that the investor contributing the property has suffered a loss that should be recognized.

[#] The Financial Accounting Standards Board has extracted the specialized accounting and reporting principles and practices contained in this AICPA Accounting Guide, see FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

.32 *Contribution of Services or Intangibles.*[**] The division believes the accounting considerations that apply to real property contributed to a partnership or joint venture also apply to contributions of services or intangibles. The investor's cost of such services or intangibles to be allocated to the cost of the investment should be determined by the investor in the same manner as for an investment in a wholly owned real estate project.

Income From Loans or Advances to a Venture

.33 Interest on loans and advances that are in substance capital contributions (for example, if all the investors are required to make loans and advances proportionate to their equity interests) should be accounted for as distributions rather than as interest income by the investors.

.34 An investor-lender that does not capitalize interest on its own real estate construction and development projects should account for interest on loans and advances that are not in substance capital contributions in accordance with the recommendations in this paragraph.

a. All interest income on the investor's loans or advances to the venture should be deferred if either of the following conditions is present.

   (i) Collectibility of the principal or interest is in doubt. This condition may exist if adequate collateral and other terms normally required by an independent lender are not present.

   (ii) There is a reasonable expectation that the other investors will not bear their shares of losses, resulting in uncertainty as to the lender's share of the venture's related interest expense.

b. If neither of the conditions in (*a*) is present and either the venture has recorded interest as an expense or the venture has capitalized the interest but in order to conform to the investor's accounting policies, the investor has recorded its equity in the income or loss of the venture as if the venture had charged the interest to expense, the entire interest income accrued on loans or advances to a venture should be recorded as earned.

c. If the conditions in (*a*) or (*b*) are not present, a portion of interest income from loans and advances to a venture should be deferred based on the investor's percentage interest in the profits and losses of the venture. However, an evaluation similar to that discussed in paragraphs .18 and .19 for recording the investor's share of losses should be made to avoid recording as interest income amounts that may ultimately be borne as losses by the investor making the loan.

[.35] [Effectively superseded by FASB Statement No. 34, *Capitalization of Interest Cost,* effective for fiscal years beginning after December 15, 1979.]

Sales of Real Estate to a Venture

.36 Sales of real estate by an investor to a real estate venture are subject to all of the provisions set forth in the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate.*[#]

[**] The provisions of this paragraph do not apply to real estate syndication activities in which the syndicators receive or retain partnership interests. Such activities are discussed in SOP 92-1, *Accounting for Real Estate Syndication Income* [section 10,500].

[#] The Financial Accounting Standards Board has extracted the specialized accounting and reporting principles and practices contained in this AICPA Accounting Guide, see FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

Sales of Services to a Venture

.37 If services are performed for a venture by an investor and their cost is capitalized by the venture, profit may be recognized by the investor to the extent attributable to the outside interests in the venture if the following conditions are met:

a. The substance of the transaction does not significantly differ from its form.

b. There are no substantial uncertainties about the ability of the investor to complete performance (as may be the case if the investor lacks experience in the business of the venture) or the total cost of services to be rendered.

c. There is a reasonable expectation that the other investors will bear their share of losses, if any.

The method of recognizing income from services rendered should be consistent with the method followed for services performed for unrelated parties.

Purchases of Real Estate or Services From a Venture

.38 An investor should not record as income its equity in the venture's profit from a sale of real estate to that investor; the investor's share of such profit should be recorded as a reduction in the carrying amount of the purchased real estate and recognized as income on a pro rata basis as the real estate is depreciated or when it is sold to a third party. Similarly, if a venture performs services for an investor and the cost of those services is capitalized by the investor, the investor's share of the venture's profit in the transaction should be recorded as a reduction in the carrying amount of the capitalized cost.

Accounting for the Sale of an Interest in a Real Estate Venture

.39 The division believes that a sale of an investment in a real estate venture (including the sale of stock in a corporate real estate venture) is the equivalent of a sale of an interest in the underlying real estate and should be evaluated under the guidelines set forth in the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*.[#]

[.40] [Effectively superseded by FASB Statement No. 66, *Accounting for Sales of Real Estate*, effective for real estate sales transactions entered into after December 31, 1982.]

Transition

.41 The division recommends applying this statement of position to financial statements issued for fiscal years and interim periods beginning after December 24, 1978. Adjustments resulting from a change in accounting method to comply with the recommendations in this statement should be applied retroactively, if material, and, to enhance comparability between periods, financial statements presented for the periods affected should be restated for as many periods as is practicable to give retroactive effect to such adjustments and to changes in presentation. The division encourages earlier application of

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[#] The Financial Accounting Standards Board has extracted the specialized accounting and reporting principles and practices contained in this AICPA Accounting Guide, see FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

the recommendations in this statement for fiscal years beginning before December 25, 1978, in financial statements not previously issued.

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Section 10,330

Statement of Position 81-1[*] Accounting for Performance of Construction-Type and Certain Production-Type Contracts

July 15, 1981

[Proposal to the Financial Accounting Standards Board]

Note: Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since it was originally issued. The changes are identified in a schedule in Appendix D of the statement.

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

Introduction

.01 This statement of position provides guidance on the application of generally accepted accounting principles in accounting for the performance of contracts for which specifications are provided by the customer for the construction of facilities or the production of goods or for the provision of related services. Changes in the business environment have increased significantly the variety and uses of those types of contracts and the types of business enterprises that use them. In the present business environment, diverse types of contracts, ranging from relatively simple to highly complex and from relatively short- to long-term, are widely used in many industries for construction, production, or provision of a broad range of goods and services. However, existing principles related to accounting for contracts were written in terms of long-term construction-type contracts, and they are not stated in sufficient detail for the scope of activities

[*] Transactions within the scope of SOP 81-1 are not subject to the views expressed in Staff Accounting Bulletin (SAB) 101, *Revenue Recognition in Financial Statements*, issued by the Securities and Exchange Commission.

to which they presently are applied. Those activities range far beyond the traditional construction-type activity (the design and physical construction of facilities such as buildings, roads, dams, and bridges) to include, for example, the development and production of military and commercial aircraft, weapons delivery systems, space exploration hardware, and computer software. The accounting standards division believes that guidance is now needed in this area of accounting.

The Basic Accounting Issue

.02 The determination of the point or points at which revenue should be recognized as earned and costs should be recognized as expenses is a major accounting issue common to all business enterprises engaged in the performance of contracts of the types covered by this statement. Accounting for such contracts is essentially a process of measuring the results of relatively long-term events and allocating those results to relatively short-term accounting periods. This involves considerable use of estimates in determining revenues, costs, and profits and in assigning the amounts to accounting periods. The process is complicated by the need to evaluate continually the uncertainties inherent in the performance of contracts and by the need to rely on estimates of revenues, costs, and the extent of progress toward completion.

Present Accounting Requirements and Practices

.03 The pervasive principle of realization and its exceptions and modifications are central factors underlying accounting for contracts. APB Statement 4[†] states:

> Revenue is generally recognized when both of the following conditions are met: (1) the earnings process is complete or virtually complete, and (2) an exchange has taken place. [Paragraph 150]
>
> Revenue is sometimes recognized on bases other than the realization rule. For example, on long-term construction contracts revenue may be recognized as construction progresses. This exception to the realization principle is based on the availability of evidence of the ultimate proceeds and the consensus that a better measure of periodic income results. [Paragraph 152]
>
> The exception to the usual revenue realization rule for long-term construction-type contracts, for example, is justified in part because strict adherence to realization at the time of sale would produce results that are considered to be unreasonable. The judgment of the profession is that revenue should be recognized in this situation as construction progresses. [Paragraph 174]

.04 Accounting Research Bulletin No. 45 (ARB No. 45), *Long-Term Construction-Type Contracts,* issued by the AICPA Committee on Accounting Procedure in 1955, describes the two generally accepted methods of accounting for long-term construction-type contracts for financial reporting purposes:

- *The percentage-of-completion method* recognizes income as work on a contract progresses; recognition of revenues and profits generally is related to costs incurred in providing the services required under the contract.
- *The completed-contract method* recognizes income only when the contract is completed, or substantially so, and all costs and related revenues are reported as deferred items in the balance sheet until that time.

[†] Statement of Position 93-3, *Rescission of Accounting Principles Board Statements*, rescinds APB Statement No. 4. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, discusses matters similar to those in APB Statement No. 4. [Footnote added, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

The units-of-delivery is a modification of the percentage-of-completion method of accounting for contracts.

- *The units-of-delivery method* recognizes as revenue the contract price of units of a basic production product delivered during a period and as the cost of earned revenue the costs allocable to the delivered units; costs allocable to undelivered units are reported in the balance sheet as inventory or work in progress. The method is used in circumstances in which an entity produces units of a basic product under production-type contracts in a continuous or sequential production process to buyers' specifications.

The use of either of the two generally accepted methods of accounting involves, to a greater or lesser extent, three key areas of estimates and uncertainties: (*a*) the extent of progress toward completion, (*b*) contract revenues, and (*c*) contract costs. Although the ultimate amount of contract revenue is often subject to numerous uncertainties, the accounting literature has given little attention to the difficulties of estimating contract revenue. [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.05 ARB No. 45, paragraph 15, describes the circumstances in which each method is preferable as follows:

> The committee believes that in general when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable.

Both of the two generally accepted methods are widely used in practice. However, the two methods are frequently applied differently in similar circumstances. The division believes that the two methods should be used in specified circumstances and should not be used as acceptable alternatives for the same circumstances. Accordingly, identifying the circumstances in which either of the methods is preferable and the accounting that should be followed in the application of those methods are among the primary objectives of this statement of position. This statement provides guidance on the application of ARB No. 45 and does not amend that bulletin.

.06 In practice, methods are sometimes found that allocate contract costs and revenues to accounting periods on (*a*) the basis of cash receipts and payments or (*b*) the basis of contract billings and costs incurred. Those practices are not generally accepted methods of accounting for financial reporting purposes. However, those methods are appropriate for other purposes, such as the measurement of income for income tax purposes, for which the timing of cash transactions is a controlling factor. Recording the amounts billed or billable on a contract during a period as contract revenue of the period, and the costs incurred on the contract as expenses of the period, is not acceptable for financial reporting purposes because the amounts billed or billable on a contract during a period are determined by contract terms and do not necessarily measure performance on the contract. Only by coincidence might those unacceptable methods produce results that approximate the results of the generally accepted method of accounting for contracts that are appropriate in the circumstances.

Other Pronouncements and Regulations Affecting Contract Accounting

.07 Accounting Research Bulletin No. 43, chapter 11, "Government Contracts," prescribes generally accepted principles in three areas of accounting for government contracts. Section A of that chapter deals with accounting problems arising under cost-plus-fixed-fee contracts. Section B deals with certain aspects of the accounting for government contracts and subcontracts that are subject to renegotiation. Section C deals with problems involved in accounting for certain terminated war and defense contracts. Those pronouncements govern accounting for contracts in the areas indicated.

.08 The pricing and costing of federal government contracts are governed by cost principles contained in procurement regulations such as the Federal Procurement Regulation (FPR) and the Defense Acquisition Regulation (DAR). Also, most major government contractors are subject to cost accounting standards issued by the Cost Accounting Standards Board (CASB). CASB standards apply to the cost accounting procedures that government contractors use to allocate costs to contracts; CASB standards are not intended for financial reporting.

.09 Accounting for contracts for income tax purposes is prescribed by the Internal Revenue Code and the related rules and regulations. The methods of accounting for contracts under those requirements are not limited to the two generally accepted methods for financial reporting. For numerous historical and practical reasons, tax accounting rules and regulations differ from generally accepted accounting principles. Numerous nonaccounting considerations are appropriate in determining income tax accounting. This statement deals exclusively with the application of generally accepted accounting principles to accounting for contracts in financial reporting. It does not apply to income tax accounting and is not intended to influence income tax accounting.

Need for Guidance

.10 Because of the complexities and uncertainties in accounting for contracts, the increased use of diverse types of contracts for the construction of facilities, the production of goods, or the provision of related services, and present conditions and practices in industries in which contracts are performed for those purposes, additional guidance on the application of generally accepted accounting principles is needed. This statement of position provides that guidance. Appendix A contains a schematic chart showing the organization of the statement.

Scope of Statement of Position

.11 This statement of position applies to accounting for performance of contracts for which specifications are provided by the customer for the construction of facilities or the production of goods or the provision of related services that are reported in financial statements prepared in conformity with generally accepted accounting principles.[1] Existing authoritative accounting literature uses the terms "long-term" and "construction-type" in identifying the types of contracts that are the primary focus of interest. The term "long-term" is not used in this statement of position as an identifying characteristic because

[1] This statement is not intended to apply to "service transactions" as defined in the FASB's October 23, 1978 Invitation to Comment, *Accounting for Certain Service Transactions*. However, it applies to separate contracts to provide services essential to the construction or production of tangible property, such as design, engineering, procurement, and construction management (see paragraph .13 for examples).

other characteristics are considered more relevant for identifying the types of contracts covered. However, accounting for contracts by an entity that primarily has relatively short-term contracts is recommended in paragraph .31 of this statement. The scope of the statement is not limited to construction-type contracts.

Contracts Covered

.12 Contracts covered by this statement of position are binding agreements between buyers and sellers in which the seller agrees, for compensation, to perform a service to the buyer's specifications.[2] Contracts consist of legally enforceable agreements in any form and include amendments, revisions, and extensions of such agreements. Performance will often extend over long periods, and the seller's right to receive payment depends on his performance in accordance with the agreement. The service may consist of designing, engineering, fabricating, constructing, or manufacturing related to the construction or the production of tangible assets. Contracts such as leases and real estate agreements, for which authoritative accounting literature provides special methods of accounting, are not covered by this statement.

.13 Contracts covered by this statement include, but are not limited to, the following:

- Contracts in the construction industry, such as those of general building, heavy earth moving, dredging, demolition, design-build contractors, and specialty contractors (for example, mechanical, electrical, or paving).
- Contracts to design and build ships and transport vessels.
- Contracts to design, develop, manufacture, or modify complex aerospace or electronic equipment to a buyer's specification or to provide services related to the performance of such contracts.
- Contracts for construction consulting service, such as under agency contracts or construction management agreements.
- Contracts for services performed by architects, engineers, or architectural or engineering design firms.

.14 Contracts not covered by this statement include, but are not limited to, the following:

- Sales by a manufacturer of goods produced in a standard manufacturing operation, even if produced to buyers' specifications, and sold in the ordinary course of business through the manufacturer's regular marketing channels if such sales are normally recognized as revenue in accordance with the realization principle for sales of products and if their costs are accounted for in accordance with generally accepted principles of inventory costing.
- Sales or supply contracts to provide goods from inventory or from homogeneous continuing production over a period of time.
- Contracts included in a program and accounted for under the program method of accounting. For accounting purposes, a program consists of

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[2] Specifications imposed on the buyer by a third party (for example, a government or regulatory agency or a financial institution) or by conditions in the marketplace are deemed to be "buyer's specifications."

a specified number of units of a basic product expected to be produced over a long period in a continuing production effort under a series of existing and anticipated contracts.[3]

- Service contracts of health clubs, correspondence schools, and similar consumer-oriented organizations that provide their services to their clients over an extended period.
- Magazine subscriptions.
- Contracts of nonprofit organizations to provide benefits to their members over a period of time in return for membership dues.

.15 Contracts covered by this statement may be classified into four broad types based on methods of pricing: (*a*) fixed-price or lump-sum contracts, (*b*) cost-type (including cost-plus) contracts, (*c*) time-and-material contracts, and (*d*) unit-price contracts. A fixed-price contract is an agreement to perform all acts under the contract for a stated price. A cost-type contract is an agreement to perform under a contract for a price determined on the basis of a defined relationship to the costs to be incurred, for example, the costs of all acts required plus a fee, which may be a fixed amount or a fixed percentage of the costs incurred. A time-and-material contract is an agreement to perform all acts required under the contract for a price based on fixed hourly rates for some measure of the labor hours required (for example, direct labor hours) and the cost of materials. A unit-price contract is an agreement to perform all acts required under the contract for a specified price for each unit of output. Each of the various types of contracts may have incentive, penalty, or other provisions that modify their basic pricing terms. The pricing features of the various types are discussed in greater detail in Appendix B.

Definition of a Contractor

.16 The term "contractor" as used in this statement refers to a person or entity that enters into a contract to construct facilities, produce goods, or render services to the specifications of a buyer either as a general or prime contractor, as a subcontractor to a general contractor, or as a construction manager.

Definition of a Profit Center

.17 For the purpose of this statement, a "profit center" is the unit for the accumulation of revenues and costs and the measurement of income. For business enterprises engaged in the performance of contracts, the profit center for accounting purposes is usually a single contract; but under some specified circumstances it may be a combination of two or more contracts, a segment of a contract or of a group of combined contracts. This statement of position provides guidance on the selection of the appropriate profit center. The accounting recommendations, usually stated in terms of a single contract, also apply to alternative profit centers in circumstances in which alternative centers are appropriate.

Application and Effect on Existing Audit Guides and SOPs

.18 This statement of position presents the division's recommendations on accounting for contracts (as specified in paragraphs .11 to .17) in all indus-

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[3] [Footnote deleted, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

tries. The recommendations in this statement need not be applied to immaterial items. Two existing AICPA Audit and Accounting Guides, *Construction Contractors* and *Federal Government Contractors*, provide additional guidance on the application of generally accepted accounting principles to the construction industry and to federal government contracts, respectively. The recommendations in this statement take precedence in those areas. [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.19 The guidance on contract accounting and financial reporting in *Federal Government Contractors* is essentially consistent with the recommendations in this statement. Since the recommendations in this statement provide more comprehensive and explicit guidance on the application of generally accepted accounting principles to contract accounting than does the guide, *Federal Government Contractors*, the guide incorporates this statement as an appendix. The provisions of that guide should be interpreted and applied in the context of the recommendations in this statement. [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.20 This statement is not intended to supersede recommendations on accounting in other AICPA industry accounting or audit guides or in other statements of position.

The Division's Conclusions

Determining a Basic Accounting Policy for Contracts

.21 In accounting for contracts, the basic accounting policy decision is the choice between the two generally accepted methods: the percentage-of-completion method including units of delivery and the completed-contract method. The determination of which of the two methods is preferable should be based on a careful evaluation of circumstances because the two methods should not be acceptable alternatives for the same circumstances. The division's recommendations on basic accounting policy are set forth in the sections on "The Percentage-of-Completion Method" and "The Completed-Contract Method," which identify the circumstances appropriate to the methods, the bases of applying the methods, and the reasons for the recommendations. The recommendations apply to accounting for individual contracts and to accounting for other profit centers in accordance with the recommendations in the section on "Determining the Profit Center." As a result of evaluating individual contracts and profit centers, a contractor should be able to establish a basic policy that should be followed in accounting for most of his contracts. In accordance with the requirements of APB Opinion No. 22, *Disclosure of Accounting Policies,* a contractor should disclose in the note to the financial statements on accounting policies the method or methods of determining earned revenue and the cost of earned revenue including the policies relating to combining and segmenting, if applicable. Appendix C contains a summary of the disclosure requirements in this statement.

The Percentage-of-Completion Method

.22 This section sets forth the recommended basis for using the percentage-of-completion method and the reasons for the recommendation. Under most contracts for construction of facilities, production of goods, or provision of related services to a buyer's specifications, both the buyer and the seller (contractor) obtain enforceable rights. The legal right of the buyer to require specific performance of the contract means that the contractor has, in effect, agreed to sell his rights to work-in-progress as the work progresses. This view is consistent with the contractor's legal rights; he typically has no ownership claim to the work-in-progress but has lien rights. Furthermore, the contractor has the right to require the buyer, under most financing arrangements, to make progress payments to support his ownership investment and to approve the facilities constructed (or goods produced or services performed) to date if they meet the contract requirements. The buyer's right to take over the work-in-progress at his option (usually with a penalty) provides additional evidence to support that view. Accordingly, the business activity taking place supports the concept that in an economic sense performance is, in effect, a continuous sale (transfer of ownership rights) that occurs as the work progresses. Also under most contracts for the production of goods and the provision of related services that are accounted for on the basis of units delivered, both the contractor and the customer obtain enforceable rights as the goods are produced or the services are performed. As units are delivered, title to and the risk of loss on those units normally transfer to the customer, whose acceptance of the items indicates that they meet the contractual specifications. For such contracts, delivery and acceptance are objective measurements of the extent to which the contracts have been performed. The percentage-of-completion method recognizes the legal and economic results of contract performance on a timely basis. Financial statements based on the percentage-of-completion method present the economic substance of a company's transactions and events more clearly and more timely than financial statements based on the completed-contract method, and they present more accurately the relationships between gross profit from contracts and related period costs. The percentage-of-completion method informs the users of the general purpose financial statements of the volume of economic activity of a company.

Circumstances Appropriate to the Method

.23 The use of the percentage-of-completion method depends on the ability to make reasonably dependable estimates. For the purposes of this statement, "the ability to make reasonably dependable estimates" relates to estimates of the extent of progress toward completion, contract revenues, and contract costs. The division believes that the percentage-of-completion method is preferable as an accounting policy in circumstances in which reasonably dependable estimates can be made and in which all the following conditions exist:

- Contracts executed by the parties normally include provisions that clearly specify the enforceable rights regarding goods or services to be provided and received by the parties, the consideration to be exchanged, and the manner and terms of settlement.
- The buyer can be expected to satisfy his obligations under the contract.
- The contractor can be expected to perform his contractual obligations.

.24 For entities engaged on a continuing basis in the production and delivery of goods or services under contractual arrangements and for whom contracting represents a significant part of their operations, the presumption is that they have the ability to make estimates that are sufficiently dependable to justify the use of the percentage-of-completion method of accounting.[4] Persuasive evidence to the contrary is necessary to overcome that presumption. The ability to produce reasonably dependable estimates is an essential element of the contracting business. For a contract on which a loss is anticipated, generally accepted accounting principles require recognition of the entire anticipated loss as soon as the loss becomes evident. An entity without the ability to update and revise estimates continually with a degree of confidence could not meet that essential requirement of generally accepted accounting principles.

.25 Accordingly, the division believes that entities with significant contracting operations generally have the ability to produce reasonably dependable estimates and that for such entities the percentage-of-completion method of accounting is preferable in most circumstances. The method should be applied to individual contracts or profit centers, as appropriate.

a. Normally, a contractor will be able to estimate total contract revenue and total contract cost in single amounts. Those amounts should normally be used as the basis for accounting for contracts under the percentage-of-completion method.

b. For some contracts, on which some level of profit is assured, a contractor may only be able to estimate total contract revenue and total contract cost in ranges of amounts. If, based on the information arising in estimating the ranges of amounts and all other pertinent data, the contractor can determine the amounts in the ranges that are most likely to occur, those amounts should be used in accounting for the contract under the percentage-of-completion method. If the most likely amounts cannot be determined, the lowest probable level of profit in the range should be used in accounting for the contract until the results can be estimated more precisely.

c. However, in some circumstances, estimating the final outcome may be impractical except to assure that no loss will be incurred. In those circumstances, a contractor should use a zero estimate of profit; equal amounts of revenue and cost should be recognized until results can be estimated more precisely. A contractor should use this basis only if the bases in (*a*) or (*b*) are clearly not appropriate. A change from a zero estimate of profit to a more precise estimate should be accounted for as a change in an accounting estimate.

An entity using the percentage-of-completion method as its basic accounting policy should use the completed-contract method for a single contract or a group of contracts for which reasonably dependable estimates cannot be made or for which inherent hazards make estimates doubtful. Such a departure from the basic policy should be disclosed.

Nature of Reasonable Estimates and Inherent Hazards

.26 In practice, contract revenues and costs are estimated in a wide variety of ways ranging from rudimentary procedures to complex methods and

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[4] The division recognizes that many contractors have informal estimating procedures that may result in poorly documented estimates and marginal quality field reporting and job costing systems. Those conditions may influence the ability of an entity to produce reasonably dependable estimates. However, procedures and systems should not influence the development of accounting principles and should be dealt with by management as internal control, financial reporting, and auditing concerns.

systems. Regardless of the techniques used, a contractor's estimating procedures should provide reasonable assurance of a continuing ability to produce reasonably dependable estimates.[5] Ability to estimate covers more than the estimating and documentation of contract revenues and costs; it covers a contractor's entire contract administration and management control system. The ability to produce reasonably dependable estimates depends on all the procedures and personnel that provide financial or production information on the status of contracts. It encompasses systems and personnel not only of the accounting department but of all areas of the company that participate in production control, cost control, administrative control, or accountability for contracts. Previous reliability of a contractor's estimating process is usually an indication of continuing reliability, particularly if the present circumstances are similar to those that prevailed in the past.

.27 Estimating is an integral part of contractors' business activities, and there is a necessity to revise estimates on contracts continually as the work progresses. The fact that circumstances may necessitate frequent revision of estimates does not indicate that the estimates are unreliable for the purpose for which they are used. Although results may differ widely from original estimates because of the nature of the business, the contractor, in the conduct of his business, may still find the estimates reasonably dependable. Despite these widely recognized conditions, a contractor's estimates of total contract revenue and total contract costs should be regarded as reasonably dependable if the minimum total revenue and the maximum total cost can be estimated with a sufficient degree of confidence to justify the contractor's bids on contracts.

.28 ARB No. 45 discourages the use of the percentage-of-completion method of accounting in circumstances in which inherent hazards make estimates doubtful. "Inherent hazards" relate to contract conditions or external factors that raise questions about contract estimates and about the ability of either the contractor or the customer to perform his obligations under the contract. Inherent hazards that may cause contract estimates to be doubtful usually differ from inherent business risks. Business enterprises engaged in contracting, like all business enterprises, are exposed to numerous business risks that vary from contract to contract. The reliability of the estimating process in contract accounting does not depend on the absence of such risks. Assessing business risks is a function of users of financial statements.

.29 The present business environment and the refinement of the estimating process have produced conditions under which most business entities engaged in contracting can deal adequately with the normal, recurring business risks in estimating the outcome of contracts. The division believes that inherent hazards that make otherwise reasonably dependable contract estimates doubtful involve events and conditions that would not be considered in the ordinary preparation of contract estimates and that would not be expected to recur frequently, given the contractor's normal business environment. Such hazards are unrelated to, or only incidentally related to, the contractor's typical activities. Such hazards may relate, for example, to contracts whose validity is seriously in question (that is, which are less than fully enforceable), to contracts whose completion may be subject to the outcome of pending legislation

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[5] The type of estimating procedures appropriate in a particular set of circumstances depends on a careful evaluation of the costs and benefits of developing the procedures. The ability to produce reasonably dependable estimates that would justify the use of the percentage-of-completion method as recommended in paragraph .25 does not depend on the elaborateness of the estimating procedures used.

or pending litigation, or to contracts exposed to the possibility of the condemnation or expropriation of the resulting properties. Reasonably dependable estimates cannot be produced for a contract with unrealistic or ill-defined terms or for a contract between unreliable parties. However, the conditions stated in paragraph .23 for the use of the percentage-of-completion method of accounting, which apply to most bona fide contracts, make the existence of some uncertainties, including some of the type described in ARB No. 45, paragraph 15, unlikely for contracts that meet those conditions. Therefore, the division believes that there should be specific, persuasive evidence of such hazards to indicate that use of the percentage-of-completion method on one of the bases in paragraph .25 is not preferable.

The Completed-Contract Method

.30 This section sets forth the recommended basis for using the completed-contract method and the reasons for the recommendation. Under the completed-contract method, income is recognized only when a contract is completed or substantially completed. During the period of performance, billings and costs are accumulated on the balance sheet, but no profit or income is recorded before completion or substantial completion of the work. This method precludes reporting on the performance that is occurring under the enforceable rights of the contract as work progresses. Although the completed-contract method is based on results as finally determined rather than on estimates for unperformed work, which may involve unforeseen costs and possible losses, it does not reflect current performance when the period of a contract extends beyond one accounting period, and it therefore may result in irregular recognition of income. Financial statements based on this method may not show informative relationships between gross profit reported on contracts and related period costs.

Circumstances of Use

.31 The completed-contract method may be used as an entity's basic accounting policy in circumstances in which financial position and results of operations would not vary materially from those resulting from use of the percentage-of-completion method (for example, in circumstances in which an entity has primarily short-term contracts). Although this statement does not formally distinguish on the basis of length between long-term and short-term contracts, the basis for recording income on contracts of short duration poses relatively few problems. In accounting for such contracts, income ordinarily is recognized when performance is substantially completed and accepted. Under those circumstances, revenues and costs in the aggregate for all contracts would be expected to result in a matching of gross profit with period overhead or fixed costs similar to that achieved by use of the percentage-of-completion method. For example, the completed-contract method, as opposed to the percentage-of-completion method, would not usually produce a material difference in net income or financial position for a small plumbing contractor that performs primarily relatively short-term contracts during an accounting period; performance covers such a short span of time that the work is somewhat analogous to the manufacture of shelf production items for sale. An entity using the completed-contract method as its basic accounting policy should depart from that policy for a single contract or a group of contracts not having the features described in this paragraph and use the percentage-of-completion method on one of the bases described in paragraph .25. Such a departure should be disclosed.

.32 The completed-contract method is preferable in circumstances in which estimates cannot meet the criteria for reasonable dependability discussed in the section on the percentage-of-completion method or in which there are inherent hazards of the nature of those discussed in that section. An entity using the percentage-of-completion method as its basic accounting policy should depart from that policy and use the completed-contract method for a single contract or a group of contracts only in the circumstances described in paragraph .25.

.33 The use of the completed-contract method is recommended for the circumstances described in paragraphs .31 and .32. However, for circumstances in which there is an assurance that no loss will be incurred on a contract (for example, when the scope of the contract is ill-defined but the contractor is protected by a cost-plus contract or other contractual terms), the percentage-of-completion method based on a zero profit margin, rather than the completed-contract method, is recommended until more precise estimates can be made. The significant difference between the percentage-of-completion method applied on the basis of a zero profit margin and the completed-contract method relates to the effects on the income statement. Under the zero profit margin approach to applying the percentage-of-completion method, equal amounts of revenue and cost, measured on the basis of performance during the period, are presented in the income statement; whereas, under the completed-contract method, performance for a period is not reflected in the income statement, and no amount is presented in the income statement until the contract is completed. The zero profit margin approach to applying the percentage-of-completion method gives users of general purpose financial statements an indication of the volume of a company's business and of the application of its economic resources.

Determining the Profit Center

.34 The basic presumption should be that each contract is the profit center for revenue recognition, cost accumulation, and income measurement. That presumption may be overcome only if a contract or a series of contracts meets the conditions described for combining or segmenting contracts. A group of contracts (combining), and a phase or segment of a single contract or of a group of contracts (segmenting) may be used as a profit center in some circumstances. Since there are numerous practical implications of combining and segmenting contracts, evaluation of the circumstances, contract terms, and management intent are essential in determining contracts that may be accounted for on those bases.

Combining Contracts

.35 A group of contracts may be so closely related that they are, in effect, parts of a single project with an overall profit margin, and accounting for the contracts individually may not be feasible or appropriate. Under those circumstances, consideration should be given to combining such contracts for profit recognition purposes. The presumption in combining contracts is that revenue and profit are earned, and should be reported, uniformly over the performance of the combined contracts. For example, a group of construction-type contracts may be negotiated as a package with the objective of achieving an overall profit margin, although the profit margins on the individual contracts may vary. In those circumstances, if the individual contracts are performed and reported in different periods and accounted for separately, the reported profit margins in those periods will differ from the profit margin contemplated in the negotiations for reasons other than differences in performance.

.36 Contracts may be combined for accounting purposes only if they meet the criteria in paragraphs .37 and .38.

.37 A group of contracts may be combined for accounting purposes if the contracts

a. Are negotiated as a package in the same economic environment with an overall profit margin objective. Contracts not executed at the same time may be considered to have been negotiated as a package in the same economic environment only if the time period between the commitments of the parties to the individual contracts is reasonably short. The longer the period between the commitments of the parties to the contracts, the more likely it is that the economic circumstances affecting the negotiations have changed.

b. Constitute in essence an agreement to do a single project. A project for this purpose consists of construction, or related service activity with different elements, phases, or units of output that are closely interrelated or interdependent in terms of their design, technology, and function or their ultimate purpose or use.

c. Require closely interrelated construction activities with substantial common costs that cannot be separately identified with, or reasonably allocated to, the elements, phases, or units of output.

d. Are performed concurrently or in a continuous sequence under the same project management at the same location or at different locations in the same general vicinity.

e. Constitute in substance an agreement with a single customer. In assessing whether the contracts meet this criterion, the facts and circumstances relating to the other criteria should be considered. In some circumstances different divisions of the same entity would not constitute a single customer if, for example, the negotiations are conducted independently with the different divisions. On the other hand, two or more parties may constitute in substance a single customer if, for example, the negotiations are conducted jointly with the parties to do what in essence is a single project.

Contracts that meet all of these criteria may be combined for profit recognition and for determining the need for a provision for losses in accordance with ARB No. 45, paragraph 6. The criteria should be applied consistently to contracts with similar characteristics in similar circumstances.

.38 Production-type contracts that do not meet the criteria in paragraph .37 or segments of such contracts may be combined into groupings such as production lots or releases for the purpose of accumulating and allocating production costs to units produced or delivered on the basis of average unit costs in the following circumstances:[6]

a. The contracts are with one or more customers for the production of substantially identical units of a basic item produced concurrently or sequentially.

b. Revenue on the contracts is recognized on the units-of-delivery basis of applying the percentage-of-completion method.

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[6] [Footnote deleted to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

Segmenting a Contract

.39 A single contract or a group of contracts that otherwise meet the test for combining may include several elements or phases, each of which the contractor negotiated separately with the same customer and agreed to perform without regard to the performance of the others. If those activities are accounted for as a single profit center, the reported income may differ from that contemplated in the negotiations for reasons other than differences in performance. If the project is segmented, revenues can be assigned to the different elements or phases to achieve different rates of profitability based on the relative value of each element or phase to the estimated total contract revenue. A project, which may consist of a single contract or a group of contracts, with segments that have different rates of profitability may be segmented if it meets the criteria in paragraph .40, paragraph .41, or paragraph .42. The criteria for segmenting should be applied consistently to contracts with similar characteristics and in similar circumstances.

.40 A project may be segmented if all the following steps were taken and are documented and verifiable:

a. The contractor submitted bona fide proposals on the separate components of the project and on the entire project.

b. The customer had the right to accept the proposals on either basis.

c. The aggregate amount of the proposals on the separate components approximated the amount of the proposal on the entire project.

.41 A project that does not meet the criteria in paragraph .40 may be segmented only if it meets all the following criteria:

a. The terms and scope of the contract or project clearly call for separable phases or elements.

b. The separable phases or elements of the project are often bid or negotiated separately.

c. The market assigns different gross profit rates to the segments because of factors such as different levels of risk or differences in the relationship of the supply and demand for the services provided in different segments.

d. The contractor has a significant history of providing similar services to other customers under separate contracts for each significant segment to which a profit margin higher than the overall profit margin on the profit is ascribed.[7]

e. The significant history with customers who have contracted for services separately is one that is relatively stable in terms of pricing policy rather than one unduly weighted by erratic pricing decisions (responding, for example, to extraordinary economic circumstances or to unique customer-contractor relationships).

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[7] In applying the criterion in paragraph .41(*d*), values assignable to the segments should be on the basis of the contractor's normal historical prices and terms of such services to other customers. The division considered but rejected the concept of allowing a contractor to segment on the basis of prices charged by other contractors, since it does not follow that those prices could have been obtained by a contractor who has no history in the market.

f. The excess of the sum of the prices of the separate elements over the price of the total project is clearly attributable to cost savings incident to combined performance of the contract obligations (for example, cost savings in supervision, overhead, or equipment mobilization). Unless this condition is met, segmenting a contract with a price substantially less than the sum of the prices of the separate phases or elements would be inappropriate even if the other conditions are met. Acceptable price variations should be allocated to the separate phases or elements in proportion to the prices ascribed to each. In all other situations a substantial difference in price (whether more or less) between the separate elements and the price of the total project is evidence that the contractor has accepted different profit margins. Accordingly, segmenting is not appropriate, and the contracts should be the profit centers.

g. The similarity of services and prices in the contract segments and services and the prices of such services to other customers contracted separately should be documented and verifiable.

.42 A production-type contract that does not meet the criteria in paragraphs .40 or .41 may also be segmented and included in groupings such as production lots or releases for the purpose of accumulating and allocating production costs to units produced or delivered on the basis of average unit cost under the conditions specified in paragraph .38.

Measuring Progress on Contracts

.43 This section describes methods of measuring the extent of progress toward completion under the percentage-of-completion method and sets forth criteria for selecting those methods and for determining when a contract is substantially completed. Meaningful measurement of the extent of progress toward completion is essential since this factor is used in determining the amounts of estimated contract revenue and estimated gross profit that will be recognized as earned in any given period.

Methods of Measuring Extent of Progress Toward Completion

.44 In practice, a number of methods are used to measure the extent of progress toward completion. They include the cost-to-cost method, variations of the cost-to-cost method, efforts-expended methods, the units-of-delivery method, and the units-of-work-performed method. Those practices are intended to conform to ARB No. 45, paragraph 4.[8] Some of the measures are sometimes made and certified by engineers or architects, but management should review and understand the procedures used by those professionals.

.45 Some methods used in practice measure progress toward completion in terms of costs, some in terms of units of work, and some in terms of values

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[8] ARB No. 45, paragraph 4, states:

The committee recommends that the recognized income [under the percentage-of-completion method] be that percentage of estimated total income, either:

(*a*) that incurred costs to date bear to estimated total costs after giving effect to estimates of costs to complete based upon most recent information, or

(*b*) that may be indicated by such other measure of progress toward completion as may be appropriate having due regard to work performed.

Costs as here used might exclude, especially during the early stages of a contract, all or a portion of the cost of such items as materials and subcontracts if it appears that such an exclusion would result in a more meaningful periodic allocation of income.

added (the contract value of total work performed to date). All three of these measures of progress are acceptable in appropriate circumstances. The division concluded that other methods that achieve the objective of measuring extent of progress toward completion in terms of costs, units, or value added are also acceptable in appropriate circumstances. However, the method or methods selected should be applied consistently to all contracts having similar characteristics. The method or methods of measuring extent of progress toward completion should be disclosed in the notes to the financial statements. Examples of circumstances not appropriate to some methods are given within the discussion of input and output measures.

Input and Output Measures

.46 The several approaches to measuring progress on a contract can be grouped into input and output measures. Input measures are made in terms of efforts devoted to a contract. They include the methods based on costs and on efforts expended. Output measures are made in terms of results achieved. They include methods based on units produced, units delivered, contract milestones, and value added. For contracts under which separate units of output are produced, progress can be measured on the basis of units of work completed. In other circumstances, progress may be measured, for example, on the basis of cubic yards of excavation for foundation contracts or on the basis of cubic yards of pavement laid for highway contracts.

.47 Both input and output measures have drawbacks in some circumstances. Input is used to measure progress toward completion indirectly, based on an established or assumed relationship between a unit of input and productivity. A significant drawback of input measures is that the relationship of the measures to productivity may not hold, because of inefficiencies or other factors. Output is used to measure results directly and is generally the best measure of progress toward completion in circumstances in which a reliable measure of output can be established. However, output measures often cannot be established, and input measures must then be used. The use of either type of measure requires the exercise of judgment and the careful tailoring of the measure to the circumstances.

.48 The efforts-expended method is an input method based on a measure of the work, such as labor hours, labor dollars, machine hours, or material quantities. Under the labor-hours method, for example, extent of progress is measured by the ratio of hours performed to date to estimated total hours at completion. Estimated total labor hours should include (*a*) the estimated labor hours of the contractor and (*b*) the estimated labor hours of subcontractors engaged to perform work for the project, if labor hours of subcontractors are a significant element in the performance of the contract. A labor-hours method can measure the extent of progress in terms of efforts expended only if substantial efforts of subcontractors are included in the computation. If the contractor is unable to obtain reasonably dependable estimates of subcontractors' labor hours at the beginning of the project and as work progresses, he should not use the labor-hours method.

.49 The various forms of the efforts-expended method generally are based on the assumption that profits on contracts are derived from the contractor's efforts in all phases of operations, such as designing, procurement, and management. Profit is not assumed to accrue merely as a result of the acquisition of material or other tangible items used in the performance of the contract or the awarding of subcontracts. As previously noted, a significant drawback of efforts-expended methods is that the efforts included in the measure may not all be productive.

.50 Measuring progress toward completion based on the ratio of costs incurred to total estimated costs is also an input method. Some of the costs incurred, particularly in the early stages of the contract, should be disregarded in applying this method because they do not relate to contract performance. These include the costs of items such as uninstalled materials not specifically produced or fabricated for the project or of subcontracts that have not been performed. For example, for construction projects, the cost of materials not unique to the project that have been purchased or accumulated at job sites but that have not been physically installed do not relate to performance.[9] The costs of such materials should be excluded from costs incurred for the purpose of measuring the extent of progress toward completion. Also, the cost of equipment purchased for use on a contract should be allocated over the period of its expected use unless title to the equipment is transferred to the customer by terms of the contract. For production-type contracts, the complement of expensive components (for example, computers, engines, radars, and complex "black boxes") to be installed into the deliverable items may aggregate a significant portion of the total cost of the contract. In some circumstances, the costs incurred for such components, even though the components were specifically purchased for the project, should not be included in the measurement before the components are installed if inclusion would tend to overstate the percentage of completion otherwise determinable.

.51 The acceptability of the results of input or output measures deemed to be appropriate to the circumstances should be periodically reviewed and confirmed by alternative measures that involve observation and inspection. For example, the results provided by the measure used to determine the extent of progress may be compared to the results of calculations based on physical observations by engineers, architects, or similarly qualified personnel. That type of review provides assurance somewhat similar to that provided for perpetual inventory records by periodic physical inventory counts.

Completion Criteria Under the Completed-Contract Method

.52 As a general rule, a contract may be regarded as substantially completed if remaining costs and potential risks are insignificant in amount. The overriding objectives are to maintain consistency in determining when contracts are substantially completed and to avoid arbitrary acceleration or deferral of income. The specific criteria used to determine when a contract is substantially completed should be followed consistently and should be disclosed in the note to the financial statements on accounting policies. Circumstances to be considered in determining when a project is substantially completed include, for example, delivery of the product, acceptance by the customer, departure from the site, and compliance with performance specifications.

Income Determination—Revenue Elements

.53 Estimating the revenue on a contract is an involved process, which is affected by a variety of uncertainties that depend on the outcome of a series of

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[9] The cost of uninstalled materials specifically produced, fabricated, or constructed for a project should be included in the costs used to measure extent of progress. Such materials consist of items unique to a project that a manufacturer or supplier does not carry in inventory and that must be produced or altered to meet the specifications of the project.

future events. The estimates must be periodically revised throughout the life of the contract as events occur and as uncertainties are resolved.

.54 The major factors that must be considered in determining total estimated revenue include the basic contract price, contract options, change orders, claims, and contract provisions for penalties and incentive payments, including award fees and performance incentives. All those factors and other special contract provisions must be evaluated throughout the life of a contract in estimating total contract revenue to recognize revenues in the periods in which they are earned under the percentage-of-completion method of accounting.

Basic Contract Price—General

.55 The estimated revenue from a contract is the total amount that a contractor expects to realize from the contract. It is determined primarily by the terms of the contract and the basic contract price. Contract price may be relatively fixed or highly variable and subject to a great deal of uncertainty, depending on the type of contract involved. Appendix B describes basic contract types and major variations in the basic types. The total amount of revenue that ultimately will be realized on a contract is often subject to a variety of changing circumstances and accordingly may not be known with certainty until the parties to the contract have fully performed their obligations. Thus, the determination of total estimated revenue requires careful consideration and the exercise of judgment in assessing the probabilities of future outcomes.

.56 Although fixed-price contracts usually provide for a stated contract price, a specified scope of the work to be performed, and a specified performance schedule, they sometimes have adjustment schedules based on application of economic price adjustment (escalation), price redetermination, incentive, penalty, and other pricing provisions. Determining contract revenue under unit-price contracts generally involves the same factors as under fixed-price contracts. Determining contract revenue from a time-and-material contract requires a careful analysis of the contract, particularly if the contract includes guaranteed maximums or assigns markups to both labor and materials; and the determination involves consideration of some of the factors discussed below in regard to cost-type contracts.

Basic Contract Price—Cost-Type Contracts

.57 Cost-type contracts have a variety of forms (see Appendix B). The various forms have differing contract terms that affect accounting, such as provisions for reimbursable costs (which are generally spelled out in the contract), overhead recovery percentages, and fees. A fee may be a fixed amount or a percentage of reimbursable costs or an amount based on performance criteria.[10] Generally, percentage fees may be accrued as the related costs are incurred, since they are a percentage of costs incurred, and profits should therefore be recognized as costs are incurred. Cost-type contracts often include provisions for guaranteed maximum total reimbursable costs or target penalties and rewards relating to underruns and overruns of predetermined target prices, completion dates, plant capacity on completion of the project, or other criteria.

.58 One problem peculiar to cost-type contracts involves the determination of the amounts of reimbursable costs that should be reflected as revenue. Under some contracts, particularly service-type contracts, a contractor acts sol-

[10] Cost-type government contracts with fees based on a percentage of cost are no longer granted under government regulations.

ely in the capacity of an agent (construction manager) and has no risks associated with costs managed. This relationship may arise, for example, if an owner awards a construction management contract to one entity and a construction contract to another. If the contractor, serving as the construction manager, acts solely as an agent, his revenue should include only the fee and should exclude subcontracts negotiated or managed on behalf of the owner and materials purchased on behalf of the owner.

.59 In other circumstances, a contractor acts as an ordinary principal under a cost-type contract. For example, the contractor may be responsible to employees for salaries and wages and to subcontractors and other creditors for materials and services, and he may have the discretionary responsibility to procure and manage the resources in performing the contract. The contractor should include in revenue all reimbursable costs for which he has risk or on which his fee was based at the time of bid or negotiation. In addition, revenue from overhead percentage recoveries and the earned fee should be included in revenue.

Customer-Furnished Materials

.60 Another concern associated with measuring revenue relates to materials furnished by a customer or purchased by the contractor as an agent for the customer. Often, particularly for large, complex projects, customers may be more capable of carrying out the procurement function or may have more leverage with suppliers than the contractor. In those circumstances, the contractor generally informs the customer of the nature, type, and characteristics or specifications of the materials required and may even purchase the required materials and pay for them, using customer purchase orders and checks drawn against the customer's bank account. If the contractor is responsible for the nature, type, characteristics, or specifications of material that the customer furnishes or that the contractor purchases as an agent of the customer, or if the contractor is responsible for the ultimate acceptability of performance of the project based on such material, the value of those items should be included as contract price and reflected as revenue and costs in periodic reporting of operations. As a general rule, revenues and costs should include all items for which the contractor has an associated risk, including items on which his contractual fee was based.

Change Orders

.61 Change orders are modifications of an original contract that effectively change the provisions of the contract without adding new provisions. They may be initiated by either the contractor or the customer, and they include changes in specifications or design, method or manner of performance, facilities, equipment, materials, sites, and period for completion of the work. Many change orders are unpriced; that is, the work to be performed is defined, but the adjustment to the contract price is to be negotiated later. For some change orders, both scope and price may be unapproved or in dispute. Accounting for change orders depends on the underlying circumstances, which may differ for each change order depending on the customer, the contract, and the nature of the change. Change orders should therefore be evaluated according to their characteristics and the circumstances in which they occur. In some circumstances, change orders as a normal element of a contract may be numerous, and separate identification may be impractical. Such change orders may be evaluated statistically on a composite basis using historical results as modified by current conditions. If such change orders are considered by the parties to be a normal element within the original scope of the contract, no change in the contract price is required. Otherwise, the adjustment to the contract price may be routinely negotiated. Contract revenue and costs should be adjusted to reflect change orders approved by the customer and the contractor regarding both scope and price.

.62 Accounting for unpriced change orders depends on their characteristics and the circumstances in which they occur. Under the completed-contract method, costs attributable to unpriced change orders should be deferred as contract costs if it is probable that aggregate contract costs, including costs attributable to change orders, will be recovered from contract revenues. For all unpriced change orders, recovery should be deemed probable if the future event or events necessary for recovery are likely to occur. Some of the factors to consider in evaluating whether recovery is probable are the customer's written approval of the scope of the change order, separate documentation for change order costs that are identifiable and reasonable, and the entity's favorable experience in negotiating change orders, especially as it relates to the specific type of contract and change order being evaluated. The following guidelines should be followed in accounting for unpriced change orders under the percentage-of-completion method.

a. Costs attributable to unpriced change orders should be treated as costs of contract performance in the period in which the costs are incurred if it is *not* probable that the costs will be recovered through a change in the contract price.

b. If it is probable that the costs will be recovered through a change in the contract price, the costs should be deferred (excluded from the cost of contract performance) until the parties have agreed on the change in contract price, or, alternatively, they should be treated as costs of contract performance in the period in which they are incurred, and contract revenue should be recognized to the extent of the costs incurred.

c. If it is probable that the contract price will be adjusted by an amount that exceeds the costs attributable to the change order and the amount of the excess can be reliably estimated, the original contract price should also be adjusted for that amount when the costs are recognized as costs of contract performance if its realization is probable. However, since the substantiation of the amount of future revenue is difficult, revenue in excess of the costs attributable to unpriced change orders should only be recorded in circumstances in which realization is assured beyond a reasonable doubt, such as circumstances in which an entity's historical experience provides such assurance or in which an entity has received a bona fide pricing offer from a customer and records only the amount of the offer as revenue.

.63 If change orders are in dispute or are unapproved in regard to both scope and price, they should be evaluated as claims (see paragraphs .65–.67).

Contract Options and Additions

.64 An option or an addition to an existing contract should be treated as a separate contract in any of the following circumstances:

a. The product or service to be provided differs significantly from the product or service provided under the original contract.

b. The price of the new product or service is negotiated without regard to the original contract and involves different economic judgments.

c. The products or services to be provided under the exercised option or amendment are similar to those under the original contract, but the contract price and anticipated contract cost relationship are significantly different.

If an option or addition to an existing contract does not meet any of the above conditions, it may be combined with the original contract if it meets the criteria in paragraph .37 or .38. Exercised options or additions that do not meet the criteria for treatment as separate contracts or for combining with the original contracts should be treated as change orders on the original contracts.

Claims

.65 Claims are amounts in excess of the agreed contract price (or amounts not included in the original contract price) that a contractor seeks to collect from customers or others for customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved as to both scope and price, or other causes of unanticipated additional costs. Recognition of amounts of additional contract revenue relating to claims is appropriate only if it is probable that the claim will result in additional contract revenue and if the amount can be reliably estimated. Those two requirements are satisfied by the existence of all the following conditions:

a. The contract or other evidence provides a legal basis for the claim; or a legal opinion has been obtained, stating that under the circumstances there is a reasonable basis to support the claim.

b. Additional costs are caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor's performance.

c. Costs associated with the claim are identifiable or otherwise determinable and are reasonable in view of the work performed.

d. The evidence supporting the claim is objective and verifiable, not based on management's "feel" for the situation or on unsupported representations.

If the foregoing requirements are met, revenue from a claim should be recorded only to the extent that contract costs relating to the claim have been incurred. The amounts recorded, if material, should be disclosed in the notes to the financial statements. Costs attributable to claims should be treated as costs of contract performance as incurred.

.66 However, a practice such as recording revenues from claims only when the amounts have been received or awarded may be used. If that practice is followed, the amounts should be disclosed in the notes to the financial statements.

.67 If the requirements in paragraph .65 are not met or if those requirements are met but the claim exceeds the recorded contract costs, a contingent asset should be disclosed in accordance with FASB Statement No. 5, paragraph 17.

Income Determination—Cost Elements

.68 Contract costs must be identified, estimated, and accumulated with a reasonable degree of accuracy in determining income earned. At any time during the life of a contract, total estimated contract cost consists of two components: costs incurred to date and estimated cost to complete the contract. A company should be able to determine costs incurred on a contract with a relatively high degree of precision, depending on the adequacy and effectiveness of its cost accounting system. The procedures or systems used in accounting for costs vary from relatively simple, manual procedures that produce relatively modest amounts of detailed analysis to sophisticated, computer-based systems that produce a great deal of detailed analysis. Despite the diversity of systems and procedures, however, an objective of each system or of each set of procedures should be to accumulate costs properly and consistently by contract with a sufficient degree of accuracy to assure a basis for the satisfactory measurement of earnings.

Contract Costs

.69 Contract costs are accumulated in the same manner as inventory costs and are charged to operations as the related revenue from contracts is recognized. Contract costs generally include all direct costs, such as materials, direct labor, and subcontracts, and indirect costs identifiable with or allocable to the contracts. However, practice varies for certain types of indirect costs considered allocable to contracts, for example, support costs (such as central preparation and processing of job payrolls, billing and collection costs, and bidding and estimating costs).

.70 Authoritative accounting pronouncements require costs to be considered period costs if they cannot be clearly related to production, either directly or by an allocation based on their discernible future benefits.

.71 Income is recognized over the term of the contract under the percentage-of-completion method or is recognized as units are delivered under the units-of-delivery modification and is deferred until performance is substantially complete under the completed-contract method. None of the characteristics peculiar to those methods, however, require accounting for contract costs to deviate in principle from the basic framework established in existing authoritative literature applicable to inventories or business enterprises in general.

.72 A contracting entity should apply the following general principles in accounting for costs of construction-type and those production-type contracts covered by this statement. The principles are consistent with generally accepted accounting principles for inventory and production costs in other areas, and their application requires the exercise of judgment.

a. All direct costs, such as material, labor, and subcontracting costs, should be included in contract costs.

b. Indirect costs allocable to contracts include the costs of indirect labor, contract supervision, tools and equipment, supplies, quality control and inspection, insurance, repairs and maintenance, depreciation and amortization, and, in some circumstances, support costs, such as central preparation and processing of payrolls. For government contractors, other types of costs that are allowable or allocable under pertinent government contract regulations may be allocated to contracts as indirect costs if otherwise allowable under GAAP.[11] Methods of allocating indirect costs should be systematic and rational. They include, for example, allocations based on direct labor costs, direct

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[11] The AICPA Audit and Accounting Guide *Federal Government Contractors* states, "Practice varies among government contractors concerning the extent to which costs are included in inventory. Some contractors include in inventory all direct costs and only certain indirect costs. . . . Other contractors record as inventory all costs identified with the contract, including an allocation of general and administrative . . . expenses." The guide points out that many accountants believe that the practice of allocating general and administrative expenses to contract costs, which is permitted under the completed-contract method by ARB No. 45, paragraph 10, may appropriately be extended to government contracts because they believe that "costs incurred pursuant to a government contract are associated directly with the contract's revenue, and both should be recognized in the same period." [Footnote revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

labor hours, or a combination of direct labor and material costs. The appropriateness of allocations of indirect costs and of the methods of allocation depend on the circumstances and involve judgment.

c. General and administrative costs ordinarily should be charged to expense as incurred but may be accounted for as contract costs under the completed-contract method of accounting[12] or, in some circumstances, as indirect contract costs by government contractors.[13]

d. Selling costs should be excluded from contract costs and charged to expense as incurred unless they meet the criteria for precontract costs in paragraph .75.

e. Costs under cost-type contracts should be charged to contract costs in conformity with generally accepted accounting principles in the same manner as costs under other types of contracts because unrealistic profit margins may result in circumstances in which reimbursable cost accumulations omit substantial contract costs (with a resulting larger fee) or include substantial unallocable general and administrative costs (with a resulting smaller fee).

f. In computing estimated gross profit or providing for losses on contracts, estimates of cost to complete should reflect all of the types of costs included in contract costs.

g. Inventoriable costs should not be carried at amounts that when added to the estimated cost to complete are greater than the estimated realizable value of the related contracts.

Interest costs should be accounted for in accordance with FASB Statement No. 34, *Capitalization of Interest Cost.*

Precontract Costs

.73 In practice, costs are deferred in anticipation of future contract sales in a variety of circumstances. The costs may consist of (*a*) costs incurred in anticipation of a specific contract that will result in no future benefit unless the contract is obtained (such as the costs of mobilization, engineering, architectural, or other services incurred on the basis of commitments or other indications of interest in negotiating a contract), (*b*) costs incurred for assets to be used in connection with specific anticipated contracts (for example, costs for the purchase of production equipment, materials, or supplies), (*c*) costs incurred to acquire or produce goods in excess of the amounts required under a contract in anticipation of future orders for the same item, and (*d*) learning, start-up, or mobilization costs incurred for anticipated but unidentified contracts.

.74 Learning or start-up costs are sometimes incurred in connection with the performance of a contract or a group of contracts. In some circumstances, follow-on or future contracts for the same goods or services are anticipated. Such costs usually consist of labor, overhead, rework, or other special costs that must be incurred to complete the existing contract or contracts in progress and

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[12] Paragraph 10 of ARB No. 45, *Long-Term Construction-Type Contracts,* states:

When the completed-contract method is used, it may be appropriate to allocate general and administrative expenses to contract costs rather than to periodic income. This may result in a better matching of costs and revenues than would result from treating such expenses as period cost, particularly in years when no contracts were completed.

[13] See the discussion of the AICPA Audit and Accounting Guide *Federal Government Contractors* in footnote 11. [Footnote revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

are distinguished from research and development costs.[14] A direct relationship between such costs and the anticipated future contracts is often difficult to establish, and the receipt of future contracts often cannot reasonably be anticipated.

.75 The division recommends the following accounting for precontract costs:

a. Costs that are incurred for a specific anticipated contract and that will result in no future benefits unless the contract is obtained should not be included in contract costs or inventory before the receipt of the contract. However, such costs may be otherwise deferred, subject to evaluation of their probable recoverability, but only if the costs can be directly associated with a specific anticipated contract and if their recoverability from that contract is probable.[‡]

b. Costs incurred for assets, such as costs for the purchase of materials, production equipment, or supplies, that are expected to be used in connection with anticipated contracts may be deferred outside the contract cost or inventory classification if their recovery from future contract revenue or from other dispositions of the assets is probable.

c. Costs incurred to acquire or produce goods in excess of the amounts required for an existing contract in anticipation of future orders for the same items may be treated as inventory if their recovery is probable.

d. Learning or start-up costs incurred in connection with existing contracts and in anticipation of follow-on or future contracts for the same goods or services should be charged to existing contracts.[15]

e. Costs appropriately deferred in anticipation of a contract should be included in contract costs on the receipt of the anticipated contract.

f. Costs related to anticipated contracts that are charged to expenses as incurred because their recovery is not considered probable should not be reinstated by a credit to income on the subsequent receipt of the contract.

Cost Adjustments Arising From Back Charges

.76 Back charges are billings for work performed or costs incurred by one party that, in accordance with the agreement, should have been performed or incurred by the party to whom billed. These frequently are disputed items. For example, owners bill back charges to general contractors, and general contractors bill back charges to subcontractors. Examples of back charges include charges for cleanup work and charges for a subcontractor's use of a general contractor's equipment.

.77 A common practice is to net back charges in the estimating process. The division recommends the following procedures in accounting for back charges:

- Back charges to others should be recorded as receivables and, to the extent considered collectible, should be applied to reduce contract costs.

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[14] FASB Statement No. 2, *Accounting for Research and Development Costs,* requires that research and development costs be charged to expense when incurred.

[‡] SOP 98-5, *Reporting on the Costs of Start-Up Activities*, amends this SOP by requiring precontract costs that are start-up activities to be expensed as incurred if they are determined to be within the scope of SOP 98-5. [Footnote revised, July 2002, to reflect conforming changes necessary due to the issuance of Statement of Position 98-5.]

[15] [Footnote deleted, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

However, if the billed party disputes the propriety or amount of the charge, the back charge is in effect a claim, and the criteria for recording claims apply.

- Back charges from others should be recorded as payables and as additional contract costs to the extent that it is probable that the amounts will be paid.

Estimated Cost to Complete

.78 The estimated cost to complete, the other component of total estimated contract cost, is a significant variable in the process of determining income earned and is thus a significant factor in accounting for contracts. The latest estimate may be determined in a variety of ways and may be the same as the original estimate. Practices in estimating total contract costs vary, and guidance is needed in this area because of the impact of those practices on accounting. The following practices should be followed:

a. Systematic and consistent procedures that are correlated with the cost accounting system should be used to provide a basis for periodically comparing actual and estimated costs.

b. In estimating total contract costs, the quantities and prices of all significant elements of cost should be identified.

c. The estimating procedures should provide that estimated cost to complete includes the same elements of cost that are included in actual accumulated costs; also, those elements should reflect expected price increases.

d. The effects of future wage and price escalations should be taken into account in cost estimates, especially when the contract performance will be carried out over a significant period of time. Escalation provisions should not be blanket overall provisions but should cover labor, materials, and indirect costs based on percentages or amounts that take into consideration experience and other pertinent data.

e. Estimates of cost to complete should be reviewed periodically and revised as appropriate to reflect new information.

Computation of Income Earned for a Period Under the Percentage-of-Completion Method

.79 Total estimated gross profit on a contract, the difference between total estimated contract revenue and total estimated contract cost, must be determined before the amount earned on the contract for a period can be determined. The portion of total revenue earned or the total amount of gross profit earned to date is determined by the measurement of the extent of progress toward completion using one of the methods discussed in paragraphs .44 to .51 of this statement. The computation of income earned for a period involves a determination of the portion of total estimated contract revenue that has been earned to date (earned revenue) and the portion of total estimated contract cost related to that revenue (cost of earned revenue). Two different approaches to determining earned revenue and cost of earned revenue are widely used in practice. Either of the alternative approaches may be used on a consistent basis.[16]

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[16] The use of Alternative A in the discussion and in the presentation of some of the provisions of this statement is for convenience and consistency and is not intended to imply that Alternative A is the preferred approach.

Alternative A

.80 The advocates of this method believe that the portion of total estimated contract revenue earned to date should be determined by the measurement of the extent of progress toward completion and that, in accordance with the matching concept, the measurement of extent of progress toward completion should also be used to allocate a portion of total estimated contract cost to the revenue recognized for the period. They believe that this procedure results in reporting earned revenue, cost of earned revenue, and gross profit consistent with the measurement of contract performance. Moreover, they believe that, if there are no changes in estimates during the performance of a contract, the procedure also results in a consistent gross profit percentage from period to period. However, they recognize that a consistent gross profit percentage is rarely obtained in practice because of the need to be responsive in the accounting process to changes in estimates of contract revenues, costs, earned revenue, and gross profits. In accordance with this procedure, earned revenue, cost of earned revenue, and gross profit should be determined as follows:

a. *Earned Revenue* to date should be computed by multiplying total estimated contract revenue by the percentage of completion (as determined by one of the acceptable methods of measuring the extent of progress toward completion). The excess of the amount over the earned revenue reported in prior periods is the earned revenue that should be recognized in the income statement for the current period.

b. *Cost of Earned Revenue* for the period should be computed in a similar manner. Cost of earned revenue to date should be computed by multiplying total estimated contract cost by the percentage of completion on the contract. The excess of that amount over the cost of earned revenue reported in prior periods is the cost of earned revenue that should be recognized in the income statement for the current period. The difference between total cost incurred to date and cost of earned revenue to date should be reported on the balance sheet.

c. *Gross Profit* on a contract for a period is the excess of earned revenue over the cost of earned revenue.

Alternative B

.81 The advocates of this method believe that the measurement of the extent of progress toward completion should be used to determine the amount of gross profit earned to date and that the earned revenue to date is the sum of the total cost incurred on the contract and the amount of gross profit earned. They believe that the cost of work performed on a contract for a period, including materials, labor, subcontractors, and other costs, should be the cost of earned revenue for the period. They believe that the amount of costs incurred can be objectively determined, does not depend on estimates, and should be the amount that enters into the accounting determination of income earned. They recognize that, under the procedure that they advocate, gross profit percentages will vary from period to period unless the cost-to-cost method is used to measure the extent of progress toward completion. However, they believe that varying profit percentages are consistent with the existing authoritative literature when costs incurred do not provide an appropriate measure of the extent of progress toward completion. In accordance with Alternative B, earned revenue, cost of earned revenue, and gross profit are determined as follows:

a. *Earned Revenue* is the amount of gross profit earned on a contract for a period plus the costs incurred on the contract during the period.

b. *Cost of Earned Revenue* is the cost incurred during the period, excluding the cost of materials not unique to a contract that have not been used for the contract and costs incurred for subcontracted work that is still to be performed.

c. *Gross Profit* earned on a contract should be computed by multiplying the total estimated gross profit on the contract by the percentage of completion (as determined by one of the acceptable methods of measuring extent of progress toward completion). The excess of that amount over the amount of gross profit reported in prior periods is the earned gross profit that should be recognized in the income statement for the current period.

Revised Estimates

.82 Adjustments to the original estimates of the total contract revenue, total contract cost, or extent of progress toward completion are often required as work progresses under the contract and as experience is gained, even though the scope of the work required under the contract may not change. The nature of accounting for contracts is such that refinements of the estimating process for changing conditions and new developments are continuous and characteristic of the process. Additional information that enhances and refines the estimating process is often obtained after the balance sheet date but before the issuance of the financial statements; such information should result in an adjustment of the unissued financial statements. Events occurring after the date of the financial statements that are outside the normal exposure and risk aspects of the contract should not be considered refinements of the estimating process of the prior year but should be disclosed as subsequent events.

.83 Revisions in revenue, cost, and profit estimates or in measurements of the extent of progress toward completion are changes in accounting estimates and, as such, should be accounted for in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*.[17] A change in accounting estimate shall be accounted for in (*a*) the period of change if the change affects that period only or (*b*) the period of change and future periods if the change affects both. A change in accounting estimate shall not be accounted for by restating or retrospectively adjusting amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods. FASB Statement No. 154 carries forward the following two alternative methods of accounting for changes in accounting estimates identified in APB Opinion No. 20, *Accounting Changes*:

- *Cumulative Catch-up.* Account for the change in estimate in the period of change so that the balance sheet at the end of the period of change and the accounting in subsequent periods are as they would have been if the revised estimate had been the original estimate.
- *Reallocation.* Account for the effect of the change ratably over the period of change in estimate and subsequent periods.

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[17] [Footnote deleted, June 2007, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Although both methods are used in practice to account for changes in estimates of total revenue, total costs, or extent of progress under the percentage-of-completion method, the cumulative catch-up method is more widely used. Accordingly, to narrow the areas of differences in practice, such changes should be accounted for by the cumulative catch-up method. [Paragraph revised, June 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 154.]

.84 Although estimating is a continuous and normal process for contractors, FASB Statement No. 154, paragraph 22 requires disclosure of the effect of significant revisions if the effect is material.[18] The effect on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and any related per-share amounts of the current period shall be disclosed for a change in estimate that affects several future periods. If a change in estimate does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, a description of that change in estimate shall be disclosed whenever the financial statements of the period of change are presented. [Paragraph revised, June 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 154.]

Provisions for Anticipated Losses on Contracts

.85 When the current estimates of total contract revenue and contract cost indicate a loss, a provision for the entire loss on the contract should be made. Provisions for losses should be made in the period in which they become evident under either the percentage-of-completion method or the completed-contract method. If a group of contracts are combined based on the criteria in paragraph .37 or .38, they should be treated as a unit in determining the necessity for a provision for a loss. If contracts are segmented based on the criteria in paragraph .40, .41, or .42 of this statement, the individual segments should be considered separately in determining the need for a provision for a loss.

.86 Losses on cost-type contracts, although less frequent, may arise if, for example, a contract provides for guaranteed maximum reimbursable costs or target penalties. In recognizing losses for accounting purposes, the contractor's normal cost accounting methods should be used in determining the total cost overrun on the contract, and losses should include provisions for performance penalties.

.87 The costs used in arriving at the estimated loss on a contract should include all costs of the type allocable to contracts under paragraph .72 of this statement. Other factors that should be considered in arriving at the projected loss on a contract include target penalties and rewards, nonreimbursable costs on cost-plus contracts, change orders, and potential price redeterminations. In circumstances in which general and administrative expenses are treated as contract costs under the completed-contract method of accounting, the estimated loss should include the same types of general and administrative expenses.

.88 The provision for loss arises because estimated cost for the contract exceeds estimated revenue. Consequently, the provision for loss should be accounted for in the income statement as an additional contract cost rather

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[18] [Footnote deleted, June 2007, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

than as a reduction of contract revenue, which is a function of contract price, not cost. Unless the provision is material in amount or unusual or infrequent in nature, the provision should be included in contract cost and need not be shown separately in the income statement. If it is shown separately, it should be shown as a component of the cost included in the computation of gross profit.

.89 Provisions for losses on contracts should be shown separately as liabilities on the balance sheet, if significant, except in circumstances in which related costs are accumulated on the balance sheet, in which case the provisions may be deducted from the related accumulated costs. In a classified balance sheet, a provision shown as a liability should be shown as a current liability.

Transition

.90 An accounting change from the completed-contract method or from the percentage-of-completion method to conform to the recommendations of this statement of position should be made retrospectively by restating the financial statements of prior periods. The restatement should be made on the basis of current information if historical information is not available. If the information for restatement of prior periods is not available on either a historical or current basis, financial statements and summaries should be restated for as many consecutive prior periods preceding the transition date of this statement as is practicable, and the cumulative effect on the retained earnings at the beginning of the earliest period restated (or at the beginning of the period in which the statement is first applied if it is not practicable to restate any prior periods) should be included in determining net income for that period (see paragraphs 8 and 9 of FASB Statement No. 154). [Paragraph revised, June 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 154.]

.91 Accounting changes to conform to the recommendations of this statement of position, other than those stated in paragraph .90, should be made prospectively for contracting transactions, new contracts, and contract revisions entered into on or after the effective date of this statement. The division recommends the application of the provisions of this statement for fiscal years, and interim periods in such fiscal years, beginning after June 30, 1981. The division encourages earlier application of this statement, including retroactive application to all contracts regardless of when they were entered into. Disclosures should be made in the financial statements in the period of change in accordance with paragraph 17 of FASB Statement No. 154. [Paragraph revised, June 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 154.]

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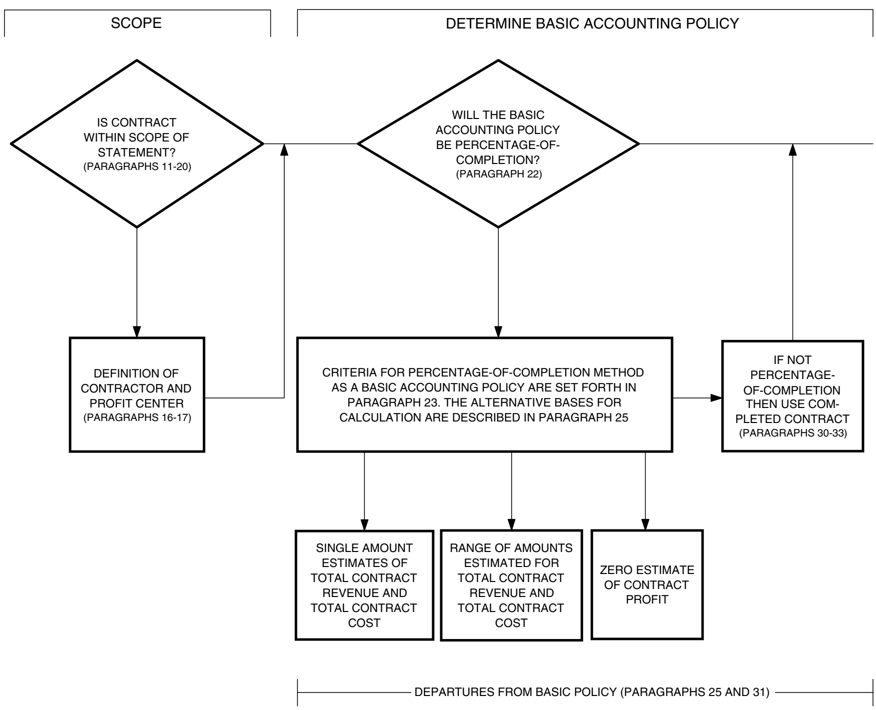
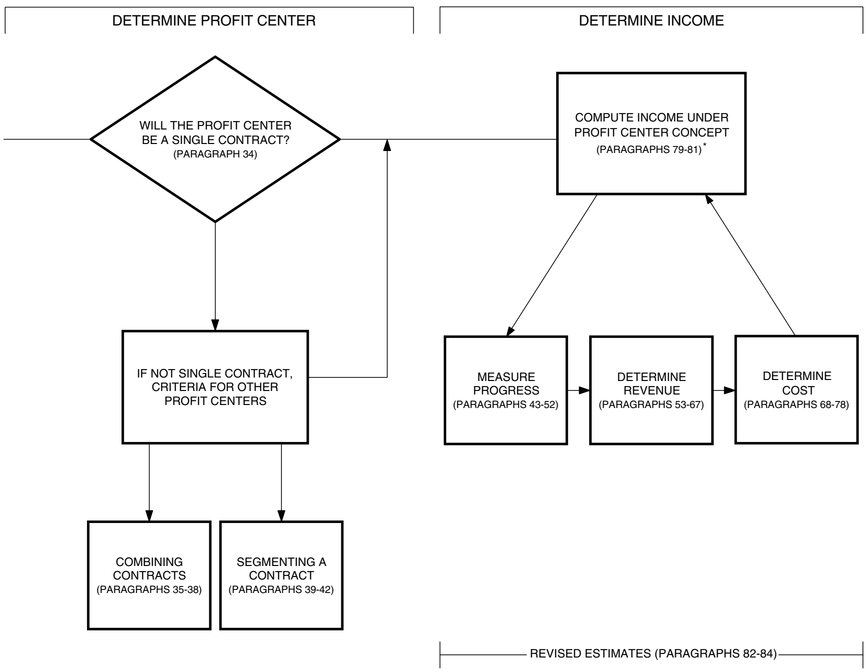
Appendix A

Schematic Chart of SOP Organization



NOTE: ALL PARAGRAPH NUMBERS ABOVE REFER TO TEXT OF SOP.

* If computation results in a loss, see paragraphs 85-89


DETERMINE PROFIT CENTER
DETERMINE INCOME
WILL THE PROFIT CENTER BE A SINGLE CONTRACT? (PARAGRAPH 34)
COMPUTE INCOME UNDER PROFIT CENTER CONCEPT (PARAGRAPHS 79-81)*
IF NOT SINGLE CONTRACT, CRITERIA FOR OTHER PROFIT CENTERS
MEASURE PROGRESS (PARAGRAPHS 43-52)
DETERMINE REVENUE (PARAGRAPHS 53-67)
DETERMINE COST (PARAGRAPHS 68-78)
COMBINING CONTRACTS (PARAGRAPHS 35-38)
SEGMENTING A CONTRACT (PARAGRAPHS 39-42)
REVISED ESTIMATES (PARAGRAPHS 82-84)

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Appendix B

Types of Contracts

Four basic types of contracts are distinguished on the basis of their pricing arrangements in paragraph .15 of this statement: (*a*) fixed-price or lump-sum contracts, (*b*) time-and-material contracts, (*c*) cost-type (including cost-plus) contracts, and (*d*) unit-price contracts. This appendix describes the basic types of contracts in greater detail and briefly describes common variations of each basic type.

Fixed-Price or Lump-Sum Contracts

A fixed-price or lump-sum contract is a contract in which the price is not usually subject to adjustment because of costs incurred by the contractor. Common variations of fixed-price contracts are:

1. *Firm fixed-price contract*—A contract in which the price is not subject to any adjustment by reason of the cost experience of the contractor or his performance under the contract.
2. *Fixed-price contract with economic price adjustment*—A contract which provides for upward or downward revision of contract price upon the occurrence of specifically defined contingencies, such as increases or decreases in material prices or labor wage rates.
3. *Fixed-price contract providing for prospective periodic redetermination of price*—A contract which provides a firm fixed-price for an initial number of unit deliveries or for an initial period of performance and for prospective price redeterminations either upward or downward at stated intervals during the remaining period of performance under the contract.
4. *Fixed-price contract providing for retroactive redetermination of price*—A contract which provides for a ceiling price and retroactive price redetermination (within the ceiling price) after the completion of the contract, based on costs incurred, with consideration being given to management ingenuity and effectiveness during performance.
5. *Fixed-price contract providing for firm target cost incentives*—A contract which provides at the outset for a firm target cost, a firm target profit, a price ceiling (but not a profit ceiling or floor), and a formula (based on the relationship which final negotiated total cost bears to total target cost) for establishing final profit and price.
6. *Fixed-price contract providing for successive target cost incentives*—A contract which provides at the outset for an initial target cost, an initial target profit, a price ceiling, a formula for subsequently fixing the firm target profit (within a ceiling and a floor established along with the formula, at the outset), and a production point at which the formula will be applied.
7. *Fixed-price contract providing for performance incentives*—A contract which incorporates an incentive to the contractor to surpass stated performance targets by providing for increases in the profit to the extent that such targets are surpassed and for decreases to the extent that such targets are not met.

8. *Fixed-price level-of-effort term contract*—A contract which usually calls for investigation or study in a specific research and development area. It obligates the contractor to devote a specified level of effort over a stated period of time for a fixed dollar amount.[1]

Time-and-Material Contracts

Time-and-material contracts are contracts that generally provide for payments to the contractor on the basis of direct labor hours at fixed hourly rates (that cover the cost of direct labor and indirect expenses and profit) and cost of materials or other specified costs. Common variations of time and material contracts are:

1. Time at marked-up rate.
2. Time at marked-up rate, material at cost.
3. Time and material at marked-up rates.
4. Guaranteed maximum cost—labor only or labor and material.

Cost-Type Contracts

Cost-type contracts provide for reimbursement of allowable or otherwise defined costs incurred plus a fee that represents profit. Cost-type contracts usually only require that the contractor use his best efforts to accomplish the scope of the work within some specified time and some stated dollar limitation. Common variations of cost-plus contracts are

1. *Cost-sharing contract*—A contract under which the contractor is reimbursed only for an agreed portion of costs and under which no provision is made for a fee.
2. *Cost-without-fee contract*—A contract under which the contractor is reimbursed for costs with no provision for a fee.
3. *Cost-plus-fixed-fee contract*—A contract under which the contractor is reimbursed for costs plus the provision for a fixed fee.
4. *Cost-plus-award-fee contract*—A contract under which the contractor is reimbursed for costs plus a fee consisting of two parts: (*a*) a fixed amount which does not vary with performance and (*b*) an award amount based on performance in areas such as quality, timeliness, ingenuity, and cost-effectiveness. The amount of award fee is based upon a subjective evaluation by the government of the contractor's performance judged in light of criteria set forth in the contract.
5. *Cost-plus-incentive-fee contract (Incentive based on cost)*—A contract under which the contractor is reimbursed for costs plus a fee which is adjusted by formula in accordance with the relationship which total allowable costs bear to target cost. At the outset there is negotiated a target cost, a target fee, a minimum and maximum fee, and the adjustment formula.

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[1] AICPA Audit and Accounting Guide *Federal Government Contractors*, chapter 1. [Footnote revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

6. *Cost-plus-incentive-fee contract (Incentive based on performance)*—A contract under which a contractor is reimbursed for costs plus an incentive to surpass stated performance targets by providing for increases in the fee to the extent that such targets are surpassed and for decreases to the extent that such targets are not met.[2]

Unit-Price Contracts

Unit-price contracts are contracts under which the contractor is paid a specified amount for every unit of work performed. A unit-price contract is essentially a fixed-price contract with the only variable being units of work performed. Variations in unit-price contracts include the same type of variations as fixed-price contracts. A unit-price contract is normally awarded on the basis of a total price that is the sum of the product of the specified units and unit prices. The method of determining total contract price may give rise to unbalanced unit prices because units to be delivered early in the contract may be assigned higher unit prices than those to be delivered as the work under the contract progresses.

[2] AICPA Audit and Accounting Guide *Federal Government Contractors*, chapter 1. [Footnote revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

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Appendix C

Summary of Disclosure Recommendations in Statement of Position

SOP Par.	*Nature of Disclosure*
.21	Accounting policy—methods of reporting revenue
.45	Method or methods of measuring extent of progress toward completion
.52	Criteria for determining substantial completion
.65–.67	Information on revenue and costs arising from claims
.84	Effects of changes in estimates on contracts
.90–.91	Effects of accounting changes to conform to SOP

.95

Appendix D

Schedule of Changes Made to Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts

Reference	Change	Date
General	Deleted "Audits of" in all references to all applicable Guide titles.	May, 2004
Appendix title	Footnote * added.	May, 2002
Notice to Readers	Revised to reflect the issuance of SAS No. 69.	June, 1998
Paragraph .03	Note reference to supersession of APB Statement No. 4 added.	May, 1993
Paragraph .04	Reference to Industry Audit Guide *Audits of Government Contractors,* deleted.	October, 1990
Paragraph .14	Footnote deleted.	October, 1990
Paragraphs .18 and .19	References to Industry Audit Guide *Audits of Government Contractors*, have been changed to Audit and Accounting Guide *Audits of Federal Government Contractors*.	October, 1990
Paragraph .38	Footnote deleted.	October, 1990
Paragraph .72	References in footnotes 11 and 13 to Industry Audit Guide *Audits of Government Contractors*, have been changed to Audit and Accounting Guide *Audits of Federal Government Contractors*.	October, 1990
Paragraph .75	Footnote deleted.	October, 1990
Paragraph .75(*a*)	Footnote added to reflect the issuance of SOP 98-5.	June, 1998
Paragraphs .83, .84, .90, and .91	Revised to reflect the issuance of FASB Statement No. 154.	June, 2007
Appendix B	References in footnotes 1 and 2 to Industry Audit Guide *Audits of Government Contractors,* have been changed to Audit and Accounting Guide *Audits of Federal Government Contractors*.	October, 1990
Appendix B	References in footnotes 1 and 2 delete Guide section numbers and, in their place, insert Guide section titles.	May, 2003

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[The next page is 78,931.]

Section 10,350

Statement of Position 82-1 Accounting and Financial Reporting for Personal Financial Statements

October 1, 1982

[Amendment to AICPA Industry Audit Guide *Audits of Personal Financial Statements*]

NOTE

This statement of position significantly amends the recommendations on accounting principles in the AICPA Industry Audit Guide, *Audits of Personal Financial Statements* (1968), for personal financial statements dated June 30, 1983, or after.

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

Introduction

.01 This statement of position deals with the preparation and presentation of personal financial statements, that is, financial statements of individuals or groups of related individuals (families). Personal financial statements are prepared for individuals either to formally organize and plan their financial affairs in general or for specific purposes, such as obtaining of credit, income tax planning, retirement planning, gift and estate planning, or public disclosure of their financial affairs. Users of personal financial statements rely on them in determining whether to grant credit, in assessing the financial activities of individuals, in assessing the financial affairs of public officials and candidates for public office, and for similar purposes.

.02 The 1968 AICPA Industry Audit Guide, *Audits of Personal Financial Statements,* supported historical cost as the primary basis of measurement for personal financial statements and recommended the presentation of estimated current values as additional information. The preface to that guide stated that "generally accepted accounting principles and auditing standards developed for commercial enterprises are applicable in general to personal financial statements." However, the increasing use of personal financial statements and experience with the use of the guide suggested the need to reassess those conclusions in light of the purposes for which personal financial statements are prepared, the users to whom they are directed, and the ways in which they are used. This statement of position is the result of that reassessment; it supersedes the accounting provisions of the 1968 AICPA Industry Audit Guide, *Audits of Personal Financial Statements,* in accordance with the transition and effective date set forth in paragraph .33 of this statement of position.

Basis of Presentation of Personal Financial Statements

.03 The primary focus of personal financial statements is a person's assets and liabilities, and the primary users of personal financial statements normally consider estimated current value information to be more relevant for their decisions than historical cost information. Lenders require estimated current value information to assess collateral, and most personal loan applications require estimated current value information. Estimated current values are required for estate, gift, and income tax planning, and estimated current value information about assets is often required in federal and state filings of candidates for public office.

.04 The accounting standards division therefore believes personal financial statements should present assets at their estimated current values and liabilities at their estimated current amounts at the date of the financial statements. Paragraph .12 of this statement of position defines estimated current values of assets. Paragraph .27 defines estimated current amounts of liabilities. This statement of position explains how the estimated current values of assets and the estimated current amounts of liabilities should be determined and applied in the preparation and presentation of personal financial statements.[1]

Presentation of Personal Financial Statements

The Reporting Entity

.05 Personal financial statements may be prepared for an individual, a husband and wife, or a family.

The Form of the Statements

.06 Personal financial statements consist of—

a. *A statement of financial condition.* This is the basic personal financial statement. It presents the estimated current values of assets, the estimated current amounts of liabilities, estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases, and net worth at a specified date. The term *net worth* should be used in the statement to designate the difference between total assets and total liabilities, after deducting estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases.

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[1] The division recognizes that users of personal financial statements may sometimes request certain historical cost information. This statement of position does not prohibit supplemental presentation of such information.

b. *A statement of changes in net worth.* This statement presents the major sources of increases and decreases in net worth. It should present the major sources of increases in net worth: income, increases in the estimated current values of assets, decreases in the estimated current amounts of liabilities, and decreases in estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases. It should present the major sources of decreases in net worth: expenses, decreases in the estimated current values of assets, increases in the estimated current amounts of liabilities, and increases in estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases. One statement combining income and other changes is desirable because of the mix of business and personal items in personal financial statements. The presentation of a statement of changes in net worth is optional.

c. *Comparative financial statements.* The presentation of comparative financial statements of the current period and one or more prior periods may sometimes be desirable. Such a presentation is more informative than the presentation of financial statements for only one period. The presentation of comparative financial statements is optional.

Illustrative financial statements are presented in appendix A [paragraph .34] to this statement of position.

The Methods of Presentation

.07 Assets and liabilities and changes in them should be recognized on the accrual basis, not on the cash basis.

.08 The most useful and readily understood presentation of assets and liabilities in personal financial statements is by order of liquidity and maturity, without classification as current and noncurrent, since the concept of working capital applied to business enterprises is inappropriate for personal financial statements.

.09 If personal financial statements are prepared for one of a group of joint owners of assets, the statements should include only the person's interest as a beneficial owner, as determined under the property laws of the state having jurisdiction. If property is held in joint tenancy, as community property, or through a similar joint ownership arrangement, the legal status of the separate equities of the parties may not be evident. In that case, the person may require legal advice to determine whether an interest in the property should be included among the person's assets and, if so, the proper allocation of the equity in the property under the applicable state laws.

.10 Business interests that constitute a large part of a person's total assets should be shown separately from other investments. The estimated current value of an investment in a separate entity, such as a closely held corporation, a partnership, or a sole proprietorship, should be shown in one amount as an investment if the entity is marketable as a going concern. Assets and liabilities of the separate entity should not be combined with similar personal items.

.11 The estimated current values of assets and the estimated current amounts of liabilities of limited business activities not conducted in a separate business entity, such as an investment in real estate and a related mortgage, should be presented as separate amounts, particularly if a large portion of the liabilities may be satisfied with funds from sources unrelated to the investment.

Guidelines for Determining the Estimated Current Values of Assets and the Estimated Current Amounts of Liabilities

General

.12 Personal financial statements should present assets at their estimated current values and liabilities at their estimated current amounts. The estimated current value of an asset in personal financial statements is the amount at which the item could be exchanged between a buyer and seller, each of whom is well informed and willing, and neither of whom is compelled to buy or sell. Costs of disposal, such as commissions, if material, should be considered in determining estimated current values.[2] The division recognizes that the estimated current values of some assets may be difficult to determine and the cost of obtaining estimated current values of some assets directly may exceed the benefits of doing so; therefore, the division recommends that judgment be exercised in determining estimated current values.

.13 Recent transactions involving similar assets and liabilities in similar circumstances ordinarily provide a satisfactory basis for determining the estimated current value of an asset and the estimated current amount of a liability. If recent sales information is unavailable, other methods that may be used include the capitalization of past or prospective earnings, the use of liquidation values, the adjustment of historical cost based on changes in a specific price index, the use of appraisals, or the use of the discounted amounts of projected cash receipts and payments.

.14 In determining the estimated current values of some assets (for example, works of art, jewelry, restricted securities, investments in closely held businesses, and real estate), the person may need to consult a specialist.

.15 The methods used to determine the estimated current values of assets and the estimated current amounts of liabilities should be followed consistently from period to period unless the facts and circumstances dictate a change to different methods.

Receivables

.16 Personal financial statements should present receivables at the discounted amounts of cash the person estimates will be collected, using appropriate interest rates at the date of the financial statements.

Marketable Securities

.17 Marketable securities include both debt and equity securities for which market quotations are available. The estimated current values of such securities are their quoted market prices. The estimated current values of securities traded on securities exchanges are the closing prices of the securities

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[2] Paragraph .27 defines the estimated current amount of a liability.

on the date of the financial statements (valuation date) if the securities were traded on that date. If the securities were not traded on that date but published bid and asked prices are available, the estimated current values of the securities should be within the range of those prices.

.18 For securities traded in the over-the-counter market, quotations of bid and asked prices are available from several sources, including the financial press, various quotation publications and financial reporting services, and individual broker-dealers. For those securities, the mean of the bid prices, of the bid and asked prices, or of the prices of a representative selection of broker-dealers quoting the securities may be used as the estimated current values.

.19 An investor may hold a large block of the equity securities of a company. A large block of stock might not be salable at the price at which a small number of shares were recently sold or quoted. Further, a large minority interest may be difficult to sell despite isolated sales of a small number of shares. However, a controlling interest may be proportionately more valuable than minority interests that were sold. Consideration of those factors may require adjustments to the price at which the security recently sold. Moreover, restrictions on the transfer of a security may also suggest the need to adjust the recent market price in determining the estimated current value.[3]

Options

.20 If published prices of options are unavailable, their estimated current values should be determined on the basis of the values of the assets subject to option, considering such factors as the exercise prices and length of the option periods.

Investment in Life Insurance

.21 The estimated current value of an investment in life insurance is the cash value of the policy less the amount of any loans against it. The face amount of life insurance the individuals own should be disclosed.

Investments in Closely Held Businesses

.22 The division recognizes that the estimated current values of investments in closely held businesses usually are difficult to determine. The problems relate to investments in closely held businesses in any form, including sole proprietorships, general and limited partnerships, and corporations. As previously stated, only the net investment in a business enterprise (not its assets and liabilities) should be presented in the statement of financial condition. The net investment should be presented at its estimated current value at the date of the financial statement. Since there is usually no established ready market for such an investment, judgment should be exercised in determining the estimated current value of the investment.

.23 There is no one generally accepted procedure for determining the estimated current value of an investment in a closely held business. Several procedures or combinations of procedures may be used to determine the estimated current value of a closely held business, including a multiple of earnings, liquidation value, reproduction value, appraisals, discounted amounts of projected cash receipts and payments, or adjustments of book value or cost of the

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[3] For further discussion on valuing marketable securities, see the section in AICPA Audit and Accounting Guide *Investment Companies* titled *Methods of Valuing Investments*, paragraphs 2.28–.40.

person's share of the equity of the business.[4] The owner of an interest in a closely held business may have entered into a buy-sell agreement that specifies the amount (or the basis of determining the amount) to be received in the event of withdrawal, retirement, or sale. If such an agreement exists, it should be considered, but it does not necessarily determine estimated current value. Whatever procedure is used, the objective should be to approximate the amount at which the investment could be exchanged between a buyer and a seller, each of whom is well informed and willing, and neither of whom is compelled to buy or sell.

Real Estate (Including Leaseholds)

.24 Investments in real estate (including leaseholds) should be presented in personal financial statements at their estimated current values. Information that may be used in determining their estimated current values includes—

a. Sales of similar property in similar circumstances.

b. The discounted amounts of projected cash receipts and payments relating to the property or the net realizable value of the property, based on planned courses of action, including leaseholds whose current rental value exceeds the rent in the lease.

c. Appraisals based on estimates of selling prices and selling costs obtained from independent real estate agents or brokers familiar with similar properties in similar locations.

d. Appraisals used to obtain financing.

e. Assessed value for property taxes, including consideration of the basis for such assessments and their relationship to market values in the area.

Intangible Assets

.25 Intangible assets should be presented at the discounted amounts of projected cash receipts and payments arising from the planned use or sale of the assets if both the amounts and timing can be reasonably estimated. For example, a record of receipts under a royalty agreement may provide sufficient information to determine its estimated current value. The cost of a purchased intangible should be used if no other information is available.

Future Interests and Similar Assets

.26 Nonforfeitable rights to receive future sums that have all the following characteristics should be presented as assets at their discounted amounts:

- The rights are for fixed or determinable amounts.
- The rights are not contingent on the holder's life expectancy or the occurrence of a particular event, such as disability or death.
- The rights do not require future performance of service by the holder.

Nonforfeitable rights that may have those characteristics include—

- Guaranteed minimum portions of pensions.

[4] The book value or cost of a person's share of the equity of a business adjusted for appraisals of specific assets, such as real estate or equipment, is sometimes used as the estimated current value.

- Vested interests in pension or profit sharing plans.
- Deferred compensation contracts.
- Beneficial interests in trusts.
- Remainder interests in property subject to life estates.
- Annuities.
- Fixed amounts of alimony for a definite future period.

Payables and Other Liabilities

.27 Personal financial statements should present payables and other liabilities at the discounted amounts of cash to be paid. The discount rate should be the rate implicit in the transaction in which the debt was incurred. If, however, the debtor is able to discharge the debt currently at a lower amount, the debt should be presented at the lower amount.[5]

Noncancellable Commitments

.28 Noncancellable commitments to pay future sums that have all the following characteristics should be presented as liabilities at their discounted amounts:

- The commitments are for fixed or determinable amounts.
- The commitments are not contingent on others' life expectancies or the occurrence of a particular event, such as disability or death.
- The commitments do not require future performance of service by others.

Noncancellable commitments that may have those characteristics include fixed amounts of alimony for a definite future period and charitable pledges.

Income Taxes Payable

.29 The liability for income taxes payable should include unpaid income taxes for completed tax years and an estimated amount for income taxes accrued for the elapsed portion of the current tax year to the date of the financial statements. That estimate should be based on the relationship of taxable income earned to date to total estimated taxable income for the year, net of taxes withheld or paid with estimated income tax returns.

Estimated Income Taxes on the Differences Between the Estimated Current Values of Assets and the Estimated Current Amounts of Liabilities and Their Tax Bases

.30 A provision should be made for estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases, including consideration of negative tax bases of tax shelters, if any. The provision should be computed as if the estimated current values of all assets had been realized and the estimated current amounts of all liabilities had been liquidated on the statement

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[5] For a further discussion of the setting of a discount rate for payables and other liabilities, see APB Opinion 21, *Interest on Receivables and Payables,* paragraph 13.

date, using applicable income tax laws and regulations, considering recapture provisions and available carryovers. The estimated income taxes should be presented between liabilities and net worth in the statement of financial condition. The methods and assumptions used to compute the estimated income taxes should be fully disclosed. Appendix B [paragraph .35] to this statement of position illustrates how to compute the provision.

Financial Statement Disclosures

.31 Personal financial statements should include sufficient disclosures to make the statements adequately informative. The disclosures may be made in the body of the financial statements or in the notes. The following enumeration is intended not to be all-inclusive but simply indicative of the nature and type of information that ordinarily should be disclosed:

a. A clear indication of the individuals covered by the financial statements

b. That assets are presented at their estimated current values and liabilities are presented at their estimated current amounts

c. The methods used in determining the estimated current values of major assets and the estimated current amounts of major liabilities or major categories of assets and liabilities, since several methods are available, and changes in methods from one period to the next

d. If assets held jointly by the person and by others are included in the statements, the nature of the joint ownership

e. If the person's investment portfolio is material in relation to his or her other assets and is concentrated in one or a few companies or industries, the names of the companies or industries and the estimated current values of the securities

f. If the person has a material investment in a closely held business, at least the following:

- The name of the company and the person's percentage of ownership
- The nature of the business
- Summarized financial information about assets, liabilities, and results of operations for the most recent year based on the financial statements of the business, including information about the basis of presentation (for example, generally accepted accounting principles, income tax basis, or cash basis) and any significant loss contingencies

g. Descriptions of intangible assets and their estimated useful lives

h. The face amount of life insurance the individuals own

i. Nonforfeitable rights that do not have the characteristics discussed in paragraph .26, for example, pensions based on life expectancy

j. The following tax information:

- The methods and assumptions used to compute the estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases and a statement that the provision will probably differ from the amounts of income taxes that might eventually be paid because those amounts are determined by the timing and the method of disposal, realization, or liquidation and the tax laws and regulations in effect at the time of disposal, realization, or liquidation

- Unused operating loss and capital loss carryforwards
- Other unused deductions and credits, with their expiration periods, if applicable
- The differences between the estimated current values of major assets and the estimated current amounts of major liabilities or categories of assets and liabilities and their tax bases

k. Maturities, interest rates, collateral, and other pertinent details relating to receivables and debt

l. Noncancellable commitments that do not have the characteristics discussed in paragraph .28, for example, operating leases

.32 Generally accepted accounting principles other than those discussed in this statement of position may apply to personal financial statements. For example, FASB Statement No. 5, *Accounting for Contingencies,* and related amendments and interpretations, provide guidance on accounting for contingencies, and FASB Statement No. 57, *Related Party Disclosures,* provides guidance on related-party disclosures.

Transition and Effective Date

.33 The accounting standards division recommends that the provisions of this statement of position should apply to personal financial statements dated June 30, 1983, or after. Comparative statements of prior periods should be restated to comply with the provisions of this statement of position.

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Appendix A

Illustrative Financial Statements

James and Jane Person
Statements of Financial Condition
December 31, 19X3 and 19X2

	December 31,	
	19X3	*19X2*
Assets		
Cash	$ 3,700	$ 15,600
Bonus receivable	20,000	10,000
Investments		
Marketable securities (Note 2)	160,500	140,700
Stock options (Note 3)	28,000	24,000
Kenbruce Associates (Note 4)	48,000	42,000
Davekar Company, Inc. (Note 5)	550,000	475,000
Vested interest in deferred profit sharing plan	111,400	98,900
Remainder interest in testamentary trust (Note 6)	171,900	128,800
Cash value of life insurance ($43,600 and $42,900), less loans payable to insurance companies ($38,100 and $37,700) (Note 7)	5,500	5,200
Residence (Note 8)	190,000	180,000
Personal effects (excluding jewelry) (Note 9)	55,000	50,000
Jewelry (Note 9)	40,000	36,500
	$1,384,000	$1,206,700

	December 31, 19X3	December 31, 19X2
Liabilities		
Income taxes—current year balance	$ 8,800	$ 400
Demand 10.5 % note payable to bank	25,000	26,000
Mortgage payable (Note 10)	98,200	99,000
Contingent liabilities (Note 11)		
	132,000	125,400
Estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases (Note 12)	239,000	160,000
Net worth	1,013,000	921,300
	$ 1,384,000	$ 1,206,700

The accompanying notes are an integral part of these financial statements.

James and Jane Person
Statements of Changes in Net Worth
For the Years Ended December 31, 19X3 and 19X2

	Year ended December 31,	
	19X3	*19X2*
Realized increases in net worth		
Salary and bonus	$ 95,000	$ 85,000
Dividends and interest income	2,300	1,800
Distribution from limited partnership	5,000	4,000
Gains on sales of marketable securities	1,000	500
	103,300	91,300
Realized decreases in net worth		
Income taxes	26,000	22,000
Interest expense	13,000	14,000
Real estate taxes	4,000	3,000
Personal expenditures	36,700	32,500
	79,700	71,500
Net realized increase in net worth	23,600	19,800

	Year ended December 31,	
	19X3	19X2
Unrealized increases in net worth		
Marketable securities (net of realized gains on securities sold)	$ 3,000	$ 500
Stock options	4,000	500
Davekar Company, Inc.	75,000	25,000
Kenbruce Associates	6,000	
Deferred profit sharing plan	12,500	9,500
Remainder interest in testamentary trust	43,100	25,000
Jewelry	3,500	
	147,100	60,500
Unrealized decrease in net worth		
Estimated income taxes in the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases	79,000	22,000
Net unrealized increase in net worth	68,100	38,500
Net increase in net worth	91,700	58,300
Net worth at the beginning of year	921,300	863,000
Net worth at the end of year	$ 1,013,000	$ 921,300

The accompanying notes are an integral part of these financial statements.

James and Jane Person

Notes to Financial Statements

Note 1. The accompanying financial statements include the assets and liabilities of James and Jane Person. Assets are stated at their estimated current values, and liabilities at their estimated current amounts.

Note 2. The estimated current values of marketable securities are either (*a*) their quoted closing prices or (*b*) for securities not traded on the financial statement date, amounts that fall within the range of quoted bid and asked prices.

Marketable securities consist of the following:

	December 31, 19X3		December 31, 19X2	
	Number of shares or bonds	*Estimated current values*	*Number of shares or bonds*	*Estimated current values*
Stocks				
Jaiven Jewels, Inc.	1,500	$ 98,813		
McRae Motors, Inc.	800	11,000	600	$ 4,750
Parker Sisters, Inc.	400	13,875	200	5,200
Rosenfield Rug Co.			1,200	96,000
Rubin Paint Company	300	9,750	100	2,875
Weiss Potato Chips, Inc.	200	20,337	300	25,075
		153,775		133,900
Bonds				
Jackson Van Lines, Ltd. (12 % due 7/1/X9)	5	5,225	5	5,100
United Garvey, Inc. (7% due 11/15/X6)	2	1,500	2	1,700
		6,725		6,800
		$160,500		$140,700

Note 3. Jane Person owns options to acquire 4,000 shares of stock of Winner Corp. at an option price of $5 per share. The option expires on June 30, 19X5. The estimated current value is its published selling price.

Note 4. The investment in Kenbruce Associates is an 8% interest in a real estate limited partnership. The estimated current value is determined by the projected annual cash receipts and payments capitalized at a 12% rate.

Note 5. James Person owns 50% of the common stock of Davekar Company, Inc., a retail mail order business. The estimated current value of the investment is determined by the provisions of a shareholders' agreement, which restricts the sale of the stock and, under certain conditions, requires the company to repurchase the stock based on a price equal to the book value of the net assets plus an agreed amount for goodwill. At December 31, 19X3, the agreed amount for goodwill was $112,500, and at December 31, 19X2, it was $ 100,000.

A condensed balance sheet of Davekar Company, Inc., prepared in conformity with generally accepted accounting principles, is summarized below:

	December 31, 19X3	December 31, 19X2
Current assets	$ 3,147,000	$ 2,975,000
Plant, property and equipment—net	165,000	145,000
Other assets	120,000	110,000
Total assets	3,432,000	3,230,000
Current liabilities	2,157,000	2,030,000
Long-term liabilities	400,000	450,000
Total liabilities	2,557,000	2,480,000
Equity	875,000	750,000
Total Liabilities and Equity	3,432,000	3,230,000

The sales and net income for 19X3 were $ 10,500,000 and $125,000 and for 19X2 were $9,700,000 and $80,000.

Note 6. Jane Person is the beneficiary of a remainder interest in a testamentary trust under the will of the late Joseph Jones. The amount included in the accompanying statements is her remainder interest in the estimated current value of the trust assets, discounted at 10%.

Note 7. At December 31, 19X3 and 19X2, James Person owned a $300,000 whole life insurance policy.

Note 8. The estimated current value of the residence is its purchase price plus the cost of improvements. The residence was purchased in December 19X1, and improvements were made in 19X2 and 19X3.

Note 9. The estimated current values of personal effects and jewelry are the appraised values of those assets, determined by an independent appraiser for insurance purposes.

Note 10. The mortgage (collateralized by the residence) is payable in monthly installments of $815 a month, including interest at 10% a year through 20Y8.

Note 11. James Person has guaranteed the payment of loans of Davekar Company, Inc., under a $500,000 line of credit. The loan balance was $300,000 at December 31, 19X3, and $400,000 at December 31, 19X2.

Note 12. The estimated current amounts of liabilities at December 31, 19X3, and December 31, 19X2, equaled their tax bases. Estimated income taxes have been provided on the excess of the estimated current values of assets over their tax bases as if the estimated current values of the assets had been realized on the statement date, using applicable tax laws and regulations. The provision will probably differ from the amounts of income taxes that eventually might be paid because those amounts are determined by the timing and the method of disposal or realization and the tax laws and regulations in effect at the time of disposal or realization.

The estimated current values of assets exceeded their tax bases by $850,000 at December 31, 19X3, and by $770,300 at December 31, 19X2. The excess of estimated current values of major assets over their tax bases are—

	December 31,	
	19X3	*19X2*
Investment in Davekar Company, Inc.	$ 430,500	$ 355,500
Vested interest in deferred profit sharing plan	111,400	98,900
Investment in marketable securities	104,100	100,000
Remainder interest in testamentary trust	97,000	53,900

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Appendix B

Computing the Excess of the Estimated Current Values of Assets Over Their Tax Bases and the Estimated Income Taxes on the Excess

This appendix relates to the preceding illustrative financial statements of James and Jane Person (appendix A) and illustrates how to compute the excess of the estimated current values of assets over their tax bases and the provision for estimated income taxes on the excess.[1]

The excess or deficit of the estimated current values of major assets or categories of assets over their tax bases should be disclosed.[2] The provision for estimated income taxes should be presented in the statement of financial condition between liabilities and net worth.

The assumptions and the tax basis information used in computing the excess of the estimated current values of assets over their tax bases and the estimated income taxes on the excess depend on the facts, circumstances, tax laws and regulations, and assumptions that apply to the individual or individuals for whom the financial statements are prepared. The facts, circumstances, tax laws and regulations, and assumptions used in the following are illustrative only.

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[1] The provision for estimated income taxes should also reflect tax consequences that result from differences between the estimated current amounts of liabilities and their tax bases.

[2] Differences between the estimated current amounts of major liabilities or categories of liabilities and their tax bases should also be disclosed.

Description	(A) Estimated current values	(B) Tax bases	Excess of (A) over (B)	Effective income tax rates	Amount of estimated income taxes	Assumptions used
Cash	$ 3,700	$ 3,700	—	—	—	No tax effect.
Bonus receivable	20,000	—	$ 20,000	50 %	$ 10,000	Maximum tax rate.
Investments						
Market securities	160,500	56,400	104,100	36 %	37,500	Weighted average of short-term and long-term capital gain rates based on composition of portfolio.
Stock options	28,000	20,000	8,000	50 %	4,000	Short-term capital gain rate.
Kenbruce Associates	48,000	24,000	24,000	38 %	9,100	Weighted average of short-term and long-term capital gain rates.
Davekar Company, Inc.	550,000	119,500	430,500	20 %	86,100	Long-term capital gain rate.
Vested interest in deferred profit sharing plan	111,400	—	111,400	50 %	55,700	Maximum tax rate.
Remainder interest in testamentary trust	171,900	74,900	97,000	26 %	25,200	Weighted average of short-term and long-term capital gain rates.
Cash value of life insurance	5,500	5,500	—	—	—	No tax effect.
Residence	190,000	190,000	—	—	—	No tax effect.
Personal effects	55,000	30,000	25,000	20 %	5,000	Long-term capital gain rate.
Jewelry	40,000	10,000	30,000	20 %	6,000	Long-term capital gain rate.
	$1,384,000	$ 534,000	$ 850,000[1]		$ 239,000[2]	

[1] The excess or deficit of the estimated current values of major assets or categories of assets over their tax bases should be disclosed.
[2] This amount should be presented in the statement of financial condition between liabilities and net worth.

ACCOUNTING STANDARDS DIVISION

Accounting Standards Executive Committee (1981-1982)

Personal Financial Statements Special Committee

AICPA Staff

[The next page is 79,061.]

Section 10,390

Statement of Position 85-3 Accounting by Agricultural Producers and Agricultural Cooperatives

April 30, 1985

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

Introduction

.001 This statement discusses accounting by agricultural producers and agricultural cooperatives that intend to present financial statements in conformity with generally accepted accounting principles. The issues discussed are—

- Accounting for inventories by producers
- Accounting for development costs of land, trees and vines, intermediate-life plants, and animals
- Accounting by patrons for product deliveries to cooperatives
- Accounting by cooperatives for products received from patrons
- Accounting for investments in and income from cooperatives

This statement does not apply to personal financial statements of agricultural producers or statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, for example, the income tax or the cash basis of accounting. This statement also does not apply to growers of timber; growers of pineapple and sugarcane in tropical regions; raisers of animals for competitive sports; or merchants or noncooperative processors of agricultural products that purchase commodities from growers, contract harvesters, or others serving agricultural producers.

Definitions

.002 For purposes of this statement, the following definitions apply.

Advances. Generally used in marketing and pooling cooperatives to denote amounts paid to patrons prior to final settlement; for example, amounts paid to patrons on delivery of crops.

Agricultural cooperatives. See paragraphs .006 through .022.

Agricultural producers. See paragraphs .003 through .005.

Assigned amounts. Amounts used to record products delivered by patrons of a marketing cooperative operating on a pooling basis, and the related liability to patrons if the ultimate amounts to be paid to patrons are determined when the pool is closed. These amounts may be established on the basis of current prices paid by other buyers (sometimes referred to as "field prices"), or they may be established by the cooperative's board of directors. The assigned amounts are sometimes referred to as "established values."

Cash advance method. A method of accounting for inventories of a marketing cooperative operating on a pooling basis. Under this method, inventories are accounted for at the amount of cash advances made to patrons. (This is sometimes referred to as the "cost advance method.")

Commercial production. The point at which production from an orchard, vineyard, or grove first reaches a level that makes operations economically feasible, based on prices normally expected to prevail.

Crop development costs. Costs incurred up to the time crops are produced in commercial quantities, including the costs of land preparation, plants, planting, fertilization, grafting, pruning, equipment use, and irrigation.

Crops. Grains, vegetables, fruits, berries, nuts, and fibers grown by agricultural producers.

Exempt and nonexempt cooperatives. Cooperatives classified according to their federal income tax status. Both types are permitted to deduct from taxable income patronage distributed or allocated on a qualified basis to patrons to the extent that the distributions represent earnings of the cooperative derived from business done with or for the patrons. In addition, cooperatives meeting the requirements of Internal Revenue Code section 521 (exempt cooperatives) are permitted to deduct (1) limited amounts paid as dividends on capital stock and (2) distributions to patrons of income from business done with the U.S. government or its agencies and income from nonpatronage sources.

Farm price method. A method of accounting for inventories at the sales prices in the nearest local market for the quantities that the producer normally sells less the estimated costs of disposition.

Futures contract. A standard and transferable form of contract that binds the seller to deliver to the bearer a standard amount and grade of a commodity to a specific location at a specified time. It usually includes a schedule of premiums and discounts for quality variation.

Growing crop. A field, row, tree, bush, or vine crop before harvest.

Grove. Fruit or nut trees planted in geometric patterns to economically facilitate care of the trees and harvest of the fruit or nuts.

Harvested crop. An agricultural product, gathered but unsold.

Livestock. Registered and commercial cattle, sheep, hogs, horses, poultry, and small animals bred and raised by agricultural producers.

Market order prices. Prices for raw products established by federal or state agencies.

Marketing cooperative. A cooperative that markets the products (crops, livestock, and so on) produced by its patrons.

Member and nonmember (of a cooperative). A member is an owner-patron who is entitled to vote at corporate meetings of a cooperative. A nonmember patron is not entitled to voting privileges. A nonmember patron may or may not be entitled to share in patronage distributions, depending on the articles and bylaws of the cooperative or on other agreements.

Net realizable value. Valuation of inventories at estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation.

Orchard. Fruit trees planted in geometric patterns to economically facilitate care of the trees and harvest of the fruit.

Patron. Any individual, trust, estate, partnership, corporation, or cooperative with or for whom a cooperative does business on a cooperative basis, whether a member or nonmember of the cooperative association.

Patronage. The amount of business done with a cooperative by one of its patrons. Patronage is measured by either the quantity or value of commodities received from patrons by a marketing cooperative and the quantity or value of the goods and services sold to patrons by a supply cooperative.

Patronage allocations. Patronage earnings distributed, or allocated, to individual patrons on the basis of each patron's proportionate share of total patronage. Such allocations, which include notification to the patron, may be made on a qualified or nonqualified basis.

Patronage earnings. The excess of a cooperative's revenues over its costs arising from transactions done with or for its patrons. Generally a significant portion of those earnings is allocated to the cooperative's patrons in the form of cash, allocated equities, or both.

Pools. Accounting control centers used for determining earnings and patronage refunds due to particular patrons.

Open pools are accounting control centers that are not closed at the end of each accounting period. Open pools are sometimes used by marketing cooperatives for crops that may not be sold for two or more years after their receipt from patrons.

A single pool cooperative determines net proceeds or patronage refunds on the basis of overall operating results for all commodities marketed during an accounting period.

A multiple pool cooperative determines net proceeds or patronage refunds on the basis of separate commodities, departments, or accounting periods.

Progeny. Offspring of animals or plants.

Raised animals. Animals produced and raised from an owned herd, as opposed to purchased animals.

Recurring land development costs. Costs that do not result in permanent or long-term improvements to land, for example, maintenance costs that occur annually or periodically.

Retains. Amounts determined on a per-unit basis or as a percentage of patronage earnings that are withheld by cooperatives from distributions and allocated to patrons' capital accounts.

Supply cooperative. A cooperative that supplies to its patrons goods and services used by them in producing their products.

Unit livestock method. Accounting for livestock by using an arbitrary fixed periodic charge. For raised animals the amount is accumulated by periodic increments from birth to maturity or disposition. For purchased animals the arbitrary fixed periodic amount is added to the acquisition cost until maturity or disposition of the animal.

Vineyards. Grapevines planted in patterns for commercial cultivation and production.

Written notice of allocation. Any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice to the recipient that states the dollar amount allocated to the patron by the cooperative and the portion that constitutes a patronage dividend.

Agricultural Producers

.003 In this statement, farmers and ranchers are referred to as "agricultural producers," a term that includes, for example, those who raise crops from seeds or seedlings, breed livestock (whether registered or commercial), and feed livestock in preparation for slaughter. The term excludes, for example, merchants and processors of agricultural products who purchase commodities from growers, contract harvesters, or others serving agricultural producers, although they are covered by the term "agribusiness" as it is generally used. The term also excludes growers of timber and raisers of animals for competitive sports, although some of the accounting principles discussed in this statement may apply to such activities.

.004 Agricultural producers use every form of business organization, from sole proprietorship to a large publicly held corporation. They engage in numerous activities, for example:

- Growing wheat, milo, corn, and other grains
- Growing soybeans, vegetables, sugar beets, and sugarcane
- Growing citrus fruits, other fruits, grapes, berries, and nuts
- Growing cotton and other vegetable fibers
- Operating plant nurseries
- Breeding and feeding cattle, hogs, and sheep, including animals for wool production
- Operating dairies
- Operating poultry and egg production facilities
- Breeding horses
- Raising mink, chinchilla, and similar small animals

In addition, the operations of agricultural producers often involve various combinations of those activities. Agricultural practices and products may vary still further because of differences in temperature, soil, rainfall, and regional economics. Farm products may be used in related activities, such as the feeding of hay and grain to livestock, or they may be marketed directly by the producer. Producers often sell products in accordance with government programs or through agricultural cooperatives. Marketing strategies may include forward contracts or commodity futures contracts to reduce the risks of fluctuations in market prices.

.005 Agricultural producers often borrow to finance crop development costs and the costs of acquiring facilities and equipment.

Agricultural Cooperatives

[.006-.008] [Paragraphs deleted to remove outdated information.]

.009 Section 1141(j) of the Agricultural Marketing Act of 1929, as amended, contains the following definition of a cooperative association:

> The term "cooperative association" means any association in which farmers act together in processing, preparing for market, handling, and/or marketing the farm products of persons so engaged, and also means any association in which farmers act together in purchasing, testing, grading, processing, distributing, and/or furnishing farm supplies and/or farm business services. Provided, however, that such associations are operated for producers or purchasers and conform to one or both of the following requirements:
>
> First. That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein; and
>
> Second. That the association does not pay dividends on stock or membership capital in excess of 8 per centum per annum.
>
> And in any case to the following:
>
> Third. That the association shall not deal in farm products, farm supplies, and farm business services with or for nonmembers in an amount greater in value than the total amount of such business transacted by it with or for members. All business transacted by any cooperative association for or on behalf of the United States or any agency or instrumentality thereof shall be disregarded in determining the volume of member and nonmember business transacted by such association.

.010 A cooperative typically has the following characteristics:

a. Assets are distributed periodically to patrons on a patronage basis. In certain situations, however, assets in the amount of net-of-tax earnings may be accumulated by the cooperative and may or may not be allocated to patrons' accounts.

b. Members control the organization in their capacity as patrons and not as equity investors.

c. Membership is limited to patrons.

d. The return that can be paid on capital investment is limited.

e. At least 50 percent of the cooperative's business is done on a patronage basis.

.011 Virtually all agricultural cooperatives meet the definition of cooperatives that is used to determine eligibility for borrowing from the banks for cooperatives and for exemption from the annual reporting requirements of the Securities and Exchange Act of 1934. Failure to meet the definition, however, does not necessarily prevent an entity from being considered as operating on a cooperative basis under subchapter T of the Internal Revenue Code.

.012 The main difference between cooperatives and other business enterprises is that cooperatives and their patrons operate as single economic units to accomplish specific business purposes, such as the marketing of farm products, the purchase of supplies, or the performance of services for the benefit of the patrons. The aim is to reduce costs, increase sales proceeds, and share risks through the increased bargaining power that results from the patrons' combined resources and buying power.

.013 The patron's role as an investor is secondary and incidental to his business relationship with the cooperative.

.014 If certain requirements are met, the Internal Revenue Code permits cooperatives tax deductions for earnings allocated to their patrons. Earnings not so allocated are taxed at corporate income tax rates. Cooperatives may use other terms for earnings, such as "margins," "net proceeds," or "savings."

.015 Another difference between cooperatives and other business corporations is that the cooperative's bylaws usually require it to distribute assets to patrons, or allocate to patrons' accounts amounts equal to its earnings, on the basis of their patronage. Distributions to patrons are different from dividend payments to stockholders in other corporations. The distribution of earnings on the basis of patronage has been termed the "price adjustment theory."

.016 Under the price adjustment theory, a cooperative agrees to do business at cost. In a purchasing cooperative, for example, a patron may be charged more than cost at the time of purchase; however, the cooperative normally must return to the patron all amounts received in excess of cost, including costs of operation and processing.

.017 Both exempt and nonexempt cooperatives are subject to federal income taxes on patronage earnings that are not distributed in cash or allocated on a qualified basis. Nonexempt cooperatives are subject to income taxes on earnings arising from sources other than patronage.

.018 Cooperatives generally try to buy or sell at the current market price. Periodically, they determine total costs and make distributions to patrons in the form of cash, certificates, or other notices of allocation based on the excess of revenues over costs.

.019 The two major types of cooperatives are supply cooperatives and marketing cooperatives. *Supply cooperatives* obtain or produce such items as building materials, equipment, feed, seeds, fertilizer, and petroleum products for their patrons. *Marketing cooperatives* provide means for agricultural producers to process and sell their products.

.020 Services related to those functions are provided by some supply and marketing cooperatives; they are also provided by separate associations known as *service cooperatives,* which provide such services as trucking, storage, accounting, and data processing. A special type of service cooperative is a *bargaining cooperative,* which serves its members by negotiating with processors on their behalf.

.021 Many marketing cooperatives commingle patrons' fungible products in pools. The excess of revenues over costs for each pool is allocated to patrons on the basis of their pro rata contributions to the pool, which may be determined by the number of units delivered, the volume of product delivered, or another equitable method.

.022 The members of *local cooperatives* are agricultural producers whose activities are generally centralized. The members of *federated cooperatives* are other cooperatives whose activities are regional. Some cooperatives have both individual producers and other cooperatives as members.

Accounting for Inventories of Crops by Agricultural Producers

.023 Previously existing accounting literature does not specifically cover accounting by agricultural producers, and available material is predominantly tax oriented. Accounting Research Bulletin (ARB) No. 43, chapter 4, provides the following information about accounting for inventories:

STATEMENT 9

> Only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability. Where goods are stated above cost this fact should be fully disclosed.
>
> *Discussion*
>
> It is generally recognized that income accrues only at the time of sale, and that gains may not be anticipated by reflecting assets at their current sales prices. For certain articles, however, exceptions are permissible. Inventories of gold and silver, when there is an effective government-controlled market at a fixed monetary value, are ordinarily reflected at selling prices. A similar treatment is not uncommon for inventories representing agricultural, mineral, and other products, units of which are interchangeable and have an immediate marketability at quoted prices and for which appropriate costs may be difficult to obtain. Where such inventories are stated at sales prices, they should of course be reduced by expenditures to be incurred in disposal, and the use of such basis should be fully disclosed in the financial statements.

.024 Accounting Principles Board (APB) Statement No. 4, chapter 6, paragraph 152, states the following:

> Revenue is sometimes recognized on bases other than the realization rule. For example, on long-term construction contracts revenue may be recognized as construction progresses. This exception to the realization principle is based on the availability of evidence of the ultimate proceeds and the consensus that a better measure of periodic income results. Sometimes revenue is recognized at the completion of production and before a sale is made. Examples include certain precious metals and farm products with assured sales prices. The assured price, the difficulty in some situations of determining costs of products on hand, and the characteristic of unit interchangeability are reasons given to support this exception.

Statement of Position 93-3, *Rescission of Accounting Principles Board Statements* [section 10,560], rescinds APB Statement No. 4. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, discusses matters similar to those in APB Statement No. 4. [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.025 Accounting Research Study (ARS) 13, chapter 9, page 156, states—

> *Market as the Accounting Basis of Inventories*
>
> Exceptional cases exist in which it is not practicable to determine an appropriate cost basis for products. A market basis is acceptable if the products (1) have immediate marketability at quoted market prices that cannot be influenced by the producer, (2) have characteristics of unit interchangeability, and (3) have relatively insignificant costs of disposal. The accounting basis of those kinds of inventories should be their realizable value, calculated on the basis of quoted market prices less estimated direct costs of disposal. Examples are precious metals produced as joint products or by-products of extractive processes and fresh dressed meats produced in meat packing operations.

Paragraph 67 of FASB Concepts Statement No. 5 also discusses measurement of assets at current market value. [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Diversity in Practice

.026 Published financial statements reveal several ways that agricultural producers account for growing crops:

- Charging costs to operations when they are incurred
- Including crop development costs in deferred charges and amortizing them
- Stating costs on the balance sheet at unchanging amounts substantially less than the costs incurred and charging all current costs to operations when they are incurred
- Deferring all costs and writing them off at harvest or, for perennial crops, over the estimated productive life of the planting

Agricultural producers report harvested crops using the farm price method, at cost (LIFO, FIFO, or average cost), and at the lower of cost or market.

Some producers use the farm price method (market) to account for inventories of harvested crops. Other agricultural producers, particularly those whose securities are publicly held, account for harvested crops at the lower of cost or market.

Pros and Cons

.027 A study of accounting for producers' inventories involves an examination of chapter 4, statement 9, of ARB No. 43, which has been used as authority for accounting for producers' inventories at market.

.028 Some accountants believe that many producers cannot determine costs, and some believe that market is an appropriate valuation, whether or not cost data are available. Many accountants believe that users of producers' financial statements would find them less useful if inventories were valued at the lower of cost or market.

.029 Other reasons for the preference for market value are its long established use and the need to identify separately the gains and losses attributable to the production cycle and the marketing function, which is discussed in paragraph .035.

.030 For most business activities, the accounting literature requires an exchange of goods or services before income is recognized. That precludes accounting for inventories of unsold goods at market unless market value is less than cost. The principal exceptions to that rule are identified in chapter 9 of ARS 13 as "metals produced as joint products or by-products of extractive processes and fresh dressed meats produced in meat packing operations." Those products have unique cost identification problems. Chapter 9 of ARS 13 further states that carrying products at market is acceptable if those products "(1) have immediate marketability at quoted market prices that cannot be influenced by the producer, (2) have characteristics of unit interchangeability, and (3) have relatively insignificant costs of disposal."

.031 The first of the three conditions in ARB No. 43, statement 9, is the inability to determine costs. While many producers may not keep detailed cost records, costs usually either are available or can be determined with acceptable accuracy.

.032 Accountants who favor accounting for producers' inventories at market recognize that ARB No. 43 requires an *inability* to determine appropriate approximate costs. They point out, however, that the discussion interprets the statement to apply when "appropriate costs may be *difficult* to obtain" [emphasis added]. They also note that APB Statement No. 4,[1] chapter 6, referred to the "difficulty in some situations of determining costs of products" as a partial justification for the use of market price. Thus, they interpret statement 9 as allowing the use of market if costs are difficult to determine, not only if they are impossible to determine.

.033 A major argument for accounting for inventories at market is the availability of established markets that provide quoted market prices for most agricultural commodities. However, because variations in grade and quantity, distance from central markets, shipping hazards, and other restrictions may affect the ultimate realization of quoted market prices for agricultural products, there are often serious difficulties in determining the market price for a given product in a given place. Also, many products have no central market with established prices, and determination of their market prices may be subjective and incapable of verification.

.034 While ARS 13 does not cover inventories of agricultural products, it questions the appropriateness of accounting for inventories at market even if an established market exists. The study notes that present principles appear to allow the use of market price in accounting for inventories of precious metals if there is a fixed selling price and insignificant marketing cost regardless of whether it is practicable to determine costs. The study states—

> The apparent preferential treatment may have originally been considered appropriate because metals having fixed monetary values clearly demonstrated the "immediate marketability at quoted market prices and the characteristic of interchangeability" required in the cases in which it is impracticable to determine costs. Further question as to why preferential treatment was originally accorded to precious metals might now be considered academic. Silver no longer has a fixed monetary price, and gold has a fluctuating free market price for nonmonetary purposes. That raises questions as to whether the inventory basis for gold and silver should now be considered the same as for other metals produced as by-products or joint products.

.035 Some proponents of accounting for agricultural producers' inventories at market distinguish the production of a crop from its marketing; they believe that delays in the disposal of a harvested crop are due principally to the producer's desire to sell the commodities later at a higher price. They contend that, in order to separate the results of the two functions, the inventories should be accounted for at market prices after they are harvested. They point out that both functions are likely to cause significant gains and losses. Some opponents counter that the same argument can be made for many nonagricultural enterprises that are not permitted to recognize income at the end of production.

.036 The securities of most agricultural producers are not traded publicly, and their financial statements are prepared primarily for management and lenders. Advocates of the use of market prices contend that lenders are concerned with the market price of inventories to be used as collateral. Moreover, most producers are not required to use cost information for income tax purposes. Thus, some

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[1] Statement of Position 93-3, *Rescission of Accounting Principles Board Statements* [section 10,560], rescinds APB Statement No. 4. [Footnote added to reflect conforming changes necessary due to the issuance of recent authoritative literature; Footnote renumbered, August 2008, for editorial purposes.]

accountants argue that determining cost for financial statements is an unproductive additional burden to the producer. Conversely, cost advocates point out that both public and nonpublic producers require long-term financing, and cost-basis financial statements may provide better information for those purposes.

.037 Some accountants believe that it is difficult to argue persuasively for charging the periodic costs of growing crops to expense as they are incurred since a valuable asset is being developed. Some contend that the use of a fixed amount less than cost violates existing principles of accounting for assets. Others believe it is acceptable and consistent with a market basis of accounting to account for growing crops at net realizable value or at no value.

Division Conclusions

.038 All direct and indirect costs of growing crops should be accumulated and growing crops should be reported at the lower of cost or market.

.039 An agricultural producer should report inventories of harvested crops held for sale at (a) the lower of cost or market or (b) in accordance with established industry practice, at sales price less estimated costs of disposal, when all the following conditions exist:

- The product has a reliable, readily determinable and realizable market price.
- The product has relatively insignificant and predictable costs of disposal.
- The product is available for immediate delivery.

Accounting for Development Costs of Land, Trees and Vines, Intermediate-Life Plants, and Animals

.040 Development costs of land, trees and vines, intermediate-life plants, and animals are different from costs incurred in raising crops for harvest, which were discussed in the previous section, "Accounting for Inventories of Crops by Agricultural Producers."

.041 Land development generally includes improvements to bring the land into a suitable condition for general agricultural use and to maintain its productive condition. Some improvements are permanent; some have a limited life. Permanent land developments include, for example, clearing, initial leveling, terracing, and construction of earthen dams; they involve changes to the grade and contour of the ground and generally have an indefinite life if they are properly maintained. Limited-life developments usually include such items as water distribution systems and fencing and may also include the costs of wells, levees, ponds, drain tile, and ditches, depending on the climate, topography, soil conditions, and farming practices in the area.

.042 Orchards, vineyards, and groves generally develop over several years before they reach commercial production. Production continues for varying numbers of years, depending on such influences as type of plant, soil, and climate. During development, the plants normally require grafting, pruning, spraying, cultivation, or other care.

.043 Intermediate-life plants have growth and production cycles of more than one year but less than those of trees and vines. They include, for example, artichokes, various types of berries, asparagus, alfalfa, and grazing grasses. Development costs of intermediate-life plants include the cost of land preparation, plants, and cultural care until the plant, bush, or vine begins to produce in commercial quantities.

.044 The terms *livestock* and *animals* are used interchangeably and are meant to include cattle, sheep, hogs, horses, poultry, and other small animals. The development of animals requires care and maintenance of the breeding stock and their progeny until their transfer from the brood herd. Animals purchased before maturity also require care and maintenance to ready them for productive use or sale. The animals are ultimately identified for transfer to breeding herds, dairy herds, or other productive functions, are selected for sale, or are transferred to a feeding or other marketing operation.

Diversity in Practice

.045 Development costs of land, trees and vines, intermediate-life plants, and animals are accounted for in the following ways:

- Charged to operations when they are incurred
- Included in deferred charges
- Included on the balance sheet at fixed amounts substantially less than the costs incurred, with all or a majority of the current costs charged to operations as they are incurred
- Capitalized and amortized over the estimated productive life of the animal, tree, vine, or plant
- Carried at market values

.046 In the case of annual field crops that are planted and harvested in the same accounting period, producers generally match costs with revenues. When the growing cycle continues beyond the accounting period, costs often are not matched with revenues.

.047 Few significant diversities of practice are apparent in the financial statements primarily because of lack of disclosure. However, some agricultural producers charge land development costs to expense based on provisions of the income tax laws.

.048 In accounting for development costs of trees and vines, some producers agree that the costs should be capitalized and depreciated over the expected productive life, but the costs to be capitalized and those to be charged to expense are not identified uniformly. Income tax concepts have had a strong influence on accounting practices for those development costs.

.049 Crops from intermediate-life plants have generally been accounted for in the same way as annual crops, with no distinctions for variations in the periods of development and productivity.

.050 Many livestock producers charge the costs of developing animals to expense without regard to their productive lives or future use or sales value. Animals are sometimes reported at cost and other times at market values. Some producers use the unit livestock method, and in many instances, the annual unit cost increments are below market and probably below cost.

Pros and Cons

.051 Some accountants believe that large-scale improvements that transform the land to new and better uses are permanent land improvements to be capitalized and that subsequent modifications and improvements are necessary and should be classified as period expenses.

.052 Others believe that it is difficult, or nearly impossible, to distinguish between permanent, limited-life, and recurring land development costs. Land improvements that an owner has made over many years tend to lose their original characteristics. Such improvements are usually accompanied by increasingly intensive land use over relatively long periods. Prior improvements are modified, improved on, or eliminated, and the resulting land configuration and use are noticeably changed. The characteristics of continuing land improvements accomplished over long periods are given as justification for classifying those costs as recurring.

.053 Many accountants believe that all direct and related indirect costs of land development, such as leveling, clearing of brush, terracing, and installation of drain tile, should be capitalized. They further believe that land development costs that waste away or diminish in efficiency through use, such as drainage tile, should be depreciated or amortized over the number of seasons that the land can reasonably be expected to produce without renovation or renewal of the particular development.

.054 It is generally agreed that development costs of orchards, vineyards, and groves should be capitalized, but there is no agreement on the specific costs that should be capitalized. Many believe it necessary to capitalize only those costs that the income tax laws require to be capitalized.

.055 Some accountants believe that all direct and indirect costs for orchards, vineyards, and groves incurred during the development period should be capitalized until commercial production is achieved. Others believe all such costs, except annual maintenance costs, should be capitalized. All agree that capitalized costs should be depreciated or amortized over the useful life of the plantings.

.056 Accounting practices for development costs of intermediate-life plants are inconsistent. Producers who deduct expenses before revenues are realized for intermediate-life plants and orchardists and vineyardists who do not want to capitalize development costs and depreciate them over the estimated productive life of the developed asset are motivated by the same reasons. The question of capitalization and depreciation is similar for producers of intermediate-life plants and for producers of trees and vines. The principal distinctions are in development period and productive life. For example, orchard trees may require four to seven years before nominal production, while limited production may occur during the first year of such crops as alfalfa, some berries, and asparagus.

.057 Some accountants have resisted accumulating development costs for growing animals, based on the difficulty and expense of accumulating such information and, in some instances, the problem of identifying individual animals or groups and categories of animals. Instead of cost, the unit livestock method or a market value has been used for assigning amounts to the animals at each level of maturity in the belief that such accounting methods, if consistently applied, would not adversely affect income recognition.

.058 Others believe that all direct and indirect development costs of raising livestock should be accumulated and capitalized until the livestock have reached maturity and have been selected for breeding or other productive purposes. Many believe that income-producing livestock should be depreciated on the basis of their expected productive lives.

Division Conclusions

.059 Permanent land development costs should be capitalized and should not be depreciated or amortized, since they have, by definition, an indefinite useful life.

.060 Limited-life land development costs and direct and indirect development costs of orchards, groves, vineyards, and intermediate-life plants should be capitalized during the development period and depreciated over the estimated useful life of the land development or that of the tree, vine or plant.

.061 All direct and indirect costs of developing animals should be accumulated until the animals reach maturity and are transferred to a productive function. At that point the accumulated development costs, less any estimated salvage value, should be depreciated over the animals' estimated productive lives.

.062 All direct and indirect development costs of animals raised for sale should be accumulated, and the animals should be accounted for at the lower of cost or market until they are available for sale. Agricultural producers should report animals available and held for sale (*a*) at the lower of cost or market or (*b*) in accordance with established industry practice at sales price, less estimated costs of disposal, when all of the following conditions exist:

- There are reliable, readily determinable and realizable market prices for the animals.
- The costs of disposal are relatively insignificant and predictable.
- The animals are available for immediate delivery.

Accounting for Patrons' Product Deliveries to Marketing Cooperatives Operating on a Pooling Basis

.063 Agricultural marketing cooperatives process and market their patrons' products. There are frequently good bases for recording transfers of products between cooperatives and their patrons. For example, dairy cooperatives record transfers of products on the basis of market order prices, and grain cooperatives record transfers of products on the basis of readily determined cash prices. Many cooperatives, therefore, transfer patrons' products at market prices, and the transactions are treated as purchases by the cooperatives and as sales by the patrons.

.064 However, cooperatives operating on a pooling basis may receive products from their patrons without paying a fixed price to the patrons. A cooperative may assign amounts to products based on current prices paid by other buyers or on amounts established by the cooperative's board of directors, or it may assign no amount. The cooperative estimates a liability to patrons equal to the assigned amount for the delivered product, and it usually pays this liability on a short-term basis. The excess of revenues over the assigned amounts and operating costs at the end of a pool period, which may be a week, a month, a year, or longer, is paid or allocated to patrons. Assets equal to that excess may be distributed to the patrons or retained by the cooperative.

.065 The different accounting methods used by pooling cooperatives have been developed to satisfy provisions of their bylaws and contractual arrangements with patrons and to provide equitable methods of settlement from pool period to pool period, as well as among the various classes of patrons. For pooling cooperatives, accounting methods have been developed to allow the use of the single-pool or multiple-pool methods of accounting.

Diversity in Practice

.066 Significant information about the accounting practices of patrons in recording the delivery of raw products to marketing cooperatives is scarce. Among the practices used are recognition (1) at the estimated net return, presumably at the time of delivery, and (2) at the time of sale by the cooperative to an outside party. Those two examples provide the extremes, one recognizing the delivery to the cooperative as a sale and the other continuing to carry the product as inventory of the producer until it is sold by the cooperative. Transfer prices for products delivered to cooperatives are established in diverse ways:

- At market order price or governmental support price
- At market price
- At an assigned amount determined by the cooperative's board of directors to approximate market price
- At the amount of advances
- At cost to the producer
- At no amount until the cooperative advises the producer of the expected proceeds from the ultimate disposition of the product

.067 Cooperatives that receive products from patrons and pay their patrons a firm market price, at or shortly after delivery, treat the payments as purchases. In those situations the prices are paid regardless of the amount of the cooperatives' earnings. Those cooperatives normally report inventories at the lower of cost or market. However, pooling cooperatives estimate amounts due to patrons at the time of delivery, and those amounts are later adjusted on the basis of the pool's earnings. This presents a significant accounting problem. The following paragraphs discuss only the accounting issues that result from deliveries of products by patrons to cooperatives operating on a pooling basis.

.068 In cooperatives operating on a pooling basis, products delivered by patrons are commingled with other patrons' products, processed, and marketed. Earnings from the sale of finished products are returned to patrons, either in cash or in some form of equity, whether or not those earnings were determined on the basis of current market prices at the time of delivery. Many cooperatives value patrons' products at assigned amounts (usually current market prices) set by the board of directors at delivery. A corresponding estimated liability is accrued for amounts due to patrons. At the end of the pool period, the pool's net earnings are credited to amounts due patrons on a patronage basis.

.069 Some cooperatives cannot determine the market prices of patrons' products when they receive them because of limited cash purchases by other processors. They are usually cooperatives that process and market a high percentage of limited specialty crops. Many of those cooperatives account for inventories of goods in process and finished goods at net realizable value, determined by deducting estimated completion and disposition costs from the estimated sales value of the processed inventory, because a reliable price for the unprocessed product is not available to account for inventories at the lower of cost or market. Furthermore, many cooperatives must determine net realizable value to comply with bylaw provisions and contractual obligations and to facilitate equitable pool settlements from pool period to pool period and among various classes of patrons.

.070 A 1973 survey by the National Council of Farmer Cooperatives indicated that many marketing cooperatives use net realizable value to account for inventories. An excerpt from an article on this subject prepared for the council's legal, tax, and accounting committee appears below.

> The National Council of Farmer Cooperatives made a survey of the inventory valuation methods used by its marketing cooperatives. The results of this survey confirm what has been the private belief of most cooperative accountants, that the net realizable market value method is perhaps the most widely used and accepted method of inventory valuation by marketing cooperatives. This survey reflects the responses of 49 cooperatives and, in summary, indicates that the following inventory methods are in use.

Method	*Cooperactives*	*Sales (In Thousands)*	*% of Total Sales*
Net realizable market value	24	$2,310,938	48 %
Lower of cost or market, using field price as the established value of raw product	8	630,898	13
Net realizable market, value and lower of cost or market, using field price as the established value of raw product	5	802,567	17
Cost	2	53,400	1
Rev. Rul. 69-67[2]	7	367,469	8
Other	3	621,925	13
	49	$4,787,197	100 %

.071 The net realizable value method of accounting for inventories permits the recognition of the pool's estimated net earnings at the end of the fiscal period in which the patrons supply their crops to the cooperative or when pools are closed. Inventories are stated at net realizable value, and the amounts due to patrons are credited with the earnings. The net realizable value method of accounting for inventories permits the closing of the pools and provides equitable treatment to patrons if the cooperative transfers the inventories forward to the next period's pool at estimated market value.

.072 Some marketing cooperatives receive products from patrons without assigning amounts to them. During the year, cash is advanced to patrons on the basis of anticipated earnings. Inventories are recorded at amounts advanced plus costs of processing, and patrons' products are valued at the amount of advances made to the date of the financial statements. This is commonly called the "cash advance method."

[2] Note: Rev. Rul. 69–67 refers to the cash advance method. [Footnote renumbered, August 2008, for editorial purposes.]

Authoritative Literature

.073 The primary source of authoritative guidance for accounting for inventories that result from deliveries of products by patrons to cooperatives has been ARB No. 43.

Pros and Cons

.074 A transaction is usually completed when a patron delivers his product to a cooperative. The patron's product is commingled with that of other patrons, and title and individual risk of loss have passed. Some accountants believe that no accounting is necessary at the time of delivery because the transfer price is frequently not known until some later date. Nevertheless, accrual basis accounting calls for reporting the transaction according to the best information available at the time. While greater accuracy may be achieved by waiting for the cooperative to advise the patron of the net proceeds, the handicap of not having current financial information could outweigh the benefit of greater accuracy, and the lack of consistency in reporting could be confusing to the users of the financial statements.

.075 Some accountants argue that pooling cooperatives should not use an assigned amount for products received from patrons for financial accounting and reporting purposes because the amounts may not be reliable and the patrons may be paid more or less than that amount at the end of the pool period. Others argue that the use of an assigned amount permits the establishment of a tentative liability due patrons and allows inventories to be stated at the lower of cost or market. The method also facilitates allocation of pool proceeds to patrons.

.076 Some accountants believe that the net realizable value method of accounting for inventories is unacceptable because it anticipates cooperative earnings. Further, they believe that future selling prices and disposition costs are too uncertain to base accounting on them. Alternatively, those who favor the use of the net realizable value method believe that the problems of determining net realizable value do not differ from those of determining market under the lower of cost or market method. They also consider the method to be acceptable in accounting for pools because it enables the cooperative to settle pools annually and to comply with bylaw provisions and contractual obligations. In essence, they claim, the inventory is transferred to the next period's pool on an equitable basis.

.077 Some accountants believe that cooperatives may record products received from patrons at assigned amounts and then account for the inventories at net realizable value. That method permits the closing of pools at least annually on an equitable basis. Others believe that, if assigned amounts are used on receipt of the product, the inventories should be accounted for at the lower of cost or market.

.078 Some accountants favor the cash advance method of accounting for inventories. They believe that the only product cost that should be accounted for is the total of cash advanced to patrons to the date of the financial statements, because the cooperative has no liability to pay more unless more is earned. Others favor the cash advance method because the Internal Revenue Service has held in several rulings that pooling cooperatives should use that method in tax computations. Others reject the cash advance method because advances to patrons are primarily determined on availability of cash, the percentage of the pool production sold to the date of the financial statements, and short-term inventory loan restrictions rather than on the value of products received. Further, they reject the method because the amount and timing of advances are generally subject to the board of directors' action and may vary from period to period.

Division Conclusions

Accounting by Patrons for Products Delivered to Pooling Cooperatives

.079 If control over the future economic benefits relating to the product has passed, which ordinarily is evidenced by the transfer of title, and if a price is available by reference to contemporaneous transactions in the market, or if the cooperative establishes an assigned amount, a delivery to the cooperative should be recorded as a sale by the patron at that amount on the date of delivery. If there is a reasonable indication that the proceeds from the cooperative will be less than the market price or the assigned amount, the lower amount should be used.

.080 If control over the future economic benefits relating to the product has passed, which ordinarily is evidenced by the transfer of title, and there are neither prices determined by other market buyers nor amounts assigned by the cooperative, or if such amounts are erratic, unstable, or volatile, the patron should record the delivery to the cooperative as a sale at the recorded amount of the inventory and should record an unbilled receivable. If there is a reasonable indication that the proceeds from the cooperative will be less than the receivable, the lower amount should be used.

.081 If title has not passed, the identity of the individual patron's product is maintained by the cooperative, and the price to the patron is to be based on the identified product's sale, the transaction is not complete, and the product should be included in the patron's inventory until it is sold by the cooperative, at which time the patron should record the sale.

.082 Advances are financing devices and should be treated as reductions in the unbilled receivable and should not be used as amounts for recording sales.

Accounting by Pooling Cooperatives for Products Received From Patrons

.083 If the boards of directors of agricultural marketing cooperatives operating on a pooling basis with no obligation to pay patrons fixed prices (pooling cooperatives) assign amounts that approximate estimated market to unprocessed products received from patrons, the assigned amounts are cost and should be charged to cost of goods sold and credited to amounts due patrons. The inventories should be accounted for at the lower of cost or market or, as described more fully in paragraph .084, at net realizable value. When assigned amounts are used, they should approximate estimated market of unprocessed products delivered by patrons (an example of inventories at lower of cost or market is provided in the appendix [paragraph .107], column A). The method used and the dollar amounts assigned to members' products should be disclosed.

.084 If the boards of directors of pooling cooperatives assign amounts to products received from patrons, the cooperatives should use those assigned amounts in determining the estimated amounts due patrons. Such cooperatives may use net realizable value for determining pool proceeds, transferring inventory amounts to subsequent pools, or for other purposes (an example is provided in the appendix [paragraph .107], column B). The method used and the dollar amounts assigned to members' products should be disclosed.

.085 If the boards of directors of pooling cooperatives do not assign amounts that approximate market to unprocessed products received from patrons, the cooperatives should account for inventories at net realizable value (an example is provided in the appendix [paragraph .107], column C). Because amounts that approximate estimated market are not assigned to products received from patrons, cost of goods sold will not include a charge for unprocessed products under this method.

.086 Pooling cooperatives should not use the cash advance method to account for inventories.

Accounting for Investments in and Income From Cooperatives

.087 Member patrons of cooperatives can be producers or other cooperatives. Member patrons provide most of the capital required by cooperatives. The capital usually represents long-term investments acquired through initial cash investments, retains, or noncash patronage allocations. Voting rights for those investments are usually based on one-member-one-vote or limited weighted voting rather than on the number or amount of securities or other evidence of equity ownership held. The investments are made primarily to obtain an economical source of supply or marketing services and not on the expectation of a return on investment. The sale of such investments, other than back to the issuing cooperative, is usually restricted or prohibited.

Diversity in Practice

.088 Investments in cooperatives are generally carried by producers at cost, at cost plus declared retains, at cost plus estimated retains, or at an amount less than cost.

.089 Most cooperatives carry their investments in other cooperatives at cost if they are purchased or at face amount if they are received in other than purchase transactions (retains or noncash patronage allocations). However, they usually write the investments down to estimated net realizable value if evidence indicates they will be unable to recover the full carrying amount of the investments. That practice has been endorsed in Accounting Research Bulletin 2, issued by the National Society of Accountants for Cooperatives, which states—

> Investments in cooperatives made by user patrons for the purpose of providing capital for operations of the investee cooperative should be carried at cost, if purchased, or at face value if received in transactions other than purchases such as non-cash patronage dividends. Such investments should be written down to an appropriate amount if reliable evidence indicates that their value has been permanently impaired.
>
> It should be noted that in most instances accounting for investments in other cooperatives (including banks for cooperatives and other cooperative financing organizations, such as the National Rural Utilities Cooperative Finance Corporation) on the basis outlined above results in investment carrying values equal to the equity values of the investing cooperative's interest in the investee

cooperatives; therefore, it would appear that the basis outlined complies with APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, to the extent that the intent of the opinion is applicable to investments of cooperatives. In the infrequent instances where the investor's share of unallocated retained earnings of an investee cooperative is material to the investor, the principles set forth in APB Opinion No. 18 should be applied.

.090 Cooperatives that invest in other cooperatives usually recognize allocated equities in the cooperative investor's fiscal year within which written notice of allocation is received, and the investment is carried at cost plus allocated equities. That method of revenue recognition conforms with federal income tax requirements. It is the most practical method of reporting because many investee cooperatives issue financial statements and determine patronage allocations only at the close of their accounting years. Many cooperatives do that because they find determination of patronage allocations to be complex and time consuming, since their operations may include both marketing and supply functions, as well as several departments under each function.

.091 Diversity in practice has developed in accounting for unallocated equities. Some patrons who hold at least a 20 percent ownership interest recognize their interest in unallocated equities in accordance with APB Opinion No. 18. Others do not recognize unallocated equities, primarily because the equity ownership percentage changes according to patronage and because voting is usually based on the one-member-one-vote principle, which does not necessarily provide significant influence. Interpretation and application of APB Opinion No. 18 may become more significant in financial reporting for cooperatives because 1978 changes in the Internal Revenue Code, relating to the investment tax credit, may encourage cooperatives to reduce distributions of assets to patrons and increase unallocated net after-tax earnings for the purchase of assets.

.092 Most patrons recognize their patronage allocations when they are notified, which conforms with federal income tax reporting requirements. Other patrons accrue patronage allocations on the basis of the cooperatives' interim financial statements.

.093 Presentation of patronage allocations in patrons' financial statements is also diverse. Some patrons recognize patronage allocations as reductions of purchase or interest costs on purchases from supply or financing cooperatives or as increases in sales for deliveries to marketing cooperatives. Other patrons recognize all patronage allocations as nonoperating income.

Authoritative Literature

.094 Authoritative literature on marketable investments—FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*,[*] and FASB Interpretation No. 16, *Clarification of Definitions and Accounting for Marketable Equity Securities That Become Nonmarketable*—has little applicability to investments in cooperatives. Investments in cooperatives are not equity securities and usually are not readily marketable, and transfer or sale, other than back to the issuing cooperative, is usually restricted or

[*] FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, amends certain parts of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. [Footnote added to reflect conforming changes necessary due to the issuance of recent authoritative literature; Footnote renumbered, August 2008, for editorial purposes.]

prohibited. Current accounting literature supports the carrying of long-term investments, such as nonmarketable investments in agricultural cooperatives, at cost if the value of the investments is not impaired. Carrying amounts are reduced when the investor becomes unable to recover the full carrying amounts. APB Opinion No. 18 requires the equity method of accounting for investments in which the investor has significant influence over an investee's operating and financial policies.

.095 The significance of investments by patrons results primarily from the purchasing or marketing rights and participation in the operating earnings. As such, the operations of cooperatives have many of the attributes of corporate joint ventures or partnerships.

Pros and Cons

.096 Some accountants argue that the investment in a cooperative is in substance a long-term investment and, as such, should be carried at cost or at cost plus allocated equities. Others believe that the investments should be discounted to their present value. The carrying amounts would be adjusted downward as required by generally accepted accounting principles when the patron becomes unable to recover the full carrying amounts.

.097 Those that support discounting of investments in cooperatives to present value believe that it results in satisfactory presentation in the financial statements because allocated equities are usually not redeemed or are redeemed over a long period. However, others believe that patrons contribute amounts to cooperatives not as investments but to obtain supply or marketing sources, and the allocated equities represent a proportionate share of the cooperative's earnings for the period of patronage. That is similar to accounting for equities in partnerships or corporate joint ventures, in which undistributed earnings are recognized for accounting purposes on the same basis as for federal income tax reporting. Proponents of the stated amount method also believe that it produces symmetry, since the investee records the issuance of securities or book credits at par or face amounts rather than on the basis of discounted values. They argue further that the method conforms with the underlying price-adjustment theory of cooperatives, which holds that such allocated equities are merely reductions of the cost of supply purchases or increases in the proceeds of products marketed through the cooperative and that they should therefore be reflected in the patrons' results of operations.

.098 Accountants who believe that a cooperative's unallocated losses should not be recognized by the patrons base their contention on the premise that operating losses may indicate temporary rather than permanent declines in value because they may result from identifiable, isolated, or nonrecurring events. Accordingly, they should not be recognized. Furthermore, because many investor cooperatives determine patronage allocations on the basis of financial statement reporting rather than federal income tax reporting, some accountants argue that financial statement recognition by investor cooperatives of unallocated losses will cause the payment of federal income taxes by the investor cooperative that would not otherwise be payable and such taxes will not be recoverable if the losses are later allocated. That adverse effect is the result of federal income tax regulations that limit the patronage refund deduction to the lesser of the patronage refund "paid" and the patronage refund "allowable," as determined in accordance with federal income tax rules and regulations.

.099 Those who believe that unallocated losses should be recognized argue that patrons must recognize allocated losses for consistent reporting, much as if the investment were in a corporate joint venture or partnership rather than a cooperative. They further contend that failure to recognize unallocated losses permits manipulation of earnings because patrons often serve on the cooperative's board of directors or can influence the board of directors, which has the authority to determine the portions, if any, of the losses that will be allocated to patrons.

.100 Accountants who believe that unallocated equities should not be recognized by the patrons generally contend that APB Opinion No. 18 does not apply because equity ownership generally does not convey voting control and because ownership interests in unallocated equities may be temporary, being subject to changes in patronage participation and the redemption of equities. However, others argue that APB Opinion No. 18 should apply to all investments in cooperatives in which the patrons hold at least 20 percent of the equity securities, regardless of the one-member-one-vote requirement and the fact that ownership interests may change. They believe that the patron frequently has significant influence due to patronage volume, assured representation on the board of directors, or other means.

.101 Some accountants believe that patronage allocations should be recognized in the accounting period in which the supply is purchased or the product is marketed, since those transactions are the source of the patronage allocations and are adjustments of the price at which the supply is purchased or the product marketed. Others believe that the accrual of estimated patronage allocations is impractical because many cooperatives do not determine patronage allocations during interim periods and the amount of the allocations usually cannot be determined from the cooperatives' interim financial statements. Further, existing federal income tax rules and regulations, as well as the bylaws of most investee cooperatives, require the investee's patronage allocations to be included in taxable income in the period the investor is notified of the patronage allocation. This requirement may cause adverse tax effects for investors.

.102 Some accountants argue that allocated and unallocated equities should be reflected in the statement of operations as reductions of costs or increases in proceeds because such amounts result from the transactions by which supplies are purchased, interest is paid, or products are sold. Accordingly, the proponents believe that the equities should be reported in the same manner as the original transactions to report sales, cost of sales, and operating expenses. Other accountants believe that the allocations should be reported as other income rather than as increases or decreases in sales, cost of sales, or operating expenses; they argue that including the allocations in sales, cost of sales, or operating expenses could misstate gross profit or expenses.

Division Conclusions

.103 Investments in cooperatives should be accounted for at cost, including allocated equities and retains. The carrying amount of an investment in a cooperative should be reduced if the patron is unable to recover the full carrying value of the investment. Losses unallocated by the investee may indicate such an inability, and, at a minimum, the excess of unallocated losses over unallocated equities should be recognized by the patron based on the patron's proportionate share of the total equity of the investee cooperative, or any other appropriate method, unless the patron demonstrates that it is probable that the carrying amount of the investment in the cooperative can be fully recovered.

.104 Patrons should recognize patronage refunds either—

a. When the related patronage occurs if it is then probable that (1) a patronage refund applicable to the period will be declared, (2) one or more future events confirming the receipt of a patronage refund are expected to occur, (3) the amount of the refund can be reasonably estimated, and (4) the accrual can be consistently made from year to year or

b. On notification by the distributing cooperative.

The accrual should be based on the latest available reliable information and should be adjusted on notification of allocation.

.105 Either (1) the classification of the allocations in the financial statements should follow the recording of the costs or proceeds or (2) the allocations should be presented separately.

Effective Date and Transition

.106 The Accounting Standards Division recommends application of this statement to financial statements prepared for fiscal years, and interim periods in such fiscal years, beginning after June 15, 1985. Accounting changes to conform to the recommendations of this statement should be made prospectively for transactions or activities occurring on or after the effective date of this statement. Application for earlier years, including retroactive application, is encouraged for all transactions or activities regardless of when they occurred. Disclosures should be made in the financial statements in the period of change in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections*, which supersedes APB Opinion No. 20, *Accounting Changes*.[†]

[†] [Footnote deleted, August 2007, for editorial purposes; Footnote renumbered, August 2008, for editorial purposes.]

.107

Appendix

Accounting by Pooling Cooperatives for Products Received From Patrons

The following illustrates the statement of net earnings prepared under each of two possible methods of accounting for inventories (columns A and B), the statement of net proceeds prepared under the net realizable value method (column C), and the respective statements of amounts due patrons, if such latter statement is included in the financial statements. (See paragraphs .083, .084, and .085.) Column A demonstrates the lower of cost or market method with patrons' raw product being charged to cost of production at assigned amounts. Column B demonstrates the net realizable value method with patrons' raw product being charged to cost of production at assigned amounts. Column C demonstrates the net realizable value method when no amounts are assigned to patrons' raw product; therefore, there is no charge to cost of production for patrons' raw product. The assumed facts are as follows:

Sales	$129,630
Beginning inventory	
Net realizable value	31,128
Lower of cost or market	28,380
Assigned value of patrons' raw product received	56,500
Ending inventory	
Net realizable value	35,596
Lower of cost or market	32,360
Income taxes	1,250
Other costs and expenses	56,580
Amounts paid to patrons, retains, and non-patronage earnings	74,430
Amounts due patrons at beginning of year	
Lower of cost or market method	8,910
Net realizable value method	11,748

Statements of Net Earnings (columns A and B)

Statement of Net Proceeds (column C)

	Inventories Valued At		
	Lower of Cost or Market—A	Net Realizable Value—B	Net Realizable Value—C
Sales	$129,630	$129,630	$129,630
Costs and expenses (I)	109,100	108,702	52,202
Earnings before income taxes	20,530	20,928	—
Proceeds before income taxes	—	—	77,428
Income taxes	1,250	1,250	1,250
Net earnings	$ 19,280	$ 19,678	
Net proceeds			$ 76,178
I. Beginning inventory	$ 28,380	$31,218	$31,218
Assigned value of patrons' raw product received	56,500	56,500	—
Ending inventory	(32,360)	(35,596)	(35,596)
Other costs and expenses	56,580	56,580	56,580
	$109,100	$108,702	$ 52,202

Statements of Amounts Due Patrons

	Inventories Valued At		
	Lower of Cost or Market—A	Net Realizable Value—B	Net Realizable Value—C
Amounts due patrons at beginning of year	$ 8,910	$11,748	$11,748
Net earnings	19,280	19,678	—
Net proceeds	—	—	76,178
Assigned value of patrons' raw product received	56,500	56,500	—
	84,690	87,926	87,926
Less amounts paid to patrons, retains, and non-patronage earnings	74,430	74,430	74,430
Amounts due patrons at end of year	$10,260	$13,496	$13,496

Under the two inventory methods presented, the difference in amounts due patrons at the end of the year results from the difference in the ending inventory valuations, illustrated as follows:

Inventories of finished goods and goods in process at:	
Net realizable value	$35,596
Lower of cost or market	(32,360)
	3,236
Amounts due patrons at end of year on lower of cost or market basis	10,260
Amounts due patrons at end of year on net realizable value basis	$13,496

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Section 10,430

Statement of Position 88-1 Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications

September 30, 1988

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

Summary

This statement of position (SOP) provides guidance on applying generally accepted accounting principles in accounting for developmental and preoperating costs, purchases and exchanges of take-off and landing slots, and airframe modifications. Briefly, the SOP recommends the following:

- Developmental costs related to preparation of operations of new routes should not be capitalized as previously permitted under *Audits of Airlines*, the AICPA Industry Audit Guide. However, preoperating costs related to integration of new types of aircraft would continue to be eligible to be capitalized, as permitted by the guide. The amortization period for such deferred preoperating costs should begin when the new aircraft is ready to be placed in service.
- The costs of acquiring take-off and landing slots are identifiable intangible assets that should be accounted for in conformity with FASB Statement No. 142, *Goodwill and Other Intangible Assets*. When airlines exchange slots, the slots acquired should be recorded in conformity with FASB Statement No. 142 and APB Opinion No. 29, *Accounting for Nonmonetary Transactions*.
- The costs associated with airframe modifications that enhance the usefulness of the aircraft should be capitalized and depreciated over the estimated useful life of the aircraft or the modifications, whichever is less. The cost of the replaced asset net of accumulated depreciation and anticipated recovery value should be charged to income in the current period.

The provisions of this statement are effective for transactions initiated after September 30, 1988. [Paragraph added, February 2008, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Industry Developments

Deregulation

.01 In 1981, when the AICPA Industry Audit Guide, *Audits of Airlines*, was issued, airlines were regulated by the Civil Aeronautics Board (CAB). However, the Airline Deregulation Act of 1978 (ADA) terminated the CAB's authority over rates and route access on January 1, 1983, and its responsibility for evaluating the fitness of new entrants on January 1, 1985.

.02 In addition to liberalizing the general provisions for awarding certificates to new airlines, the ADA established new provisions for automatic market entry and issuance of experimental certificates on a temporary basis. Other provisions eased restrictions on suspension and reduction of service and expedited market entry and exit. As a result, the ADA has enabled many new entrants to gain access to domestic markets and has allowed trunk, local service, and commuter carriers to expand and otherwise alter their service patterns. Airlines are now classified as certificated scheduled (route) airlines, certificated nonscheduled (charter) airlines, air-cargo airlines, and intrastate airlines. Within the route airline classification, airlines are now identified as major, national, regional, and air-taxi operators.

.03 In addition, the ADA transferred responsibility for overseeing airline operations to the Department of Transportation (DOT). The DOT has assumed responsibility for both monitoring the air safety and fitness characteristics of the various airlines and approving merger proposals and sales of airline routes. In this new competitive environment, marketing strategies, pricing of tickets, and costs of service have become important business issues for the airlines.

International Air Transportation

.04 Airline operations between countries continue to be governed by specific bilateral agreements between the countries. The access of U.S. airlines to routes between the United States and other countries requires the approval of the respective countries for both landing rights at specified airports and frequency of flights.

.05 The International Air Transport Association (IATA), a voluntary organization of international airlines, was established in 1946 to negotiate international air fares, cargo rates, conditions of service, and ancillary matters. The Federal Aviation Act required U.S. airlines participating in such an organization to obtain approval from the CAB. In 1946, the CAB granted U.S. airlines immunity from antitrust laws, permitting them to participate in IATA conferences for the purpose of establishing fares and rates. Agreements reached by the airlines at those meetings are subject to the approval of the respective governments.

.06 In anticipation of deregulation in the United States, IATA established two types of airline participation: one deals with facilitation matters and is mandatory for all members; the other sets fares and rates for air transportation. Participation in the latter is optional, but a member choosing to participate in fare and rate conferences must do so for all areas served.

Air Transport Association of America (ATA)

.07 Founded in 1936, the Air Transport Association of America is a trade and service organization representing member U.S.-scheduled airlines. The joint interests of the airlines as an industry are expressed through a system of councils and related committees on which airline and ATA representatives work together.

.08 Because travel agent sales constitute a significant portion of the airline business, the ATA designed the Area Settlement Plan (ASP), which is operated by the Airlines Reporting Corporation. The plan enables each travel agent to submit one sales report to an area processing center that then distributes the agent's sales and receivable transactions to the respective airlines. Because the dollar volumes involved and competitive needs for sales information are substantial, the ASP program requires continuous monitoring and updating. This service is provided to the airlines and travel agents by the ATA.

.09 Other plans, called bank settlement plans (BSPs), have been established recently in Japan, the United Kingdom, the Federal Republic of Germany, and other countries. The BSPs, although not identical to the ASP, contain many of the same features.

Regional Airline Association

.10 The Regional Airline Association, formerly the Commuter Airline Association, is the national association of member airlines engaged in scheduled air transportation of passengers and cargo in local, feeder, and short-haul markets throughout the United States and its territories. In addition, the association's finance and accounting committee has developed a uniform system of accounts for regional airline use.

Regulations and Reporting

.11 Although the CAB is no longer in existence, airline accounting information continues to be reported to the DOT in conformity with the Uniform System of Accounts and Reports (USAR) previously issued by the CAB. The USAR consists of a list of titles and account numbers and instructions for their use. DOT—and, previously, CAB—policy has been to conform its accounting requirements to generally accepted accounting principles.

.12 Financial data and reports based on the USAR must be filed with the DOT on Form 41 quarterly and annually. Securities and Exchange Commission filings and annual financial reports frequently follow the wording and captions of the USAR accounts.

Computerized Reservation Systems (CRSs)

.13 Computerized reservation systems (CRSs) developed by several airlines (CRS vendors) allow travel agents to access airline schedules and information regarding hotels, car rentals, and so forth. The CRSs permit the agency user to, among other things, check seat availability, make reservations, and print tickets for flights on participating domestic and international airlines. In 1984, the CAB ordered the elimination of display preference in the systems for all participating airlines (those paying a fee to participate) and required CRS vendors to charge uniform booking fees for airline users of CRSs, based on the level of service received. Nonparticipating airline schedules are also included in the CRSs for informational purposes. [Paragraph revised, February 2008, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.14 The CRS vendors receive booking fees per segment from participating airlines on which flights are booked and user fees from the travel agencies. Some airlines have contracted with CRS vendors to process all of their reservations through the CRS vendors' reservation systems, thereby eliminating the need for the airlines' in-house reservation systems.

.15 The CRSs increase the amount of information that may be captured online at the time the reservation is booked. This information normally includes passenger name, ticket number, the travel agent selling the ticket, itinerary, class of service, and price.

Marketing Arrangements

.16 One of the developments in the deregulated environment is the *hub and spoke strategy* that has been adopted by many airlines. Under this concept, the airline identifies certain cities as hub cities to serve both long-haul flights and connecting short-haul flights. This strategy has led carriers operating from a hub city to enter into agreements with other carriers to coordinate flight schedules at the hub city to facilitate the interchange of passengers. The advantage to both airlines is that each feeds passengers to the other. The agreements may include joint promotion and advertising efforts, use of the major carrier's reservation system, and dual designation of flights in a CRS or other reservation systems and the official airline guide. The dual designation of flights (that is, a national or regional flight arriving at or departing the hub city using the same flight number as the major carrier) is the subject of controversy within the industry.

Commissions

.17 Before deregulation, commissions to travel agents were limited to amounts authorized by the CAB or foreign governments. Since deregulation, a myriad of commission arrangements has evolved both domestically and internationally. In addition to basic commissions, travel agents may be entitled to incentive commissions for certain routes, travel periods, and defined volumes. Auditors should consider the significant cost and complexity of travel agents' commission arrangements when assessing risk and planning and performing audit procedures related to commissions expense. [Paragraph revised, February 2008, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Accounting Issues

.18 The guidance presented in this statement modifies certain aspects of the guide and addresses issues that have developed as a result of deregulation.

Developmental and Preoperating Costs

.19 Developmental and preoperating costs are as follows:

Developmental costs include those types of costs directly related to the development of new routes (or extension of existing routes), such as advertising and promotion expenses, related travel and incidental expenses, and expenses of regulatory proceedings.

> *Preoperating costs* include flight crew training, maintenance training, prerevenue flight expenses, insurance, and depreciation. Like developmental costs, preoperating costs relate directly to specific preoperating projects, such as preparation for operation of new routes . . . or integration of new types of aircraft . . .

[Revised to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.20 Before deregulation, costs meeting the foregoing criteria for developmental and preoperating costs were normally deferred and amortized over the expected period of benefit, generally two-to-five years. In that regulated environment, the expected future benefit and recoverability of such costs was generally not in doubt.

.21 Under the ADA, new domestic routes can be obtained more readily without regulatory delay, and there is presently little domestic protection against new entrants. The designation of additional U.S. cities as gateway cities with direct service to various international cities, as well as the increased competition over traditional international routes, has altered the historical competitive relationship and earnings potential that previously existed on given routes. Therefore, the future benefits to be derived from new routes may be uncertain in the present operating environment.

Division's Conclusions

.22 Because of the current deregulated environment and the uncertainty regarding the recoverability of route developmental costs, the majority of the Accounting Standards Executive Committee (AcSEC) believes that developmental costs, other than advertising costs, related to preparation of operations of new routes should not be capitalized, as previously permitted under the guide. (Advertising costs should be accounted for in conformity with the gui dance in SOP 93-7, *Reporting on Advertising Costs* [ACC sec. 10,590].) Route expansion or alteration has become a recurring activity among the airlines, and any related cost is considered a normal and recurring cost of conducting business. [As amended, effective for financial statements for years beginning after June 15, 1994, by Statement of Position 93-7. Paragraph revised, February 2008, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.23 Preoperating costs related to the integration of new types of aircraft should be expensed as incurred.[*] [As amended, effective for financial statements for fiscal years beginning after December 15, 1998, by Statement of Position 98-5. Paragraph revised, February 2008, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.24 A minority of AcSEC believes that the current accounting model permits the capitalization of developmental costs. They believe that the airline industry should not be precluded from capitalizing those costs.

[.25] [Paragraph deleted, February 2008, by Statement of Position 98-5, *Reporting on the Costs of Start-Up Activities*, effective for financial statements for fiscal years beginning after December 15, 1998.]

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[*] [Footnote deleted, February 2008, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Take-off and Landing Slots

.26 New entrants to a market and airlines expanding in markets need gates, and take-off and landing slots available to them at the airports in those markets. At certain airports, the frequency of take-offs and landings at all times is generally at capacity. At other airports, the slots during popular travel times are at capacity.

.27 Because an airline cannot enter a market where no slots are available, the DOT has adopted a rule under which airlines may sell or trade slots. These transactions frequently include the sale of or access to gates for the acquiring airlines. Although slots, particularly those in high-demand time periods, have always had intrinsic value, the DOT policy of transferability through sale or exchange has made the slot a salable right.

Division's Conclusions

.28 When airlines buy slots, the recorded asset is an intangible asset that should be accounted for in conformity with FASB Statement No. 142, *Goodwill and Other Intangible Assets*. When determining a useful life of such intangible assets, the following factors should be considered, in addition to the factors indicated in FASB Statement No. 142:

- The accelerated pace of change in the airline industry and the effects of competition among airports
- The uncertainty of the continuation of the current governmental policy regarding sale of and access to landing slots
- The terms of existing facility leases at airports
- Probability of new airport construction to serve the same metropolitan area
- Traffic patterns and trends and local operating restrictions

[Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 142, which superseded APB Opinion No. 17, *Intangible Assets*. Paragraph revised, February 2008, to reflect conforming changes necessary due to the issuance of recent authoritative literature.[†]]

.29 When an airline exchanges slots with another airline, the slots acquired in the exchange are nonmonetary assets that should be recorded in conformity with APB Opinion No. 29, *Accounting for Nonmonetary Transactions,* and accounted for in accordance with FASB Statement No. 142. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 142, which superseded APB Opinion No. 17, *Intangible Assets*. Paragraph revised, February 2008, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Airframe Modifications‡

.30 Historically, airlines have undertaken major programs to modify interior configurations of certain aircraft types—including the reconfiguration and replacement of seats, galley equipment, and storage space—in response to

[†] [Footnote deleted, February 2008, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

‡ Readers should consider the requirements of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and its implications regarding airframe modifications.

market forces and passenger demands. Since deregulation, such changes have been more frequent.

Division's Conclusions

.31 If the modifications enhance the usefulness of the aircraft, the costs associated with the changes should be capitalized and depreciated over the estimated useful life of the aircraft or the modifications, whichever is less. The cost of the replaced asset net of accumulated depreciation and anticipated recovery value should be charged to income in the current period. However, detailed records may often be inadequate to permit identification of the cost of the replaced asset; therefore, estimates may be required.

Effective Date

.32 The conclusions in this statement of position should be applied to transactions initiated after September 30, 1988. Restatement of previously issued financial statements is not permitted. [Paragraph revised, February 2008, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

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Section 10,450

Statement of Position 90-3
Definition of the Term Substantially the Same *for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position*

February 13, 1990

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

Scope

.01 This Statement of Position provides guidance for determining whether two debt instruments are *substantially the same*. The recommendations herein are limited to transactions involving a sale and purchase or exchange of debt instruments between entities who hold the debt instruments as an asset. The term *debt instruments* is used in this statement of position to include instruments usually considered to be securities such as notes, bonds, and debentures, as well as other evidence of indebtedness such as money market instruments, certificates of deposit, mortgage loans, commercial loans, and commercial paper, that often are not referred to as securities. Debt instruments also include evidence of indebtedness that represents aggregations of debt instruments, such as mortgage-backed certificates.

.02 The conclusions in this statement of position are not intended to modify, in any way, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*. Paragraph 42 of SFAS No. 15 discusses certain situations in which troubled debt restructurings may involve substituting debt of other business enterprises, individuals, or governmental units for that of the troubled debtors. The accounting principles in paragraph 42 of SFAS No. 15 are not affected by this statement of position. Also, this statement of position is not intended to apply to situations in which financial institutions originate or buy whole loan mortgages and exchange those loans for a participation certificate issued by government-sponsored enterprises or agencies (FHLMC, FNMA, or GNMA) representing direct ownership of the same mortgages. However, the statement of position does apply to exchanges of participation certificates.

.03 The recommendations in this statement of position amend AICPA Industry Audit Guide *Audits of Banks* (Bank Audit Guide)[1] and Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* (Broker-Dealer Guide).

Background

.04 The preface of the Bank Audit Guide (May 1994) stated that certain issues affecting the banking industry were not included in the guide or were under study by the AICPA or the FASB. One of those issues related to the definition of the term *substantially the same* as used in the guide.[2]

.05 In paragraphs 5.19 and 5.20 of the Bank Audit Guide (May 1994), the term *substantially the same* was used in describing wash sales as follows:[3]

> Bank supervisory agencies currently prescribe that investment security gains and losses be recognized according to the completed transaction method. In practice, serious questions develop about the proper definition of "completed transactions" when securities are sold with the intent to reacquire the same or *substantially the same* securities, most often to obtain income tax or other benefits. In such transactions, known as "wash sales," the period of time between sale and reacquisition varies. It is often very short, especially when readily marketable securities are involved. In some cases, the security or evidence of ownership of the security remains in the possession of the seller or his agent; only brokers' advices provide evidence of the sale and reacquisition.
>
> In a sale, the risks and opportunities of ownership are transferred for a reasonable period of time; such a transfer is necessary to constitute realization and permit recognition of revenue. Therefore, when a bank sells a security and concurrently reinvests the proceeds from the sale in the same or *substantially the same* security, no sale should be recognized, since the effect of the sale and repurchase transaction leaves the bank in essentially the same position as before, notwithstanding the fact that the bank has incurred brokerage fees and taxes. When the proceeds are not reinvested immediately, but soon thereafter, the test is whether the bank was at risk for a reasonable period of time to warrant recognition of a sale. The period of time cannot be defined exactly; rather, the type of securities involved and the circumstances of the particular transaction should enter into the determination of what constitutes a reasonable period of time. For example, a day may be appropriate for a quoted stock or bond that has a history of significant market price fluctuations over short periods of time. Similarly, a bank's liquidity requirements may require that a

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[1] The AICPA Audit and Accounting Guide *Banks and Savings Institutions*, incorporated and superseded Statement of Position (SOP) 90-3 to the extent SOP 90-3 amended previous editions of the Bank Audit Guide and the AICPA Audit and Accounting Guide *Audits of Savings Institutions*. [Footnote added, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

[2] See footnote 1. [Footnote added, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

[3] See footnote 1. [Footnote added, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

> long-term bond be replaced by a short-term money market instrument; but, a week later, the bank's liquidity requirements may change, and reacquisition of the bond previously sold may be a reasonable business decision, wholly independent of the previous decision to sell the bond. [*Emphasis added.*]

.06 The terms *substantially the same, substantially similar,* and *substantially identical* are also used to describe a factor that is considered in determining whether a sale of a debt instrument under an agreement to repurchase should be accounted for as a sale and a purchase or as a financing transaction. Dollar repurchase—dollar reverse repurchase agreements involve similar but not identical securities. The terms of the agreements often provide data to determine whether the securities are similar enough to make the transaction in substance a borrowing and lending of funds or whether the securities are so dissimilar that the transaction is a sale and purchase of securities.

.07 A dollar repurchase—dollar reverse repurchase agreement is an agreement (contract) to sell and repurchase or to purchase and sell back securities of the same issuer but not the original securities. Fixed coupon and yield maintenance dollar agreements comprise the most common agreement variations. In a fixed coupon agreement, the seller and buyer agree that delivery will be made with securities having the same stated interest rate as the interest rate stated on the securities sold. In a yield maintenance agreement, the parties agree that delivery will be made with securities that will provide the seller a yield that is specified in the agreement.

[.08] [Paragraph deleted, August 1991, by the issuance of the Audit and Accounting Guide *Audits of Savings Institutions*.]

.09 The term *substantially identical* is also used by brokers and dealers in discussing repurchase transactions. The AICPA Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities* states the following in paragraph 1.40:

> A repurchase transaction, commonly known as a repo transaction, is a sale of security coupled with an agreement by the seller to repurchase the same or *substantially identical* security at a stated price . . . .
>
> A reverse repurchase agreement, known as a reverse repo, is the purchase of a security at a specified price with an agreement to resell the same or *substantially identical* security at a definite price at a specific future date. [*Emphasis added.*]

The Broker/Dealer Guide does not provide any guidance for determining whether the securities are *substantially identical.*

.10 Because of the lack of an authoritative definition of *substantially the same,* alternative accounting practices have developed or may develop for the exchange of *substantially the same* assets.

Current Accounting Practices

.11 The issue of whether two debt instruments are *substantially the same* is generally encountered in connection with determining whether a transaction involving debt instruments results in a sale or a financing, for example, the sale of a debt instrument under an agreement to repurchase another debt instrument. If the debt instrument to be repurchased is *substantially the same* as a debt instrument sold, it may be viewed as a financing transaction. However, if the debt instrument to be repurchased is viewed as not being *substantially the same,* that transaction is generally recorded as a sale with a commitment to buy another debt instrument.

.12 Two debt instruments can differ in a variety of ways, such as the obligor, maturity, interest rate, and yield. If two debt instruments are exchanged and many of the characteristics of the instruments differ, for example, exchange of a U.S. Treasury bill for a mortgage-backed security, virtually all would agree that a transaction has taken place that requires accounting recognition as a sale, not a financing. In contrast, if two debt instruments are exchanged and most of the characteristics of the instruments are the same, many would view the exchange as involving *substantially the same* securities prohibiting accounting recognition, for example, the exchange of two GNMA securities bearing the identical contractual interest rate that are collateralized by similar pools of mortgages resulting in approximately the same yield. Thus, the issue to resolve is how similar the characteristics of two debt instruments have to be viewed as *substantially the same.*

Conclusions

.13 To minimize diversity in practice, the AICPA Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee believe the definition of *substantially the same* should be narrow. Therefore, the committees have concluded that for debt instruments, including mortgage-backed securities, to be *substantially the same, all* the following criteria must be met:[4]

a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same.[5]

b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.[6]

c. The debt instruments must bear the identical contractual interest rate.

d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield.[7]

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[4] See footnote 1. [Footnote added, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

[5] The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered *substantially the same.* [Footnote renumbered, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

[6] For example, the following exchanges would not meet this criterion: GNMA I securities for GNMA II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary "in form and type"); commercial paper for redeemable preferred stock. [Footnote renumbered, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

[7] For example, the exchange of a "fast-pay" GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a "slow-pay" GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields. [Footnote renumbered, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.

f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted "good delivery" standard for the type of mortgage-backed security involved.[8]

Effective Date and Transition

.14 The conclusions of this statement of position should be applied prospectively to transactions entered into after March 31, 1990. Earlier application to transactions occurring in periods for which financial statements have not been issued is encouraged. However, previously issued annual or interim financial statements should not be restated.

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[8] Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in *Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities*, which is published by PSA. [Footnote renumbered, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

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[The next page is 79,271.]

Section 10,460

Statement of Position 90-7 Financial Reporting by Entities in Reorganization Under the Bankruptcy Code

November 19, 1990

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

Introduction

.01 This statement of position (SOP) was prepared by the Task Force on Financial Reporting by Entities in Reorganization Under the *Bankruptcy Code* to provide guidance on financial reporting by entities that have filed petitions with the *Bankruptcy Court* and expect to reorganize as going concerns under *Chapter 11* of title 11 of the United States Code ("Chapter 11").[1]

Petition, Proceeding, and Plan

.02 An entity enters reorganization under Chapter 11 by filing a petition with the Bankruptcy Court, an adjunct of the United States District Courts. The filing of the *petition* starts the *reorganization proceeding*. The goal of the proceeding is to maximize recovery by creditors and shareholders by preserving it as a viable entity with a going concern value. For that purpose, the entity prepares a *plan of reorganization* intended to be confirmed by the court. The plan provides for treatment of all the assets and liabilities of the debtor, which might result in forgiveness of indebtedness. For the plan to be confirmed and the reorganization proceedings thereby concluded, the consideration to be received by parties in interest under the plan must exceed the consideration they would otherwise receive on liquidation of the entity under *Chapter 7* of the

[1] A glossary of defined terms, which are in *italics* when they first appear in the text, is in paragraph .69.

Bankruptcy Code. The court may confirm a plan even if some classes of creditors or some of the stockholders have not accepted it, provided that it meets standards of fairness required by Chapter 11 to the dissenting class of creditors or the dissenting stockholders.

.03 The plan is the heart of every Chapter 11 reorganization. The provisions of the plan specify the treatment of all creditors and equity holders upon its approval by the Bankruptcy Court. Moreover, the plan shapes the financial structure of the entity that emerges.

.04 Chapter 11 provides that, unless a *trustee* is appointed, the debtor has the exclusive right to file a plan for the first 120 days of the case, or such longer or shorter time as the Bankruptcy Court decrees, for cause. If a plan is filed within the exclusive period, additional time is provided to allow the debtor to obtain plan acceptance. The appointment of the trustee immediately terminates the debtor's exclusive right to file a plan, and any party in interest may then do so.

.05 Except to the extent that specific debts are determined by the Bankruptcy Court not to be discharged by the plan, the provisions of a *confirmed plan* bind the debtor, any entity issuing securities under the plan, any entity acquiring assets under the plan, and any creditor, equity security holder, or general partner in the debtor, regardless of whether the *claim* is impaired under the plan and whether such creditor, equity security holder, or general partner has accepted the plan. A claim is impaired if, subject to certain rights to cure defaults, its legal rights are affected adversely by the plan.

.06 In general, except as provided in the plan or in the order confirming the plan, confirmation of the plan discharges the debtor from all preconfirmation claims and terminates all rights and interest of equity security holders or general partners as provided for in the plan.

.07 The Bankruptcy Court confirms a plan if it finds all of the following:

- The plan and the plan proponent have complied with various technical requirements of the Bankruptcy Code.
- Disclosures made in soliciting acceptance of the plan have been adequate.
- Dissenting members of *consenting classes of impaired claims* would receive under the plan at least the amount they would have received under a Chapter 7 proceeding.
- Claims entitled to priority under the Bankruptcy Code will be paid in cash.
- Confirmation of the plan is not likely to be followed by liquidation or further reorganization.
- At least one class of impaired claims, apart from insiders, has accepted the plan.
- The plan proponent has obtained the consent of all impaired classes of claims or equity securities, or the plan proponent can comply with the *cram-down provisions* of the Bankruptcy Code. (Under the cram-down provisions, the court may confirm a plan even if one or more classes of holders of impaired claims or equity securities do not accept it, as long as the court finds the plan does not discriminate unfairly and is fair and equitable to each *nonconsenting class* impaired by the plan.)

.08 In general, a *secured claim* is deemed to be treated fairly and equitably if it remains adequately collateralized and will receive a stream of payments whose discounted value equals the amount of the secured claim on the effective date of the plan. In general, an *unsecured claim* is deemed to be treated fairly and equitably if it receives assets whose discounted value equals the allowed amount of the claim, or if the holder of any claim or equity security interest that is junior to the dissenting class will not receive or retain any assets under the plan. Similarly, an equity security interest is deemed fairly and equitably treated if that interest receives assets whose discounted value equals the greatest of any fixed liquidation preference, any fixed redemption price, or the value of such interest, or if no junior equity security interest will receive any assets under the plan.

Reorganization Value

.09 An important part of the process of developing a plan is the determination of the *reorganization value* of the entity that emerges from bankruptcy. Reorganization value generally approximates fair value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after the restructuring. The reorganization value of an entity is the amount of resources available and to become available for the satisfaction of postpetition liabilities and *allowed claims* and interest, as negotiated or litigated between the *debtor-in-possession* or trustee, the creditors, and the holders of equity interests. Reorganization value includes the sum of the value attributed to the reconstituted entity and other assets of the debtor that will not be included in the reconstituted entity. Reorganization value and the terms of the plan are determined only after extensive arms-length negotiations or litigation between the interested parties. Before the negotiations, the debtor-in-possession, creditors, and equity holders develop their own ideas on the reorganization value of the entity that will emerge from Chapter 11. Several methods are used to determine the reorganization value; however, generally it is determined by discounting future cash flows for the reconstituted business that will emerge from Chapter 11 and from expected proceeds or collections from assets not required in the reconstituted business, at rates reflecting the business and financial risks involved.

The Disclosure Statement

.10 A *disclosure statement* approved by the court is transmitted to all parties entitled to vote on the plan at or before the time their acceptance of the plan is solicited. The disclosure statement provides information that enables them to make informed judgments about the plan.

.11 No postpetition solicitation of acceptance of a plan may be made unless by the time of the solicitation a disclosure statement previously approved by the Bankruptcy Court has been sent to those whose acceptance is required. The disclosure statement must contain adequate information, which is defined in the Bankruptcy Code as information that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan, as far as it is reasonably practicable to provide in light of the nature and history of the *emerging entity* and the condition of the emerging entity's records. Examples of the kinds of items that may be included in disclosure statements to provide such information include a summary of the reorganization plan, historical and prospective financial information, and a pro forma balance sheet reporting the reorganization value and the capital structure of the emerging entity.

.12 What constitutes adequate information depends on the circumstances of the entity in Chapter 11, the nature of the plan, and the sophistication of the various classes whose acceptance is required. Although a valuation is not required for a Bankruptcy Court's approval of a disclosure statement, the instances in which valuations are not made are generally restricted to those in which the reorganization value of the emerging entity is greater than the liabilities or in which holders of existing voting shares retain more than 50 percent of the emerging entity's voting shares when the entity emerges from reorganization.

.13 After reorganization proceedings have started, acceptances of a plan may not be solicited by any person without a disclosure statement approved by the court, but acceptances obtained before the proceedings started may be counted if (*a*) they were solicited in compliance with applicable nonbankruptcy law governing the adequacy of disclosure or (*b*) there is not any applicable nonbankruptcy law but there was in fact adequate information provided at the time of the prebankruptcy solicitation of acceptances of the plan.

Current Literature and Reporting Practices

.14 The current financial reporting literature provides no specific guidance for financial reporting by entities in reorganization proceedings. Entities generally continue to apply the financial reporting principles they applied before filing petitions; these principles usually do not adequately reflect all changes in the entity's financial condition caused by the proceeding. The financial statements prepared while entities are in Chapter 11 reorganization are therefore not as useful to users of financial statements as they should be. For example, the Bankruptcy Code allows the debtor to reject executory contracts such as leases and take-or-pay contracts. Some entities report the resulting claims at the estimated amounts of the allowed claims, while others report them at the estimated amounts at which they will be settled.

.15 Another area in which reporting is diverse during the Chapter 11 reorganization is the classification of liabilities. Some entities report all *prepetition liabilities* as current, whereas others report them as long-term debt or as a separate item between current and long-term liabilities. Financial Accounting Standards Board (FASB) Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced,* states that all short-term obligations resulting from transactions in the normal course of business that are due in customary terms, such as trade payables, advance collections, and accrued expenses, are to be classified as current liabilities. However, FASB Statement No. 6 does not address reporting by entities in Chapter 11 reorganization whose unsecured debt may not be paid without approval of the Bankruptcy Court and therefore may neither be paid within one year, or the operating cycle, if longer, nor satisfied with current assets.

.16 Further, the financial reporting literature provides no specific guidance for financial reporting by entities emerging from Chapter 11 reorganization under confirmed plans. As a result, practice is diverse. For example, FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* in footnote 4, and FASB Technical Bulletin No. 81-6, *Applicability of Statement 15 to Debtors in Bankruptcy Situations,* indicate that Statement No. 15 does not apply to troubled debt restructurings in which debtors restate their liabilities generally under the purview of the Bankruptcy Court. A majority of reorganizations of businesses result in general restructuring of liabilities, and considerable confusion exists on how to report the restructured liabilities. FASB Interpretation No. 2, *Imputing Interest on Debt Arrangements Made under the Federal Bankruptcy Act,* states that Accounting Principles Board (APB) Opinion 21, *Interest on Receivables and Payables,* should apply to cases under the Bankruptcy Code. However, that interpretation was superseded by FASB Statement No. 15. An analysis of reporting by entities emerging from bankruptcy indicates that some report their debt at discounted amounts and others follow the guidelines in FASB Statement No. 15.

.17 There is no specific guidance on whether an emerging entity should restate assets. For example, some restate their assets—though there generally is no net write-up—through quasi-reorganizations, and others do not. An analysis of reporting by emerging entities indicates that some eliminate deficits in their retained earnings by reducing additional paid-in capital while others retain such deficits.

Scope

.18 This statement of position applies to financial reporting both by entities that have filed petitions with the Bankruptcy Court and expect to reorganize as going concerns under Chapter 11 and by entities that have emerged from Chapter 11 (emerging entities) under confirmed plans.

.19 It does not apply to entities that restructure their debt outside Chapter 11, to governmental organizations, or to entities that liquidate or adopt plans of liquidation under the Bankruptcy Code.

Conclusions

.20 The following is a summary of the conclusions reached by the Accounting Standards Division. They should be read in conjunction with the discussion of conclusions, which follows this summary and explains the basis for the conclusions.

Financial Reporting During Reorganization Proceedings

.21 Entering a reorganization proceeding, although a significant event, does not ordinarily affect or change the application of generally accepted accounting principles followed by the entity in the preparation of its financial statements. However, the needs of financial statement users change, and thus changes in the reporting practices previously followed by the entity are necessary.

.22 An objective of financial statements issued by an entity in Chapter 11 should be to reflect its financial evolution during the proceeding. For that purpose, the financial statements for periods including and subsequent to filing the Chapter 11 petition should distinguish transactions and events that are directly associated with the reorganization from the ongoing operations of the business.

Balance Sheet

.23 The balance sheet of an entity in Chapter 11 should distinguish prepetition liabilities subject to compromise from those that are not (such as fully secured liabilities that are expected not to be compromised) and *postpetition liabilities.* Liabilities that may be affected by the plan should be reported at the amounts expected to be allowed, even if they may be settled for lesser amounts. If there is uncertainty about whether a secured claim is *undersecured,* or will be impaired under the Plan, the entire amount of the claim should be included with prepetition claims subject to compromise; such a claim should not be reclassified unless it is subsequently determined that the claim is not subject to compromise.

.24 Prepetition liabilities, including claims that become known after a petition is filed, should be reported on the basis of the expected amount of the allowed claims in accordance with FASB Statement No. 5, *Accounting for Contingencies,* as opposed to the amounts for which those allowed claims may be settled. Claims not subject to reasonable estimation should be disclosed in the notes to the financial statements based on the provisions of FASB Statement No. 5. Once these claims satisfy the accrual provisions of FASB Statement No. 5, they should be recorded in the accounts in accordance with the first sentence of this paragraph.

.25 Debt discounts or premiums as well as debt issue costs should be viewed as valuations of the related debt. When the debt has become an allowed claim and the allowed claim differs from the net carrying amount of the debt, the recorded amount should be adjusted to the amount of the allowed claim (thereby adjusting existing discounts or premiums, and deferred issue costs to the extent necessary to report the debt at this allowed amount). The gain or loss resulting from the entries to record the adjustment should be classified as *reorganization items,* as discussed in paragraph .27. Premiums and discounts as well as debt issuance cost on debts that are not subject to compromise, such as fully secured claims, should not be adjusted.

.26 Liabilities subject to compromise should be segregated from those that are not subject to compromise on the balance sheet. The principal categories of the claims subject to compromise should be disclosed in the notes to the financial statements. Circumstances arising during reorganization proceedings may require a change in the classification of liabilities between those subject to compromise and those not subject to compromise. Liabilities not subject to compromise should be further segregated into current and noncurrent classifications if the entity presents a classified balance sheet.

Statement of Operations

.27 The statement of operations should portray the results of operations of the reporting entity while it is in Chapter 11. Revenues, expenses (including professional fees), realized gains and losses, and provisions for losses resulting from the reorganization and restructuring of the business should be reported separately as reorganization items, except for those required to be reported as discontinued operations and extraordinary items in conformity with APB Opinion 30, *Reporting the Results of Operations*, as amended by FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*. [Revised, March 2003, to reflect conforming changes necessary due to the issuance of FASB Statement Nos. 144 and 145.]

.28 Some entities defer professional fees and similar types of expenditures until the plan is confirmed and then reduce gain from debt discharge to the extent of the previously deferred expenses. Others accrue professional fees and similar types of expenditures upon the filing of the Chapter 11 petition. Still others expense professional fees and similar types of expenditures as incurred. The task force concluded that professional fees and similar types of expenditures directly relating to the Chapter 11 proceeding do not result in assets or liabilities and thus should be expensed as incurred and reported as reorganization items.

.29 Interest expense should be reported only to the extent that it will be paid during the proceeding or that it is probable that it will be an allowed priority, secured, or unsecured claim. Interest expense is not a reorganization item. The extent to which reported interest expense differs from stated contractual interest should be disclosed. The task force understands that the staff of the Securities and Exchange Commission (SEC) prefers that SEC registrants disclose this parenthetically on the face of the statement of operations.

.30 Interest income earned by an entity in Chapter 11 that it would not have earned but for the proceeding (normally all interest income) should be reported as a reorganization item.

Statement of Cash Flows

.31 Reorganization items should be disclosed separately within the operating, investing, and financing categories of the statement of cash flows. This presentation can be better accomplished by the use of the direct method of presenting the statement. If the indirect method is used, details of operating cash receipts and payments resulting from the reorganization should be disclosed in a supplementary schedule or in the notes to the financial statements.

Condensed Combined Financial Statements

.32 Consolidated financial statements that include one or more entities in reorganization proceedings and one or more entities not in reorganization proceedings should include condensed combined financial statements of the entities in reorganization proceedings. The combined financial statements should be prepared on the same basis as the consolidated financial statements.

.33 Intercompany receivables and payables of entities in reorganization proceedings should be disclosed in the condensed combined financial statements. In addition, the propriety of the carrying amounts of intercompany receivables from entities in Chapter 11 should be evaluated.

Earnings Per Share

.34 Earnings per share should be reported, when required, in conformity with FASB Statement No. 128, *Earnings Per Share*. If it is probable that the plan will require the issuance of common stock or common stock equivalents, thereby diluting current equity interests, that fact should be disclosed. [Revised, March 2003, to reflect conforming changes necessary due to the issuance of FASB Statement No. 128.]

Financial Reporting When Entities Emerge From Chapter 11 Reorganization

.35 Entities whose plans have been confirmed by the court and have thereby emerged from Chapter 11 should apply the reporting principles in the following paragraphs as of the confirmation date or as of a later date when all material conditions precedent to the plan's becoming binding are resolved.

Fresh-Start Reporting

.36 If the reorganization value of the assets of the emerging entity immediately before the date of confirmation is less than the total of all postpetition liabilities and allowed claims, and if holders of existing voting shares immediately before confirmation receive less than 50 percent of the voting shares of the emerging entity, the entity should adopt fresh-start reporting upon its emergence from Chapter 11. The loss of control contemplated by the plan must be substantive and not temporary. That is, the new controlling interest must not revert to the shareholders existing immediately before the plan was filed or confirmed.

.37 While the court determines the adequacy of the disclosure statement, entities that expect to adopt fresh-start reporting should report information about the reorganization value in the disclosure statement, so that creditors and stockholders can make an informed judgment about the plan. The most likely place to report the reorganization value is in the pro forma balance sheet that is commonly part of the disclosure statement. Because reorganization value may not have been allocated to individual assets concurrently with the preparation of the pro forma balance sheet included in the disclosure statement in some cases, it may be necessary to include in the pro forma balance sheet a separate line item to reflect the difference of the total reorganization value of the emerging entity over recorded amounts. When possible, reorganization value should be segregated into major categories.

.38 Entities that adopt fresh-start reporting in conformity with paragraph .36 should apply the following principles:

- The reorganization value of the entity should be allocated to the entity's assets in conformity with the procedures specified by FASB Statement No. 141, *Business Combinations*.[*] If any portion of the reorganization value cannot be attributed to specific tangible or identified intangible assets of the emerging entity, such amounts should be reported as goodwill in accordance with paragraph 6 of FASB Statement No. 142, *Goodwill and Other Intangible Assets*.
- Each liability existing at the plan confirmation date, other than deferred taxes, should be stated at present values of amounts to be paid determined at appropriate current interest rates.[*]
- Deferred taxes should be reported in conformity with generally accepted accounting principles. Benefits realized from preconfirmation net operating loss carryforwards should first reduce reorganization value in excess of amounts allocable to identifiable assets and other intangibles until exhausted and thereafter be reported as a direct addition to paid-in capital.[*]

[Revised, March 2003, to reflect conforming changes necessary due to the issuance of FASB Statement Nos. 141 and 142. Revised, May 2008, to reflect conforming changes necessary due to the issuance of FASB Staff Position (FSP) SOP 90-7-1, *An Amendment of AICPA Statement of Position 90-7*.]

.39 The financial statements of the entity as of and for the period immediately preceding the date determined in conformity with the guidance in paragraph .35 should reflect all activity through that date in conformity with the guidance in paragraphs .21 through .34. Additionally, the effects of the adjustments on the reported amounts of individual assets and liabilities resulting from the adoption of fresh-start reporting and the effects of the forgiveness of debt should be reflected in the predecessor entity's final statement of operations. Forgiveness of debt, if any, should be reported as an extinguishment of debt and classified in accordance with

[*] Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141 (revised 2007), *Business Combinations*, should be applied. [Footnote added, May 2008, due to the issuance of FASB Statement No. 141(R).]

APB Opinion 30, as amended.[†] Adopting fresh-start reporting results in a new reporting entity with no beginning retained earnings or deficit. When fresh-start reporting is adopted, the notes to the initial financial statements should disclose the following:

- Adjustments to the historical amounts of individual assets and liabilities.
- The amount of debt forgiveness.
- Significant matters relating to the determination of reorganization value, such as:

— The method or methods used to determine reorganization value and factors such as discount rates, tax rates, the number of years for which cash flows are projected, and the method of determining *terminal value*.

— Sensitive assumptions—that is, assumptions about which there is a reasonable possibility of the occurrence of a variation that would have significantly affected measurement of reorganization value.

— Assumptions about anticipated conditions that are expected to be different from current conditions, unless otherwise apparent.

[Revised, March 2003, to reflect conforming changes necessary due to the issuance of FASB Statement No. 145.]

Comparative Financial Statements

.40 Chapter 2A of Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*, state the following in paragraph 1:

> The presentation of comparative financial statements in annual and other reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the enterprise.

Paragraph 3 of that chapter requires comparative financial statements that are presented to be comparable from year to year, with any exceptions to comparability being clearly disclosed. Fresh-start financial statements prepared by entities emerging from Chapter 11 will not be comparable with those prepared before their plans were confirmed because they are, in effect, those of a new entity. Thus, comparative financial statements that straddle a confirmation date should not be presented.[2]

Reporting by Entities Not Qualifying for Fresh Start

.41 Entities emerging from Chapter 11 that do not meet the criteria in paragraph .36 do not qualify for a fresh start. Liabilities compromised by confirmed plans should be stated at present values of amounts to be paid,

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[†] FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*, eliminated the requirement to classify all gains and losses associated with extinguishment of debt as extraordinary items. As noted in paragraph A5 of FASB Statement No. 145, the rescission of FASB Statement No. 4 does not preclude gains and losses from extinguishment of debt that meet the criteria in APB Opinion 30 from being classified as extraordinary items. [Footnote added, March 2003, to reflect conforming changes necessary due to the issuance of FASB Statement No. 145; Footnote renumbered due to the issuance of FASB Statement No. 141(R), May 2008.]

[2] The SEC and other regulatory agencies may require the presentation of predecessor financial statements. However, such presentations should not be viewed as a continuum because the financial statements are those of a different reporting entity and are prepared using a different basis of accounting, and, therefore, are not comparable. Attempts to disclose and explain exceptions that affect comparability would likely result in reporting that is so unwieldy it would not be useful.

determined at appropriate current interest rates. Forgiveness of debt, if any, should be reported as an extinguishment of debt and classified in accordance with APB Opinion 30, as amended. ‡ [Revised, March 2003, to reflect conforming changes necessary due to the issuance of FASB Statement No. 145.]

.42 Because this statement of position applies to financial reporting for entities that enter and intend to emerge from Chapter 11 reorganization, quasi-reorganization accounting should not be used at the time of the reorganization.

Discussion of Conclusions

Reporting Prepetition Liabilities

.43 The task force believes that entities in Chapter 11 reorganization should segregate liabilities subject to compromise from those that are not subject to compromise. Therefore, prepetition liabilities that may be impaired by a plan and that are eligible for compromise because they are either unsecured or undersecured should be separately classified and designated in the balance sheet as prepetition liabilities subject to compromise, because that provides the most meaningful presentation while in Chapter 11 reorganization.

.44 The financial reporting literature does not specifically address the balance sheet classification issues that result from filing a petition. Guidance for classifying liabilities as current in a classified balance sheet is provided in paragraph 7 of ARB No. 43, chapter 3A, which states the following:

> The term *current liabilities* is used to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classified as current assets, or the creation of other current liabilities . . . .

Trade payables that are incurred in the normal course of business are usually classified as current in classified balance sheets because they meet the ARB No. 43 criteria cited above. However, filing a petition generally causes the payment of unsecured or undersecured prepetition liabilities to be prohibited before the plan is confirmed. The Chapter 11 reorganization ending in confirmation of a plan typically takes more than one year or one operating cycle, if longer.

.45 It might be argued that prepetition liabilities classified as current in a classified balance sheet, such as trade payables, should retain that classification under the provisions of FASB Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced.* That Statement requires all short-term liabilities incurred in the normal course of business and due in customary terms to be classified as current. Other short-term liabilities are excluded from the current liability classification under FASB Statement No. 6 if the entity intends to refinance the obligations on a long-term basis and such intent is supported by the facts. However, FASB Statement No. 6 does not address what occurs when a petition is filed.

.46 FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor,* amended paragraph 7 of ARB No. 43, chapter 3A, by

‡ FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*, eliminated the requirement to classify all gains and losses associated with extinguishment of debt as extraordinary items. As noted in paragraph A5 of FASB Statement No. 145, the rescission of FASB Statement No. 4 does not preclude gains and losses from extinguishment of debt that meet the criteria in APB Opinion 30 from being classified as extraordinary items. [Footnote added, March 2003, to reflect conforming changes necessary due to the issuance of FASB Statement No. 145; Footnote renumbered due to the issuance of FASB Statement No. 141(R), May 2008.]

requiring current liabilities classification in a classified balance sheet for long-term liabilities that, by their terms, are due on demand or will be due on demand within one year, or the operating cycle, if longer. This definition also includes long-term liabilities that are or will be callable by the creditor because of a violation of a provision of the debt agreement. The *automatic stay provisions* of Chapter 11 make it unnecessary to reclassify prepetition long-term liabilities even though prepetition creditors might demand payment or there is a violation of a covenant in the debt agreement.

.47 Prepetition liabilities should be reported at the amounts of allowed claims—that is, at the amount allowed by the court, even though such liabilities may not be paid in full.

.48 When prepetition claims become known after a petition is filed (for example, a claim resulting from the rejection of an operating lease), they should be reported at the estimated amounts of the allowed claims. Some believe that such prepetition claims should be reported at estimates of the settlement amounts. However, these prepetition claims should be reported at an amount allowed by the court because that is the amount of the liability until it is settled and the use of allowed amounts is consistent with the amounts at which other prepetition liabilities are stated and thereby provides comparability among the various kinds of claims.

Statement of Operations

.49 Losses as a result of restructuring or disposal of assets directly related to reorganization proceedings are best included as reorganization items to the extent that they are not otherwise reported as part of the results of discontinued operations in conformity with APB Opinion 30, *Reporting the Results of Operations*. That does not result in reclassification of revenues and expenses from operations sold or abandoned, except those that meet the criteria in APB Opinion 30. Rather, gains or losses classified as reorganization items might include a gain or loss on disposal of assets plus related employee costs and charges or other costs directly related to the assets disposed of or the operations restructured. Also, income, expenses, realized gains, and losses that can be directly associated with the proceeding are best segregated and presented as reorganization items in the statement of operations. Examples include interest income (as indicated in paragraph .30), professional fees, and losses on executory contracts.[3]

.50 The task force believes that segregation of reorganization items provides meaningful disclosure and is consistent with APB Opinion 30, paragraph 26, which states the following:

> A material event or transaction that is unusual in nature or occurs infrequently but not both, and therefore does not meet both criteria for classification as an extraordinary item, should be reported as a separate component of continuing operations.

Interest Expense

.51 Certain provisions of the Bankruptcy Code may relieve the entity from its obligation to pay interest. Generally, interest on secured claims accrues only to the extent that the value of underlying collateral exceeds the principal amount of the secured claim. In addition, interest on unsecured claims does not

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[3] Appendix A [paragraph .67] illustrates a statement of operations that includes reorganization items.

accrue during the proceeding if the entity is insolvent; therefore, disclosure of contractual interest is considered useful because it may differ from interest actually being reported.

Interest Income

.52 An entity in reorganization typically accumulates cash during the proceeding because it is not paying its obligations currently. The cash ultimately is distributed to creditors or others in conformity with the plan. The amount of cash accumulated does not reflect the entity's prepetition activities, and it is not expected that such an accumulation would recur in the reorganized entity. The interest income earned during the proceeding on cash accumulated during the proceeding, therefore, is a reorganization item. To the extent that management can reasonably estimate that portion of interest income applicable to normal invested working capital, it should be reported as an operating item in the ordinary manner.

Statement of Cash Flows

.53 FASB Statement No. 95, *Statement of Cash Flows*, requires information on the cash activity of reporting entities. The task force believes that such information is the most beneficial information that can be provided in the financial statements of an entity in Chapter 11. It also believes the direct method is the better method to provide such information by such entities.

.54 Paragraph 27 of FASB Statement No. 95 lists the operating items that should be reported separately when the direct method is used. That paragraph encourages further breakdown of those operating items if the entity considers such a breakdown meaningful and it is feasible to do so. Further identification of cash flows from reorganization items should be provided to the extent feasible. For example, interest received might be segregated between estimated normal recurring interest received and interest received on cash accumulated because of the reorganization. Appendix A [paragraph .67] illustrates a statement of cash flows for an entity operating under Chapter 11.

Fresh-Start Reporting

.55 The effects of a plan should be included in the entity's financial statements as of the date the plan is confirmed. However, inclusion should be delayed to a date not later than the effective date if there is a material unsatisfied condition precedent to the plan's becoming binding on all the parties in interest or if there is a stay pending appeal. That might occur, for example, if obtaining financing for the plan or for the transfer of material assets to the debtor by a third party is a condition to the plan's becoming effective.

.56 Financial statements prepared as of the date after the parties in interest have approved a plan through the voting process, and issued after the plan has been confirmed by the court, should report the effects of the plan if there are no material unsatisfied conditions.

.57 An essential element in negotiating a plan with the various classes of creditors and equity interests is the determination of reorganization value by the parties in interest. The plan provides for allocating the reorganization value among the parties in interest in accordance with their legal priorities: first to secured claims to the extent of the value of the collateral securing the claims, then to claims entitled to priority under the Bankruptcy Code, and then to the various classes of unsecured debt and equity interests in accordance with their legal priorities or as the parties may otherwise agree. In the event that the parties in interest cannot agree on the reorganization value and presumably the plan of reorganization, the court may be called upon to determine the reorganization value of the entity before a plan of reorganization can be confirmed.

.58 The task force concluded that reorganization value can be a more objective measure of fair value than a purchase price in a business combination. This view is based on two factors. First, a purchase price in a nonbankruptcy business combination may exceed the fair value of the acquired entity, because such determinations may be influenced by a variety of factors unrelated to that entity. Second, in the reorganization process, extensive information available to the parties in interest, the adversarial negotiation process, the involvement of the Bankruptcy Court, the use of specialists by one or more of the parties in interest, and the fact that all elements of the determination are focused solely on the economic viability of the emerging entity result in an objective and reliable determination of reorganization value.

.59 If, based on reorganization value, the parties in interest allow the entity to survive as a going concern and emerge from Chapter 11, the financial reporting should reflect that fact. The ability to reflect reorganization value would enhance the representational faithfulness of the emerging entity's financial statements.

.60 Under the *absolute priority doctrine* of the Bankruptcy Code, if the amount of postpetition liabilities and allowed claims exceeds the reorganization value of the emerging entity, existing shareholders lose their legal right to any economic interest without the consent of creditors. Therefore, any equity interest in the emerging entity ultimately held by existing shareholders is given to them by the creditors. Among the reasons the creditors might give such shareholders equity interests in the emerging entity are to avoid the expensive and time-consuming legal proceedings necessary to implement the cram-down provisions of the Bankruptcy Code or to preserve continuity of management.

.61 Based on the factors described in paragraphs .57, .58, and .60, some would conclude that the combination of change in majority ownership and voting control—that is, loss of control by the existing shareholders, a court-approved reorganization, and a reliable measure of the entity's fair value—results in a fresh start, creating, in substance, a new reporting entity. Others believe that a change in control and the exchange of debt and equity based on reorganization value is in substance an acquisition at fair value by new shareholders in exchange for extinguishing their debt. Although the former shareholders can receive a portion of the new equity, they have lost their rights to any equity interest in the reorganized entity and receive such interest only with the consent of the real stakeholders, the creditors who will become the new shareholders. The task force concluded that under each view a new reporting entity is created and assets and liabilities should be recorded at their fair values. That is, assets should be recorded on the basis of reorganization value and liabilities should be recorded at fair value.

.62 Some believe that the recognition of reorganization value in the balance sheet of an emerging entity that meets the criteria for fresh-start reporting should be limited to no net write-up of assets, similar to the SEC staff's interpretation of FRR Section 210 (ASR 25). That view is a combination of the notion that assets and liabilities should be reported at fair value in a fresh start and the belief that assets cannot be written up in a historical cost transaction-based accounting model. The task force did not accept that view for the reasons stated in paragraph .61.

Fair Value of Liabilities

.63 In a typical Chapter 11 reorganization, there is a general restructuring of liabilities. FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* does not apply in a general restructuring of liabilities.

.64 A general restructuring of liabilities involves negotiation between the parties in interest. The negotiation and distribution under the confirmed plan constitutes an exchange of resources and obligations. By analogy, the guidance provided by APB Opinion 16[||] for recording liabilities assumed in a business combination accounted for as a purchase should be applied in reporting liabilities by an entity emerging from Chapter 11.

Analogous Literature

.65 The task force believes that the principles of quasi-reorganization accounting are not applicable to Chapter 11 reorganizations. Some argue that such a requirement would conflict with ARB No. 43 because it would prohibit adopting an accounting procedure that is now generally accepted. The task force does not believe that is the case. ARB No. 43 relates to a procedure called a quasi-reorganization. Webster's dictionary defines *quasi* as "having some resemblance." The task force interprets ARB No. 43 to apply to situations that resemble but are not reorganizations under Chapter 11. There is no specific guidance for a legal reorganization, so practice has sometimes looked to ARB No. 43 when reporting a legal reorganization. The task force believes that is the case with many emerging entities. This statement of position provides specific guidance for all reorganizations under Chapter 11, and an analogy to ARB No. 43 is not appropriate.

Effective Date and Transition

.66 This entire statement of position shall become effective for financial statements of enterprises that have filed petitions under the Bankruptcy Code after December 31, 1990. Additionally, for enterprises that file petitions prior to January 1, 1991, and that have plans of reorganization confirmed after June 30, 1991, paragraphs .35 through .42 of this SOP shall be applied to their financial statements. Earlier application by entities in reorganization is encouraged.

[||] Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141(R) should be applied by analogy. [Footnote added, May 2008, due to the issuance of FASB Statement No. 141(R).]

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Appendix A

Illustrative Financial Statements and Notes to Financial Statements for an Entity Operating Under Chapter 11

A-1. XYZ Company is a manufacturing concern headquartered in Tennessee, with a fiscal year ending on December 31. On January 10, 19X1, XYZ filed a petition for relief under Chapter 11 of the federal bankruptcy laws. The following financial statements (balance sheet and statements of operations and cash flows) are presented as of and for the year ended December 31.

XYZ Company
(Debtor-in-Possession)
Balance Sheet
December 31, 19X1

Assets	*(000s)*
Current Assets	
Cash	$ 110
Accounts receivable, net	300
Inventory	250
Other current assets	30
Total current assets	690
Property, plant and equipment, net	430
Goodwill	210
Total Assets	$1,330

Liabilities and Shareholders' Deficit	*(000s)*	
Liabilities Not Subject to Compromise		
Current Liabilities:		
Short-term borrowings	$ 25	
Accounts payable—trade	200	
Other liabilities	50	
Total current liabilities	275	
Liabilities Subject to Compromise	1,100	(a)
Total liabilities	1,375	
Shareholders' (deficit):		
Preferred stock	325	
Common stock	75	
Retained earnings (deficit)	(445)	
	(45)	
Total Liabilities & Shareholders' (Deficit)	$ 1,330	

(a) Liabilties subject to compromise consist of the following:

Secured debt, 14%, secured by first mortgage on building	$ 300,000	(b)
Priority tax claims	50,000	
Senior subordinated secured notes, 15%	275,000	
Trade and other miscellaneous claims	225,000	
Subordinated debentures, 17%	250,000	
	$1,100,000	

(b) The secured debt in this case should be considered, due to various factors, subject to compromise.

The accompanying notes are an integral part of the financial statements.

XYZ Company
(Debtor-in-Possession)
Statement of Operations
For the Year Ended December 31, 19X1
(000s)

	19X1
Revenues:	
Sales	$2,400
Cost and expenses:	
Cost of goods sold	1,800
Selling, operating and administrative	550
Interest (contractual interest $5)	3
	2,353
Earnings before reorganization items and income tax benefit	47
Reorganization items:	
Loss on disposal of facility	(60)
Professional fees	(50)
Provision for rejected executory contracts	(10)
Interest earned on accumulated cash resulting from Chapter 11 proceeding	1
	(119)
Loss before income tax benefit and discontinued operations	(72)
Income tax benefit	10
Loss before discontinued operations	(62)
Discontinued operations:	
Loss from operations of discontinued products segment	(56)
Net loss	$ (118)
Loss per common share:	
Loss before discontinued operations	$ (.62)
Discontinued operations	$ (.56)
Net loss	$ (1.18)

The accompanying notes are an integral part of the financial statements.

XYZ Company
(Debtor-in-Possession)
Statement of Cash Flows
For the Year Ended December 31, 19X1
Increase in Cash and Cash Equivalents
(000s)

	19X1
Cash flows from operating activities:	
Cash received from customers	$ 2,220
Cash paid to suppliers and employees	(2,070)
Interest paid	(3)
Net cash provided by operating activities before reorganization items	147
Operating cash flows from reorganization items:	
Interest received on cash accumulated because of the Chapter 11 proceeding	1
Professional fees paid for services rendered in connection with the Chapter 11 proceeding	(50)
Net cash used by reorganization items	(49)
Net cash provided by operating activities	98
Cash flows from investing activities:	
Capital expenditures	(5)
Proceeds from sale of facility due to Chapter 11 proceeding	40
Net cash provided by investing activities	35
Cash flows used by financing activities:	
Net borrowings under short-term credit facility (post petition)	25
Repayment of cash overdraft	(45)
Principal payments on prepetition debt authorized by court	(3)
Net cash provided by financing activities	(23)
Net increase in cash and cash equivalents	110
Cash and cash equivalents at beginning of year	—
Cash and cash equivalents at end of year	$ 110
Reconciliation of net loss to net cash provided by operating activities	
Net loss	$ (118)
Adjustments to reconcile net loss to net cash provided by operating activities	
Depreciation	20
Loss on disposal of facility	60
Provision for rejected executory contracts	10
Loss on discontinued operations	56
Increase in postpetition payables and other liabilities	250
Increase in accounts receivable	(180)
Net cash provided by operating activities	$ 98

The accompanying notes are an integral part of the financial statements.

XYZ Company
Notes to Financial Statements
December 31, 19X1

Note X—Petition for Relief Under Chapter 11

On January 10, 19X1, XYZ Company (the "Debtor") filed petitions for relief under Chapter 11 of the federal bankruptcy laws in the United States Bankruptcy Court for the Western District of Tennessee. Under Chapter 11, certain claims against the Debtor in existence prior to the filing of the petitions for relief under the federal bankruptcy laws are stayed while the Debtor continues business operations as Debtor-in-possession. These claims are reflected in the December 31, 19X1, balance sheet as "liabilities subject to compromise." Additional claims (liabilities subject to compromise) may arise subsequent to the filing date resulting from rejection of executory contracts, including leases, and from the determination by the court (or agreed to by parties in interest) of allowed claims for contingencies and other disputed amounts. Claims secured against the Debtor's assets ("secured claims") also are stayed, although the holders of such claims have the right to move the court for relief from the stay. Secured claims are secured primarily by liens on the Debtor's property, plant, and equipment.

The Debtor received approval from the Bankruptcy Court to pay or otherwise honor certain of its prepetition obligations, including employee wages and product warranties. The Debtor has determined that there is insufficient collateral to cover the interest portion of scheduled payments on its prepetition debt obligations. Contractual interest on those obligations amounts to $5,000, which is $2,000 in excess of reported interest expense; therefore, the debtor has discontinued accruing interest on these obligations. Refer to note XX [*see Appendix B (paragraph .68), note X*] for a discussion of the credit arrangements entered into subsequent to the Chapter 11 filings.

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Appendix B

Fresh-Start Accounting and Illustrative Notes to Financial Statements

B-1. The Bankruptcy Court confirmed XYZ's plan of reorganization as of June 30, 19X2. It was determined that XYZ's reorganization value computed immediately before June 30, 19X2, the date of plan confirmation, was $1,300,000, which consisted of the following:

Cash in excess of normal operating requirements generated by operations	$ 150,000
Net realizable value of asset dispositions	75,000
Present value of discounted cash flows of the emerging entity	1,075,000
Reorganization value	$1,300,000

XYZ Company adopted fresh-start reporting because holders of existing voting shares immediately before filing and confirmation of the plan received less than 50% of the voting shares of the emerging entity and its reorganization value is less than its postpetition liabilities and allowed claims, as shown below:

Postpetition current liabilities	$ 300,000
Liabilities deferred pursuant to Chapter 11 proceeding	1,100,000
Total postpetition liabilities and allowed claims	1,400,000
Reorganization value	(1,300,000)
Excess of liabilities over reorganization value	$ 100,000

B-2. The reorganization value of the XYZ Company was determined in consideration of several factors and by reliance on various valuation methods, including discounting cash flow and price/earnings and other applicable ratios. The factors considered by XYZ Company included the following:

- Forecasted operating and cash flow results which gave effect to the estimated impact of
  - — Corporate restructuring and other operating program changes
  - — Limitations on the use of available net operating loss carryovers and other tax attributes resulting from the plan of reorganization and other events
- The discounted residual value at the end of the forecast period based on the capitalized cash flows for the last year of that period
- Market share and position
- Competition and general economic considerations
- Projected sales growth
- Potential profitability

- Seasonality and working capital requirements

B-3. After consideration of XYZ Company's debt capacity and other capital structure considerations, such as industry norms, projected earnings to fixed charges, earnings before interest and taxes to interest, free cash flow to interest, and free cash flow to debt service and other applicable ratios, and after extensive negotiations among parties in interest, it was agreed that XYZ's reorganization capital structure should be as follows:

Postpetition current liabilities	$ 300,000	
IRS note	50,000	
Senior debt	275,000	(1)
Subordinated debt	175,000	
Common stock	350,000	
	$1,150,000	(2)

(1) Due $50,000 per year for each of the next four years, at 12% interest, with $75,000 due in the fifth year.

(2) See paragraph B-5 for the balance sheet adjustments required to reflect XYZ Company's reorganization value as of the date of plan confirmation.

B-4. The following entries record the provisions of the plan and the adoption of fresh-start reporting:

Entries to record debt discharge:		
Liabilities subject to compromise	1,100,000	
Senior debt—current		50,000
Senior debt—long-term		225,000
IRS note		50,000
Cash		150,000
Subordinated debt		175,000
Common stock (new)		86,000
Additional paid-in capital		215,000
Gain on debt discharge		149,000
Entries to record exchange of stock for stock:		
Preferred stock	325,000	
Common stock (old)	75,000	
Common stock (new)		14,000
Additional paid-in capital		386,000
Entries to record the adoption of fresh-start reporting and to eliminate the deficit:		
Inventory	50,000	
Property, plant, and equipment	175,000	
Reorganization value in excess of amounts allocable to identifiable assets	175,000	
Gain on debt discharge	149,000	
Additional paid-in capital	351,000	
Goodwill		200,000
Deficit		700,000

B-5. The effect of the plan of reorganization on XYZ Company's balance sheet, as of June 30, 19X2, is as follows:

		Adjustments to Record Confirmation of Plan			
	Preconfirmation	*Debt discharge*	*Exchange of stock*	*Fresh Start*	*XYZ Company's Reorganized Balance Sheet*
Assets:					
Current Assets					
Cash	$ 200,000	$ (150,000)			$ 50,000
Receivables	250,000				250,000
Inventory	175,000			$ 50,000	225,000
Assets to be disposed of valued at market, which is lower than cost	25,000				25,000
Other current assets	25,000				25,000
	675,000	(150,000)		50,000	575,000
Property, plant, and equipment	175,000			175,000	350,000
Assets to be disposed of valued at market, which is lower than cost	50,000				50,000
Goodwill	200,000			(200,000)	
Reorganization value in excess of amounts allocable to identifiable assets				175,000	175,000
	$1,100,000	$ (150,000)		$ 200,000	$1,150,000
Liabilities and Shareholders' Deficit:					
Liabilities Not Subject to Compromise Current liabilities					
Short-term borrowings	$ 25,000				$ 25,000
Current maturities of senior debt		$ 50,000			50,000
Accounts payable trade	175,000				175,000
Other liabilities	100,000				100,000
	300,000	50,000			350,000
Liabilities Subject to Compromise					
Prepetition liabilities	1,100,000	(1,100,000)			
IRS note		50,000			50,000
Senior debt, less current maturities		225,000			225,000
Subordinated debt		175,000			175,000
Shareholders' deficit:					
Preferred stock	325,000		$(325,000)		
Additional paid-in capital		215,000	386,000	$(351,000)	250,000
Common stock-old	75,000		(75,000)		
Common stock-new		86,000	14,000		100,000
Retained earnings (deficit)	(700,000)	149,000		700,000 (149,000)	
	(300,000)	450,000	0	200,000	350,000
	$1,100,000	$ (150,000)	$ 0	$ 200,000	$1,150,000

B-6. The following illustrative footnote disclosure discusses the details of XYZ Company's confirmed plan of reorganization. In this illustration a tabular presentation entitled "Plan of Reorganization Recovery Analysis" is incorporated in the footnote. The plan of reorganization recovery analysis may alternatively be presented as supplementary information to the financial statements.

Note X—Plan of Reorganization

On June 30, 19X2, the Bankruptcy Court confirmed the Company's plan of reorganization. The confirmed plan provided for the following:

Secured Debt—The Company's $300,000 of secured debt (secured by a first mortgage lien on a building located in Nashville, Tennessee) was exchanged for $150,000 in cash and a $150,000 secured note, payable in annual installments of $27,300 commencing on June 1, 19X3, through June 1, 19X6, with interest at 12% per annum, with the balance due on June 1, 19X7.

Priority Tax Claims—Payroll and withholding taxes of $50,000 are payable in equal annual installments commencing on July 1, 19X3, through July 1, 19X8, with interest at 11% per annum.

Senior Debt—The holders of approximately $275,000 of senior subordinated secured notes received the following instruments in exchange for their notes: (*a*) $87,000 in new senior secured debt, payable in annual installments of $15,800 commencing March 1, 19X3, through March 1, 19X6, with interest at 12% per annum, secured by first liens on certain property, plants, and equipment, with the balance due on March 1, 19X7; (*b*) $123,000 of subordinated debt with interest at 14% per annum due in equal annual installments commencing on October 1, 19X3, through October 1, 19X9, secured by second liens on certain property, plant, and equipment; and (*c*) 11.4% of the new issue of outstanding voting common stock of the Company.

Trade and Other Miscellaneous Claims—The holders of approximately $225,000 of trade and other miscellaneous claims received the following for their claims: (*a*) $38,000 in senior secured debt, payable in annual installments of $6,900 commencing March 1, 19X3, through March 1, 19X6, with interest at 12% per annum, secured by first liens on certain property, plants, and equipment, with the balance due on March 1, 19X7; (*b*) $52,000 of subordinated debt, payable in equal annual installments commencing October 1, 19X3, through October 1, 19X8, with interest at 14% per annum; and (*c*) 25.7% of the new issue of outstanding voting common stock of the Company.

Subordinated Debentures—The holders of approximately $250,000 of subordinated unsecured debt received, in exchange for the debentures, 48.9% of the new issue outstanding voting common stock of the Company.

Preferred Stock—The holders of 3,250 shares of preferred stock received 12% of the outstanding voting common stock of the new issue of the Company in exchange for their preferred stock.

Common Stock—The holders of approximately 75,000 outstanding shares of the Company's existing common stock received, in exchange for their shares, 2% of the new outstanding voting common stock of the Company.

The Company accounted for the reorganization using fresh-start reporting. Accordingly, all assets and liabilities are restated to reflect their reorganization value, which approximates fair value at the date of reorganization. The following table ("Plan of Reorganization Recovery Analysis") summarizes the adjustments required to record the reorganization and the issuance of the various securities in connection with the implementation of the plan.

XYZ Company
Plan of Reorganization
Recovery Analysis

		Recovery								*Total Recovery*	
		Elimination of Debt and Equity	*Surviving Debt*	*Cash*	*IRS Note*	*Senior Debt*	*Subordinated Debt*	*Common Stock*[#] *%*	*Common Stock*[#] *Value*	*$*	*%*
Postpetition liabilities	$ 300,000		$300,000							$ 300,000	100%
Claim / Interest											
Secured debt	300,000			$150,000		$150,000				300,000	100
Priority tax claim	50,000				$50,000					50,000	100
Senior debt	275,000	$ (25,000)				87,000	$123,000	11.4%	$ 40,000	250,000	91
Trade and other miscellaneous claims	225,000	(45,000)				38,000	52,000	25.7	90,000	180,000	80
Subordinated debentures	250,000	(79,000)						48.9	171,000	171,000	68
	1,100,000										
Preferred stockholders	325,000	(283,000)						12	42,000	42,000	
Common stockholders	75,000	(68,000)						2.0	7,000	7,000	
Deficit	(700,000)	700,000									
Total	$1,100,000	$ 200,000	$300,000	$150,000	$50,000	$275,000	$175,000	100%	$350,000	$1,300,000	

[#] The aggregate par value of the common stock issued under the plan is $100,000. [Footnote renumbered due to the issuance of FASB Statement No. 141(R), May 2008.]

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Glossary

Absolute priority doctrine. A doctrine that provides that if an impaired class does not vote in favor of a plan, the court may nevertheless confirm the plan under the cram-down provisions of the Bankruptcy Code. The absolute priority doctrine is triggered when the cram-down provisions apply. The doctrine states that all members of the senior class of creditors and equity interests must be satisfied in full before the members of the second senior class of creditors can receive anything, and the full satisfaction of that class must occur before the third senior class of creditors may be satisfied, and so on.

Administrative expenses (claims). Claims that receive priority over all other unsecured claims in a bankruptcy case. Administrative claims (expenses) include the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case. Fees paid to professionals for services rendered after the petition is filed are considered administrative expenses.

Allowed claim(s). The amount allowed by the Court as a claim against the Estate. This amount may differ from the actual settlement amount.

Automatic stay provisions. Provisions causing the filing of a petition under the Bankruptcy Code to automatically stay virtually all actions of creditors to collect prepetition debts. As a result of the stay, no party, with minor exceptions, having a security or adverse interest in the debtor's property can take any action that will interfere with the debtor or the debtor's property, regardless of where the property is located or who has possession, until the stay is modified or removed.

Bankruptcy Code. A federal statute, enacted October 1, 1979, as title 11 of the United States Code by the Bankruptcy Reform Act of 1978, that applies to all cases filed on or after its enactment and that provides the basis for the current federal bankruptcy system.

Bankruptcy Court. The United States Bankruptcy Court is an adjunct of the United States District Courts. Under the jurisdiction of the District Court, the Bankruptcy Court is generally responsible for cases filed under Chapters 7, 11, 12, and 13 of the Bankruptcy Code.

Chapter 7. A liquidation, voluntarily or involuntarily initiated under the provisions of the Bankruptcy Code, that provides for liquidation of the business or the debtor's estate.

Chapter 11. A reorganization action, either voluntarily or involuntarily initiated under the provisions of the Bankruptcy Code, that provides for a reorganization of the debt and equity structure of the business and allows the business to continue operations. A debtor may also file a plan of liquidation under Chapter 11.

Claim. As defined by Section 101(4) of the Bankruptcy Code, (*a*) a right to payment, regardless of whether the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, secured, or unsecured, or (*b*) a right to an equitable remedy for breach of performance if such breach results in a right to payment, regardless of whether the right is reduced to a fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured right.

Confirmed plan. An official approval by the court of a plan of reorganization under a Chapter 11 proceeding that makes the plan binding on the debtors and creditors. Before a plan is confirmed, it must satisfy eleven requirements in section 1129(a) of the Bankruptcy Code.

Consenting classes. Classes of creditors or stockholders that approve the proposed plan.

Cram-down provisions. Provisions requiring that for a plan to be confirmed, a class of claims or interests must either accept the plan or not be impaired. However, the Bankruptcy Code allows the Court under certain conditions to confirm a plan even though an impaired class has not accepted the plan. To do so, the plan must not discriminate unfairly and must be fair and equitable to each class of claims or interests impaired under the plan that have not accepted it. The Code states examples of conditions for secured claims, unsecured claims, and stockholder interests in the fair and equitable requirement.

Debtor-in-possession. Existing management continuing to operate an entity that has filed a petition under Chapter 11. The debtor-in-possession is allowed to operate the business in all Chapter 11 cases unless the court, for cause, authorizes the appointment of a trustee.

Disclosure statement. A written statement containing information approved as adequate by the court. It is required to be presented by a party before soliciting the acceptance or rejection of a plan of reorganization from creditors and stockholders affected by the plan. Adequate information means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan.

Emerging entity (reorganized entity). An entity that has had its plan confirmed and begins to operate as a new entity.

Impaired claims. In determining which class of creditors' claims or stockholders' interests must approve the plan, it is first necessary to determine if the class is impaired. A class of creditors' claims or stockholders' interests under a plan is not impaired if the plan (*a*) leaves unaltered the legal, equitable, and contractual right of a class, (*b*) cures defaults that lead to acceleration of debt or equity interest, or (*c*) pays in cash the full amount of the claim, or for equity interests, the greater of the fixed liquidation preference or redemption price.

Nonconsenting class. A class of creditors or stockholders that does not approve the proposed plan.

Obligations subject to compromise. Includes all prepetition liabilities (claims) except those that will not be impaired under the plan, such as claims where the value of the security interest is greater than the claim.

Petition. A document filed in a court of bankruptcy, initiating proceedings under the Bankruptcy Code.

Plan (plan of reorganization). An agreement formulated in Chapter 11 proceedings under the supervision of the Bankruptcy Court that enables the debtor to continue in business. The plan, once confirmed, may affect the rights of undersecured creditors, secured creditors, and stockholders as well as those of unsecured creditors. Before a plan is confirmed by the Court, it must comply with general provisions of the Code. Those provisions mandate, for example, that (*a*) the plan is feasible, (*b*) the plan is in the best interest of the creditors, and, (*c*) if an impaired class does not accept the plan, the plan must be determined to be fair and equitable before it can be confirmed.

Postpetition liabilities. Liabilities incurred subsequent to the filing of a petition that are not associated with prebankruptcy events. Thus, these liabilities are not considered prepetition liabilities.

Prepetition liabilities. Liabilities that were incurred by an entity prior to its filing of a petition for protection under the Code, including those considered by the Bankruptcy Court to be prepetition claims, such as a rejection of a lease for real property.

Reorganization items. Items of income, expense, gain, or loss that are realized or incurred by an entity because it is in reorganization.

Reorganization proceeding. A Chapter 11 case from the time at which the petition is filed until the plan is confirmed.

Reorganization value. The value attributed to the reconstituted entity, as well as the expected net realizable value of those assets that will be disposed before reconstitution occurs. Therefore, this value is viewed as the fair value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after the restructuring.

Secured claim. A liability that is secured by collateral. A fully secured claim is one where the value of the collateral is greater than the amount of the claim.

Terminal value. Reorganization value calculated based on the discounting of cash flows normally consists of three parts: (*a*) the discounted cash flows determined for the forecast period, (*b*) residual value or terminal value, and (*c*) the current value of any excess working capital or other assets that are not needed in reorganization. Terminal or residual value represents the present value of the business attributable to the period beyond the forecast period.

Trustee. A person appointed by the Bankruptcy Court in certain situations based on the facts of the case, not related to the size of the company or the amount of unsecured debt outstanding, at the request of a party in interest after a notice and hearing.

Undersecured claim (liability). A secured claim whose collateral is worth less than the amount of the claim.

Unsecured claim (liability). A liability that is not secured by collateral. In the case of an undersecured creditor, the excess of the secured claim over the value of the collateral is an unsecured claim, unless the debtor elects in a Chapter 11 proceeding to have the entire claim considered secured. The term is generally used in bankruptcy to refer to unsecured claims that do not receive priority under the Bankruptcy Code.

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[The next page is 79,451.]

Section 10,500

Statement of Position 92-1 Accounting for Real Estate Syndication Income

February 6, 1992

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Introduction

.01 This statement of position (SOP) provides guidance for the recognition of income from real estate syndication activities. Syndication activities are efforts to directly or indirectly sponsor the formation of entities that acquire interests in real estate by raising funds from investors. As consideration for their investments, the investors receive ownership of or other financial interests in the sponsored entities.

.02 The sponsored entities are generally organized as limited partnerships, trusts, or joint ventures, but they may also be organized in other forms. For convenience, the term *partnership* is used in this SOP to refer to such entities regardless of their form.

Scope

.03 This SOP applies to the recognition of income from real estate syndication activities and to all entities that perform those activities. For purposes of applying the guidance in this SOP, entities that perform real estate syndication activities are syndicators regardless of whether their primary business is related to real estate syndication. Entities that may function as syndicators include real estate companies, brokers and dealers in securities, banks, savings and loan associations, insurance companies, finance companies, and entities organized solely to syndicate real estate.

.04 This SOP applies to the combined activities of entities in the consolidated or combined financial statements of syndicators, including those entities in which the syndicators have investments accounted for under the equity method, as set forth in Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. However, it does not apply to the separate financial statements of subsidiaries or affiliates of syndicators, unless such entities are also considered to be syndicators on the basis of the separate activities included in their consolidated or combined financial statements. For example, this SOP does not apply to the separate financial statements issued by a broker-dealer subsidiary of a syndicator if the role of the subsidiary and its subsidiaries, if any, in the transaction is limited to the sale of partnership interests.

.05 This SOP does not address accounting by the partnerships in which the interests are syndicated, and it does not apply to syndications of assets other than real estate.

Definitions

.06 Significant terms used in this SOP are defined as follows:

Blind pool or partially blind pool partnerships. Partnerships in which investment units are sold before some or all of the properties to be acquired are identified.

Flip transactions. Transactions in which syndicators acquire ownership interests and resell them to the partnerships shortly thereafter.

Investor notes. Promissory notes, generally with full recourse, that are payable by investors to partnerships in connection with purchases of partnership interests.

Ownership interests. Title to real estate or other interests in real estate, such as partnership interests or shares in joint ventures; also, options or contracts to acquire specified real estate or real estate interests.

Partnership notes. Notes payable to syndicators by partnerships in connection with acquisitions of property or in payment of fees. Partnership notes may be collateralized by investor notes, mortgages, or other liens against partnership assets.

Syndication activities. Efforts to directly or indirectly sponsor the formation of entities that acquire interests in real estate by raising funds from investors. As consideration for their investments, the investors receive ownership or other financial interests in the sponsored entities. For purposes of applying the guidance in this SOP, all general partners in syndicated partnerships are deemed to perform syndication activities.

Syndication (or securities-placement) fees. Compensation, including commissions and reimbursement of expenses, for selling debt or equity interests in partnerships. Such fees are generally paid in cash, notes, or partnership interests.

Background

.07 In order to earn commissions and fees, syndicators perform a variety of services and activities. For example, they organize partnerships, sell (syndicate) debt or equity interests in the partnerships to third parties, sell real estate to the partnerships, arrange for the partnerships to purchase real estate directly from (or sell it directly to) third parties, develop partnership properties, supervise construction of partnership properties, raise or provide funds for use by the partnerships, provide income or cash-flow guarantees to the partnerships, and provide initial and long-term property management services to the partnerships. They also earn income from a variety of other sources, such as incentive arrangements and participations in profits on future sales of real estate by the partnerships.

.08 Syndicators may receive cash, notes or other receivables, partnership interests, or rights to share in the proceeds of the sale or refinancing of the properties. At the time of syndication, partnerships generally pay cash to the syndicators for portions of their fees. The sources of the cash are generally initial payments by the investors to the partnerships or proceeds of borrowings secured by investor notes. Subsequent payments are expected to be made to the syndicators based on the availability of cash from installments on investor notes, partnership operations, mortgage refinancing, or sales of properties.

.09 Syndicators may arrange for partnerships to acquire properties in the following ways:

- By acquiring ownership interests and reselling them to the partnerships in flip transactions
- By selling to the partnerships properties that the syndicators already own, or by transferring options or contracts to buy properties
- By arranging for the partnerships to acquire the properties directly from third parties

Selling prices may be greater than the syndicators' acquisition costs, or the syndicators may receive compensation for arranging the acquisitions.

.10 In some syndication transactions, the syndicators have substantial risks of ownership in properties they sell to the partnerships or arrange for the partnerships to acquire, as indicated by some or all of the following characteristics:

- The partnerships make only nominal down payments.
- The syndicators receive partnership notes that are subject to future subordination by the partnerships to the claims of other creditors.
- The syndicators, or affiliates of the syndicators, are general partners in the partnerships.
- The syndicators are obligated to or intend to continue supporting the properties after syndication.

.11 In some syndication transactions, the syndicators market no-load investment units.[1] Some syndicators that sponsor such transactions initially own the entire partnership and, after completing the syndication, generally retain an ownership interest in the partnership. Other syndicators that do not initially have an ownership interest in the partnership generally receive an ownership interest in lieu of selling commissions. In addition, syndicators that market no-load investment units pay expenses related to organization and syndication activities in excess of contractual reimbursement allowances, such as charges for lawyers and broker-dealers. Such syndicators generally expect

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[1] The North American Securities Administrators' Association, Inc. (NASAA) defines a carried interest in the "Real Estate Programs" section of its *Statements of Policy* as an equity interest (other than a "promotional interest") that participates in all allocations and distributions and for which full consideration is neither paid nor to be paid. A syndication in which the syndicator receives a carried interest is known in the industry as a "no load" offering.

to recover their costs by charging fees for various other services, such as property acquisition and asset management.

.12 Investors in partnerships expect to realize appreciation, earn operating income, receive distributions of cash, obtain tax benefits, or obtain some or all of those benefits. The interests in real estate may be represented by direct ownership, mortgages, master leases, sale-leasebacks, or options to acquire real estate. Some partnership agreements require investors to pay their total capital contributions to the partnerships immediately; others require the investors to pay some cash immediately and permit them to issue investor notes to the partnerships for the balance.

Current Practice

.13 Syndicators use various methods of accounting for income from syndications. Some recognize profit on the sales of real estate in conformity with Financial Accounting Standards Board (FASB) Statement No. 66, *Accounting for Sales of Real Estate*, and recognize additional fee income either as part of the real estate sales transactions or separately. Others believe that FASB Statement No. 66 does not apply to syndication transactions, and they either recognize all syndication profits immediately upon entering into the syndication transaction or follow methods based on discounting cash flows.

.14 Some syndicators that apply FASB Statement No. 66 to syndication transactions in which they sell real estate to the partnerships do not apply it to syndication transactions in which they do not have ownership interests in the real estate acquired by the partnerships.

.15 Some syndicators do not apply FASB Statement No. 66 to flip transactions because they believe the brief ownership period involved in a flip transaction is not substantive.

.16 Syndicators that use discounted cash-flow methods include in reported revenue the discounted amounts of expected cash flows from partnerships. The discount rates are determined by reference to the estimated market rate of interest, using APB Opinion No. 21, *Interest on Receivables and Payables*, as guidance. Discounts or premiums on notes are determined to the extent that the stated or implicit interest rates of the notes differ from the market rates of interest. Some syndicators use the stated payment periods of principal and interest in determining the timing of the expected cash flows from the notes, whereas others use anticipated payment dates corresponding to the dates on which the syndicators expect the properties to be sold.

.17 Some syndicators determine the projected depreciated cost of the properties and subtract the estimated balances of senior mortgage debt at the properties' anticipated dates of disposal (before the maturity of partnership notes). The difference is discounted to determine the amounts at which the partnership notes should be carried.

.18 Syndicators that use discounted cash-flow methods recognize the discounted amounts of notes received from partnerships as income at the time capital is raised from investors in the partnerships. In subsequent periods, discounts or premiums on the notes, if any, are recognized in income ratably using the interest method.

.19 Some syndicators recognize all revenue as of the date of syndication. Others use the guidance in FASB Statement No. 66 and, because of continuing involvement, defer recognizing some portion of the revenue.

.20 Some syndicators use the criteria in FASB Statement No. 66 to account for fee revenue from real estate syndication transactions because they believe the transactions are, in substance, sales of real estate.

.21 Some syndicators that account for fees by applying the revenue-recognition criteria in FASB Statement No. 66 exclude from the sales value of the properties, as the term *sales value* is defined in paragraph 7 of that Statement, some or all of the fees charged to the partnerships. Accordingly, they do not include the related payments of such fees in determining whether the buyers' initial and continuing investments in the properties are adequate for the seller to recognize profit in full on the sales. Other syndicators include all fees and related payments in determining sales value and in assessing whether the buyers' initial and continuing investment criteria have been met.

.22 Syndicators of blind pool or partially blind pool transactions are often entitled to nonrefundable syndication fees at the time of syndication, which would generally be before some or all of the properties are acquired by the partnerships. The general practice is to recognize nonrefundable syndication fees or partnership interests in income when received if there will be adequate fees to compensate the syndicators for whatever future services they may have to perform for the partnerships.

.23 Syndicators may receive or retain partnership interests as compensation for services. Some syndicators do not record their partnership interests, and others record them based principally on the following amounts:

- Estimated fair values
- The proportionate shares of (*a*) the amounts at which the syndicators carried the properties, if the syndicators had ownership interests in the properties, or (*b*) the partnerships' acquisition costs, if the syndicators never had ownership interests in the properties
- The costs incurred by the syndicators in excess of amounts charged to the partnerships
- Nominal amounts

Conclusions

.24 The following conclusions should be read in conjunction with the "Discussion of Conclusions and Implementation Guidance," beginning with paragraph .40 of this SOP, which explains the bases for the conclusions and provides guidance for implementing them.

Applicability of FASB Statement No. 66 to Syndication Activities

.25 FASB Statement No. 66 applies to the recognition of profit on the sale of real estate by syndicators to partnerships. This SOP concludes that the guidance in FASB Statement No. 66 should also be applied to the recognition of profit on real estate syndication transactions even if the syndicators never had ownership interests in the properties acquired by the real estate partnerships. For purposes of applying the profit recognition criteria of FASB Statement No. 66 to transactions in which syndicators never had such ownership interests, the syndicators should recognize profit on the transactions in the same way that they would have recognized such profit had they acquired the real estate and sold it to the partnerships.

Determining the Sales Value of Property and Fee Income

.26 All fees charged by syndicators should be included in the determination of sales value in applying FASB Statement No. 66, except (*a*) fees for which future services must be performed and (*b*) syndication fees. FASB Statement No. 66 does not apply to the recognition of fees excluded from sales value.

.27 *Fees for Future Services.* Syndicators should recognize fees for future services when they render the services. If fees designated for future services are excessive or inadequate, they should be adjusted for accounting purposes and the adjustments should be allocated to or from the real estate sales portion of the transaction. However, the buyer's initial and continuing investment should not include cash payments on amounts reallocated from fees for future services until the services have been performed.

.28 *Syndication Fees.* Syndicators should not recognize syndication fees until the earnings process is complete and collectibility is reasonably assured. Further, if a syndicator receives or retains a partnership interest as compensation for a portion of the syndication fee, the profit recognized on that portion of the fee should not exceed the amount that would be recognized by applying partial sale accounting to the underlying partnership interest, as set forth in paragraph .38 of this SOP.

.29 If stated syndication fees are not reasonable, they should be adjusted for accounting purposes to amounts that are reasonable, and the adjustments should be allocated to or from the real estate sales portion of the transaction. Guidance on accounting for nonrefundable fees received from blind pools before property acquisition is provided in paragraph .32 of this SOP.

.30 The syndication fee for a transaction, which consists of cash and the value of any notes or partnership interests designated as consideration for the syndication fee, is reasonable if it falls within the range of syndication fees charged by independent brokers in similar transactions and is at least adequate to reimburse the syndicator for amounts paid to independent brokers or other third parties associated with the transaction. The range of reasonable fees can generally be determined by reference to various sources, including independent brokers, publicly offered transactions, and industry-monitoring reports.

.31 If, in addition to cash or notes, a syndicator receives a partnership interest as compensation for the syndication fee, the syndicator should include the value of the partnership interest in determining the reasonableness of the syndication fee. If the amount of the syndication fee is determined not to be reasonable, the fee should be adjusted for accounting purposes, as described in paragraph .29 of this SOP. However, the adjustment should not reduce the syndication fee by more than the sum of the cash and notes received for the syndication fee. Further, the syndication fee should not be adjusted if all, or substantially all, of the compensation to the syndicator consists of partnership interests received or retained, as in the no-load transactions discussed in paragraph .11 of this SOP.

Accounting for Nonrefundable Fees Received From Blind Pools Before Property Acquisition

.32 Syndication fees received from blind pool transactions should be recognized in income ratably as the syndication partnership invests in property acquisitions, but only to the extent that the syndication fees are nonrefundable and meet all conditions for recognition in income, as set forth in paragraphs .28 to .31 of this SOP.

Exposure to Losses or Costs From Syndicator Involvement and Collectibility Risk

.33 If syndicators are exposed to future losses or costs from (*a*) material involvement with the properties, partnerships, or partners or (*b*) uncertainties regarding the collectibility of partnership notes, they should defer income recognition on syndication fees and fees for future services until the losses or costs can be reasonably estimated. Syndicators should reduce income recognized by the estimated losses or costs. The guidance in paragraphs 29 and 30 of FASB Statement No. 66 should be used in estimating potential losses or costs of support obligations. If such losses or costs cannot be estimated, the income recognized should be reduced by the maximum exposure. Paragraphs .61 to .63 of this SOP provide examples of syndicator involvement and uncertainties surrounding the collectibility of partnership notes that should be considered in recognizing real estate syndication income.

Allocating Cash Payments

.34 For the purpose of determining whether buyers' initial and continuing investments satisfy the requirements for recognizing profit in full in conformity with FASB Statement No. 66, cash received by syndicators should be allocated to unpaid syndication fees before being allocated to the initial and continuing investment. After the syndication fee has been fully paid, additional cash received should be allocated to unpaid fees for future services, to the extent that those services have been performed by the time the cash is received, before being allocated to the initial and continuing investment.

.35 If, at or near the time of syndication, syndicators pay cash or unconditionally commit to pay cash to the partners or partnerships or to third parties on behalf of the partners or partnerships, the syndicators should account for those amounts as reductions of cash received from the partnerships, rather than as separate cash outlays.

Recognition of Partnership Interests Received or Retained

.36 This SOP amends paragraph 32 of SOP 78-9, *Accounting for Investments in Real Estate Ventures* [section 10,240.32], which requires the investor's costs of services or intangibles contributed to a partnership or joint venture to be allocated to the cost of the investment. The following footnote is appended to paragraph 32 of that SOP immediately following the paragraph heading "Contribution of Services or Intangibles":

> The provisions of this paragraph do not apply to real estate syndication activities in which the syndicators receive or retain partnership interests. Such activities are discussed in SOP 92-1, *Accounting for Real Estate Syndication Income*.

.37 *Participation in Future Profits Without Risk of Loss.* If syndicators receive or retain limited partnership interests that are subordinate for any distributions to the majority class of ownership interests, they should generally account for the interests as participations in future profits without risk of loss. Profits should be recognized when they are realized, in conformity with paragraph 43 of FASB Statement No. 66.

.38 *Partial Sale.* If the partnership interests received by the syndicators have the same pro rata rights as the majority class of ownership interests for all distributions, the syndicators should account for their partnership interests as retained interests from partial sales of real estate, in conformity with FASB Statement No. 66, regardless of whether the syndicators ever held title to the underlying properties. Syndication fees should be accounted for as set forth in paragraphs .28 to .31 of this SOP.

Effective Date and Transition

.39 The recommendations in this SOP should be applied to transactions for which the initial closing with investors occurs after March 15, 1992. Earlier application is encouraged for financial statements that have not been previously issued.

Discussion of Conclusions and Implementation Guidance

.40 The following discussion explains the bases for the conclusions reached in this SOP and provides implementation guidance.

Applicability of FASB Statement No. 66 to Syndication Activities

.41 In some syndication transactions, the syndicator acquires the properties, or options to acquire the properties, and sells them to the partnership. Paragraph 1 of FASB Statement No. 66 indicates that such real estate sales transactions are within the scope of that Statement, as follows: "This Statement establishes standards for recognition of profit on all real estate sales transactions without regard to the nature of the seller's business." Ownership interests provide evidence that syndicators are sellers of real estate, and FASB Statement No. 66 therefore applies to real estate syndication transactions in which ownership interests in properties pass from the syndicators to the partnerships. FASB Statement No. 66 does not specify the duration of ownership, so it applies as much to a brief ownership as to a lengthy one.

.42 In other transactions, the syndicator arranges for the partnership to acquire the property from a third party without ever having acquired the property or an option to acquire the property. Although the form of such transactions differs from those described previously, the substance is the same: The syndicator is primarily compensated for arranging the acquisition of property by the partnership and for arranging the sale of partnership shares to investors. Accordingly, this SOP takes the position that the guidance in FASB Statement No. 66 should be applied to the recognition of profit on real estate syndication transactions even if the syndicators never had ownership interests in the properties acquired by the real estate partnerships.

.43 The following describes how a syndicator should apply the profit-recognition criteria in FASB Statement No. 66 to a real estate syndication transaction in which a partnership acquires real estate from a third party rather than from the syndicator:

- The syndicator should impute a purchase of the real estate from the third party at the amount paid by the partnership to the third party. The syndicator should also impute a corresponding sale of the real estate to the partnership at the same price.

- Except for fees for which future services must be performed and syndication fees, all fees charged by the syndicator to the partnership as part of the syndication transaction should be added to the sales price in the imputed sales transaction to arrive at the deemed sales value of the real estate syndication transaction.
- The syndicator should recognize profit on the real estate syndication transaction to the extent that profit could be recognized in conformity with FASB Statement No. 66 on an otherwise identical transaction with the deemed sales value described in the preceding bullet. In determining whether the partnership would meet the initial and continuing investment criteria for recognition of profit in full on the imputed sales transaction, as described in paragraphs 11 and 12 of FASB Statement No. 66, the syndicator should include amounts paid by the partnership to the third party on the real estate sale.

Example 1b of appendix B of this SOP [paragraph .73] illustrates the accounting methods described previously.

Determining the Sales Value of Property and Fee Income

.44 Paragraph 7 of FASB Statement No. 66 states that sales value is determined by—

a. Adding to the stated sales price the proceeds from the issuance of a real estate option that is exercised and other payments that are *in substance additional sales proceeds*. These nominally may be management fees, points, or prepaid interest or fees that are required to be maintained in an advance status and applied against the amounts due to the seller at a later date. [*Emphasis added.*]

b. Subtracting from the sale price a discount to reduce the receivable to its present value and by the net present value of services that the seller commits to perform without compensation or by the net present value of the services in excess of the compensation that will be received.

.45 In reviewing fees charged in connection with syndication transactions, the Real Estate Committee found that syndication fees and fees for future services are the only fees that are consistently separable from the corresponding real estate sales transaction. This SOP therefore concludes that all other fees should be included in the calculation of sales value, as described in part *a* of the foregoing quotation. This SOP also concludes that fees for future services associated with syndication transactions should be accounted for in the same manner as similar fees associated with real estate sales transactions, as described in part *b* of the foregoing quotation. Guidance on accounting for syndication fees is provided in paragraphs .28 to .31 of this SOP.

.46 *Fees for Future Services.* Fees for future services excluded from sales value include fees for managing properties and brokerage commissions on sales of properties by partnerships but do not include fees directly related to the acquisition or initial financing of syndication properties, such as cash flow guarantee fees, initial loan fees, and rent-up guarantee fees.

.47 Fees for future services that are deemed to be excessive or inadequate should be adjusted for accounting purposes. If the fees for future services are deemed to be excessive, the adjustments reduce amounts accounted for as fees for future services, and the sales value of the real estate is adjusted upward. However, until the services are performed, the syndicator remains contractually obligated to the partnership for the stated amount of the fees for future services regardless of whether they have been reallocated to sales value for reporting purposes. Payments made in consideration of such services are thus not included in the determination of the buyer's initial and continuing investment until the services are performed.

.48 Conversely, if the fees are deemed to be inadequate, the adjustments increase amounts accounted for as fees for future services. The sales value of the real estate is adjusted downward, because the real estate sales price is assumed to be overstated by the amount by which the fees for future services are understated. Furthermore, the payments made on the portion of sales value reallocated to fees for future services are not considered in evaluating whether the buyer has demonstrated a commitment to pay for the real estate, as described in paragraph 8 of FASB Statement No. 66. Profit is recognized on the amounts reallocated to the fees as the services are performed.

.49 *Syndication Fees.* This SOP recommends excluding syndication fees from sales value because they relate to the raising of equity rather than to the acquisition or operation of property. Recognition of syndication fees in income on completion of the earnings process is consistent with paragraph 11 of FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, which states that the "enterprise managing a loan syndication (the syndicator) shall recognize loan syndication fees when the syndication is complete."

.50 Syndication fees are usually paid in cash at the time of syndication, and thus, their inclusion in sales value would unsoundly accelerate recognition of income on the real estate transaction, because the cash received would be included in calculating the down payment on the transaction, as provided in paragraph 8 of FASB Statement No. 66.

.51 This SOP recommends adjusting unreasonable stated syndication fees for accounting purposes to amounts that are reasonable, and allocating the adjustments to the real estate sales portion of the transaction. Such adjustments are necessary to account for the substance of the transaction.

.52 Syndication fees are generally based on a percentage of funds raised from investors. The variety of real estate syndication transactions precludes the applicability of a particular rate of syndication fee in all circumstances. For example, the rate may be affected by—

- The size of the offering.
- The effort expected to be required to market the offering.
- The tax consequences to the partnership and to the investors.
- The stated syndication fees in similar syndication transactions.
- Regulatory constraints.
- Any payments to independent brokers or other independent third parties associated with the transaction.
- Any costs incurred in connection with the syndication, such as the preparation of offering circulars or prospectuses.
- The choice of a public or private offering.
- The existence of competitors.

.53 If the adjustments increase amounts accounted for as syndication fees, the sales value of the real estate is adjusted downward because the real estate sales price is considered to be overstated by the amount by which the syndication fees are understated. The adjustments reduce the sales value of the real estate, and the payments made on the portion of sales value reallocated to syndication fees are not considered in evaluating whether the partnership has demonstrated a commitment to pay for the real estate, as described in paragraph 8 of FASB Statement No. 66, because such payments do not give the partnership an increased stake in the property.

.54 Conversely, if adjustments reduce amounts accounted for as syndication fees, the sales value of the real estate is adjusted upward, and the payments made on the portion of sales value reallocated from syndication fees are accounted for as part of the partnership's initial or continuing investment in the property, because such payments create an increased stake in the property from the partnership's perspective.

.55 Example 2 in appendix B of this SOP [paragraph .73] illustrates transactions in which syndication fees are adjusted.

.56 Syndication fees should not be adjusted in transactions in which partnership interests are received or retained by the syndicators in lieu of cash syndication fees, as in the no-load transactions discussed in paragraph .11 of this SOP, because the partnership interests represent the total compensation to which the syndicator is entitled, unless additional future services are performed. To be consistent with that guidance, this SOP prohibits adjustment of the syndication fee by more than the sum of the cash and notes received for the syndication fee.

.57 *All Other Fees.* All fees charged by syndicators, other than syndication fees and fees for which future services must be performed, are included in the determination of sales value, in conformity with FASB Statement No. 66, because they cannot be consistently distinguished from the corresponding real estate transaction as discussed in paragraph .44 of this SOP.

Accounting for Nonrefundable Fees Received From Blind Pools Before Property Acquisition

.58 In blind pool and partially blind pool syndications, partnerships generally pay syndication fees to syndicators, or promise to pay them, before the syndicators acquire properties for the partnerships. Such fees are usually stated separately from the property acquisition fees.

.59 Although the syndication fees may be contractually nonrefundable even if the syndicators do not ultimately locate properties to acquire, a syndicator that could not successfully complete that phase of the transaction would soon be out of business. As a result, the earnings process is incomplete until both the partnership shares are sold and the corresponding properties are acquired.

.60 If the syndicator arranges for the partnership to acquire a property in which the syndicator has or expects to have significant involvement, or if the syndicator has a history of such transactions, revenue recognition should be deferred for all fees related to all properties, in conformity with the guidance in the following section.

Exposure to Losses or Costs From Syndicator Involvement and Collectibility Risk

.61 If syndicators are exposed to future losses or costs from (*a*) material involvement with the properties, partnerships, or partners or (*b*) uncertainties regarding the collectibility of partnership notes, they should defer income recognition on syndication fees and fees for future services until the losses or costs can be reasonably estimated. This SOP recommends that the syndicators reduce income recognized by the estimated losses or costs. The guidance in paragraphs 29 and 30 of FASB Statement No. 66 is used in estimating potential losses or costs of support obligations. If such losses or costs cannot be estimated, the income recognized should be reduced by the maximum exposure.

.62 *Involvement.* The following scenarios describe some common forms of involvement that may expose syndicators to future losses or costs:

- The syndicator agrees to reimburse the partnership or partners for any loss of amounts invested.
- The syndicator guarantees a minimum return on amounts invested by the partnership or partners.
- The syndicator is required to operate properties belonging to the partnership or partners, or to support the operations of those properties, at its own risk.
- The syndicator is required to construct or renovate properties acquired, or to be acquired, by the partnership or partners.
- The syndicator guarantees obligations or debt of the partnership or partners.

.63 *Collectibility.* The following factors associated with syndication transactions may expose syndicators to future losses or costs beyond those normally associated with the collection of receivables:

- Collection may depend primarily on income, cash flows, gain on sale, or gain on refinancing, which are affected by future events that cannot be assured.
- Minimal levels of capital in the partnership, coupled with operating losses, may dilute the equity of the partnership in the property to such an extent that the risk of loss by default no longer sufficiently motivates the partnership or partners to honor their obligations to the syndicators.
- Certain partnership notes (for example, notes in payment of syndication fees) may be unsecured or may otherwise be subject to future subordination, as described in paragraph 17 of FASB Statement No. 66. Syndicators should determine whether any notes accounted for as proceeds of real estate sales are subject to future subordination, particularly if notes originally designated for payment of syndication fees are adjusted and reclassified as sales proceeds in conformity with paragraphs .28 to .31 of this SOP.

Allocating Cash Payments

.64 Because syndication fees have historically been paid in cash at the time of syndication, all payments should be allocated to unpaid syndication fees before being allocated to any other unpaid amounts. After the syndication fee has been fully paid, additional cash received should be allocated to unpaid fees for future services excluded from sales value, to the extent those services have been performed by the time the cash is received, before being allocated to the initial and continuing investment and to fees included in sales value. Such additional cash received does not demonstrate an additional commitment to pay for the property, as described in paragraph 8 of FASB Statement No. 66, and applying it to the initial and continuing investment would thereby unsoundly accelerate the recognition of profit in full on the real estate sales portion of the transaction.

.65 Some transactions provide for syndicators to both receive cash from the partnerships and pay cash to them. Payments received by syndicators in such transactions may effectively be refundable to the extent that the syndicators later make payments to the partnerships. Consequently, if the syndicators pay cash to the partnerships or unconditionally commit to pay cash at or near the time of syndication, the syndicators should account for those amounts as reductions of cash already received from the partnerships, rather than as separate cash outlays. The reductions are allocated first to partnership down payment, next to other fees excluded from sales value to the extent performed, and last to syndication fees.

Recognition of Partnership Interests Received or Retained

.66 As stated in paragraph .36 of this SOP, syndication services for which partnership interests are received or retained are not contributions of services to the partnership, as described in paragraph 32 of SOP 78-9 [section 10,240.32]. They are, instead, services for which a syndication fee is paid through receipt or retention of the partnership interest. Such accounting is consistent with the premise of this SOP that the guidance in FASB Statement No. 66 should be applied to the recognition of profit on real estate syndication transactions.

.67 *Participation in Future Profits Without Risk of Loss.* Transfers of subordinate limited partnership interests by partnerships to syndicators are similar to transfers of rights to participate in future profits without risk of loss. The syndicators' profits are contingent upon the ability of the partnerships to produce sufficient profits to pay their majority security holders, and the syndicators are not liable for partnership losses. Paragraph 43 of FASB Statement No. 66 provides the following guidance for accounting for participations in future profits without risk of loss:

> If the transaction otherwise qualifies for recognition of profit by the full accrual method, the transfer of risks and rewards of ownership and absence of continuing involvement criterion shall be considered met. The contingent future profits shall be recognized when they are realized. [*Footnote omitted.*]

.68 *Partial Sale.* In general, syndicators should recognize as retained interests from partial sales of real estate those partnership interests received or retained that have the same pro rata rights as the majority class of ownership interests for all distributions. Partnership interests are typically received or retained as compensation for selling properties to partnerships, arranging sales of properties to partnerships by independent third parties, or performing other services in connection with syndication transactions.

.69 If a syndicator receives or retains a partnership interest as compensation for syndication services performed, the syndication fee for performing the services should be accounted for as follows:

a. All real estate owned by the partnership should be assumed to have been sold to the partnership by the syndicator, as described in paragraph .25 of this SOP.

b. The partnership interest received or retained by the syndicator should be accounted for as a retained interest from a partial sale of the real estate by the syndicator to the partnership, as described in paragraph .38 of this SOP.

c. The amount of profit recognized as the syndication fee should be equal to the carrying amount of such a retained interest.

.70 Paragraph 33 of FASB Statement No. 66 states that a "sale is a partial sale if the seller retains an equity interest in the property or has an equity interest in the buyer." That Statement requires the use of partial sale accounting if properties acquired by the partnerships are owned by the syndicators before the syndication transactions. As noted in the preceding paragraph and in paragraph .25 of this SOP, even if a syndicator never owns a property and, for example, a transaction is a sale of securities, the guidance in FASB Statement No. 66 should be applied if real estate is the principal underlying asset.

.71 If a syndicator receives or retains a general partnership interest in a limited partnership as consideration for the portion of the syndication transaction classified as a real estate sale, the syndicator should recognize any associated profit in conformity with FASB Statement No. 66. Receipt or retention of a general partnership interest may expose a syndicator to losses or costs that should be evaluated as described in paragraphs .33 and .61 to .63 of this SOP.

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Appendix A

Other Relevant Literature

A-1. This appendix provides background information on literature discussed only briefly in the body of this SOP. It also discusses literature that is not cited in the body of this SOP but that may be relevant, directly or by analogy, to the recognition of income from syndication activities.

FASB Statement No. 5, *Accounting for Contingencies*

A-2. Paragraph 17 of FASB Statement No. 5, *Accounting for Contingencies*, states: "Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization."

FASB Statement No. 13, *Accounting for Leases*

A-3. FASB Statement No. 13, *Accounting for Leases*, specifies the accounting by lessors of residual interests in real and personal property leased under leases accounted for as sales-type and direct financing leases. In general, unguaranteed residual values are determined at the inceptions of the leases, thereby affecting the amounts of income to be recognized over the lease terms. Residual values are required to be reviewed at least annually, and downward adjustments made currently, if declines in estimated residual values are deemed to be other than temporary.

FASB Statement No. 66, *Accounting for Sales of Real Estate*

A-4. Paragraphs 29 and 30 of FASB Statement No. 66 provide the following guidance for estimating potential costs of support obligations:

> 29. *The seller is required to initiate or support operations or continue to operate the property at its own risk, or may be presumed to have such a risk, for an extended period, for a specified limited period, or until a specified level of operations has been obtained, for example, until rentals of a property are sufficient to cover operating expenses and debt service.* If support is required or presumed to be required[10] for an *extended* period of time, the transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement. If support is required or presumed to be required for a *limited* time, profit on the sale shall be recognized on the basis of performance of the services required. Performance of those services shall be measured by the costs incurred and to be incurred over the period during which the services are performed. Profit shall begin to be recognized when there is reasonable assurance that future rent receipts will cover operating expenses and debt service including payments due the seller under the terms of the transaction. Reasonable assurance that rentals will be adequate would be indicated by objective information regarding occupancy levels and rental rates in the immediate area. In assessing whether rentals will be adequate to justify recognition of profit, total estimated future rent receipts of the property shall be reduced by one-third as a reasonable safety factor unless the amount so computed is less than the rents to be received from signed leases. In this event, the rents from signed leases shall be substituted for the computed amount . . . .
>
> 30. If the sales contract does not stipulate the period during which the seller is obligated to support operations of the property, support shall be presumed for at least two years from the time of initial rental unless actual rental operations cover operating expenses, debt service, and other contractual commitments before that time. If the seller is contractually obligated for a longer time, profit

recognition shall continue on the basis of performance until the obligation expires.

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[10] Support shall be presumed to be required if: (*a*) a seller obtains an interest as a general partner in a limited partnership that acquires an interest in the property sold; (*b*) a seller retains an equity interest in the property, such as an undivided interest or an equity interest in a joint venture that holds an interest in the property; (*c*) a seller holds a receivable from a buyer for a significant part of the sales price and collection of the receivable depends on the operation of the property; or (*d*) a seller agrees to manage the property for the buyer on terms not usual for the services to be rendered, and the agreement is not terminable by either the seller or the buyer.

FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*

A-5. Paragraphs 21 and 22 of FASB Technical Bulletin No. 88-1, *Issues Related to Accounting for Leases*, requires "wrap lease" transactions to be accounted for in the following manner:

Question 5

21. An enterprise purchases an asset, leases the asset to a lessee, obtains nonrecourse financing using the lease rentals or the lease rentals and the asset as collateral, sells the asset subject to the lease and the nonrecourse debt to a third-party investor, and leases the asset back while remaining the substantive principal lessor under the original lease (commonly referred to as a wrap lease transaction). Other than as required by Statement 13, as amended by Statements 28, 66, and 98, should an enterprise ever recognize any profit on the wrap lease transaction at its inception? If not, how should the enterprise account for the transaction?

Response

22. If the property involved is real estate, the provisions of Statement 98 apply to the sale-leaseback transaction. If the property involved is not real estate, the enterprise should account for the transaction as a sale-leaseback transaction. If the property involved is not real estate, the enterprise should account for the transaction as a sale-leaseback transaction in accordance with paragraphs 32–34 of Statement 13, as amended, and the lease to the end user should be accounted for as a sublease in accordance with paragraph 36 of Statement 13. Under Statement 13 the asset should be removed from the books of the original enterprise, the leaseback should be classified in accordance with paragraph 6 of Statement 13, and any gain on the transaction should be recognized or deferred and amortized in accordance with paragraph 33 of Statement 13, as amended. The enterprise would also reflect the retained residual interest, gross sublease receivable, nonrecourse third-party debt, the leaseback obligation, and the note receivable from the investor in the statement of financial position. As in accounting for a money-over-money lease transaction . . ., the sublease asset and the related nonrecourse debt should not be offset in the statement of financial position unless a right of setoff exists.

AICPA Statement of Position No. 78-9, *Accounting for Investments in Real Estate Ventures*

A-6. SOP 78-9 [section 10,240] provides guidance on accounting for investments in real estate ventures in financial statements prepared in conformity with generally accepted accounting principles. Paragraph 32 [section 10,240.32] states the following:

Contribution of Services or Intangibles. The division believes the accounting considerations that apply to real property contributed to a partnership or joint venture also apply to contributions of services or intangibles. The investor's cost of such services or intangibles to be allocated to the cost of the investment should be determined by the investor in the same manner as for an investment in a wholly owned real estate project.

A-7. Paragraph 37 [section 10,240.37] states the following:

If services are performed for a venture by an investor and their cost is capitalized by the venture, profit may be recognized by the investor to the extent attributable to the outside interests in the venture if the following conditions are met:

a. The substance of the transaction does not significantly differ from its form.

b. There are no substantial uncertainties about the ability of the investor to complete performance (as may be the case if the investor lacks experience in the business of the venture) or the total cost of services to be rendered.

c. There is a reasonable expectation that the other investors will bear their share of losses, if any.

The method of recognizing income from services rendered should be consistent with the method followed for services performed for unrelated parties.

FASB Emerging Issues Task Force Issue No. 85-37, *Recognition of Notes Received for Real Estate Syndication Activities*

A-8. Issue No. 85-37, *Recognition of Notes Received for Real Estate Syndication Activities*, discusses a number of methods of accounting for syndication transactions, including a method described as the "cash method," under which no carrying amount is recorded for notes receivable by syndicators from the partnerships except for portions of the notes that will be paid from the proceeds of the investors' contributions. The Emerging Issues Task Force (EITF) did not reach a consensus on the issue and referred it to the AICPA Real Estate Committee. However, the Securities and Exchange Commission (SEC) observer attending the EITF meeting stated that without a task force consensus, the SEC staff would challenge registrants that use a method other than the cash method. He also stated that the SEC objects to extending the 1980 AICPA Issues Paper *Accounting by Lease Brokers* to activities other than those of lease brokers. The SEC staff has also specifically objected to accretion of income on purchased, unguaranteed lease residuals and to income recognition and accretion of income on residual interests, realization of which depends on transactions whose occurrence in the future and whose terms are currently only anticipated.

AICPA Issues Paper, *Accounting by Lease Brokers*

A-9. The 1980 AICPA Issues Paper, *Accounting by Lease Brokers*, explicitly applies to equipment-leasing transactions, but the paper has been applied to real estate syndication transactions by analogy. Under lease-broker accounting, income is recognized at the inception of a lease based on cash received and the discounted amount of the expected residual (subject to an assessment of realizability). Until the FASB issued Technical Bulletin No. 86-2, *Accounting for an Interest in the Residual Value of a Leased Asset*, the residual could be accreted until realized. The amount of income to be recognized at the inception of a lease in money-over-money lease brokerage transactions was significantly restricted in FASB Technical Bulletin No. 88-1.

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Appendix B

Examples

Example 1

B-1. The following examples illustrate the determination of sales value, the allocation of cash payments, and the calculation of syndication fees, as described in paragraphs .26 to .31, .34, and .35 of this SOP.

B-2. ***Example 1a.*** A syndicator arranges for a newly formed partnership to acquire a single-tenancy property using part of the proceeds raised through the sale of partnership interests to unrelated third parties, as follows:

- Limited partners contribute $4,000, of which $700 is retained for working capital, and the unrelated general partner contributes $100.
- The partnership acquires real estate from the syndicator at the syndicator's cost of $20,000. The partnership gives the following consideration:
  - — $3,000 in cash.
  - — The assumption of a $16,250 nonrecourse first mortgage note, payable in monthly installments over fifteen years with interest at a market rate.
  - — A second mortgage note, payable to the syndicator for the balance of $750. The second mortgage is payable on the same terms as the first mortgage.
- The cash flow on the property is currently sufficient to meet the required principal and interest payments on the first and second mortgage notes.
- In addition, the syndicator receives the following:
  - — Syndication fee:

Cash	$ 100
Note bearing a market rate of interest due in three years secured by a lien on the property that is not subject to future subordination	300
	$ 400

  - — Other fees—rent-up fee for activities prior to acquisition (accounted for as part of sales value)

Cash	$ 300
Note bearing a market rate of interest due in three years secured by a lien on the property that is not subject to future subordination	650
	$ 950
Total fees	$ 1,350

Sales Value

Purchase price		$20,000
Other fees accounted for as part of sales value—rent-up fee for activities prior to acquisition		950
Adjusted sales value		$20,950

Cash Down Payment

Per sales contract		$ 3,000
Add: Fees paid in cash that are included in sales value	$300	
Less: Portion of syndication fee not paid in cash	300	-0-
Adjusted cash down payment		$ 3,000

Gain Calculation

Sales value	$20,950
Syndicator's cost	20,000
Gain	$ 950

Gain Recognition

Down-payment test:

$$\frac{\text{Down payment } \$3{,}000}{\text{Sales value } \$20{,}950} = 14\%$$

Required minimum down payment set forth in paragraph 54 of FASB Statement No. 66 15%

The sale does not meet the minimum required down-payment test for full profit recognition.

Use of the installment method[2] would result in profit recognition of:

$$\frac{\text{Down payment } \$3{,}000}{\text{Sales value } \$20{,}950} \times \$950 = \$136^{3}$$

Syndication Fee Recognition

The syndication fee of $400 is deemed to have been received in cash and, accordingly, to have been collected. In addition, the syndicator's involvement with the property does not indicate that a funding obligation by the syndicator is likely. Therefore, the entire fee is recognizable currently. The collectibility of the balance of the amount designated as the note in payment of the syndication fee ($300) is evaluated as part of the evaluation of the collectibility of all notes from the real estate sale.

If the $300 note were unsecured or otherwise subject to future subordination, profit to the extent of the note would be recognized under the cost-recovery

[2] The method used is consistent with FASB Emerging Issues Task Force Issue No. 88-24, *Effect of Various Forms of Financing under FASB Statement No. 66*.

[3] Because the seller's receivable of $1,700 ($750 second mortgage plus $300 designated for syndication fees plus $650 designated for other fees) for the sales price and the fees exceeds the amount of deferred gain of $814 ($950 total gain less $136 profit recognized), no additional gain is currently recognized.

method. Profit to be recognized under the installment method would thus be reduced to $650 ($950 total less $300 under the cost-recovery method) and recognized as follows:

$$\frac{\text{Down payment } \$3{,}000}{\text{Sales value } \$20{,}650^{4}} \times \$650 = \$94$$

B-3. ***Example 1b.*** The same facts apply as in example 1a, except that the property is purchased from an independent third party for $20,000.

Sales Value		
Same as in example 1a		$20,950
Cash Down Payment		
Same as in example 1a		$ 3,000
Gain Calculation		
Same as in example 1a		$ 950

Gain Recognition

Same as in example 1a

The sale does not meet the minimum required down-payment test for full profit recognition.

Use of the installment method would result in profit recognition of $136.

Syndication Fee Recognition

Same as in example 1a

B-4. ***Example 1c.*** The same facts apply as in example 1a, except that the syndicator retains a 3 percent limited partnership interest.

Sales Value		
Same as in example 1a		$20,950
Cash Down Payment		
Same as in example 1a		$ 3,000
Gain Calculation		
Sales value		$20,950
Syndicator's cost	$20,000	
Less: 3% limited partnership interest—partial sale	112[5]	19,888
Gain		$ 1,062

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[4] In the calculation of profit under the installment method, the $20,950 sales value determined in example 1a is reduced by the $300 note that is being recognized under the cost-recovery method.

[5] The $112 partial sale amount is computed by applying the limited partnership percentage (3 percent) to the difference between the syndicator's cost ($20,000) and the amount of the nonrecourse first mortgage note ($16,250) assumed at purchase by the partnership.

Gain Recognition

Down-payment test:

$$\frac{\text{Down payment } \$3{,}000}{\text{Sales value } \$20{,}950} = 14\%$$

Required minimum down payment set forth in paragraph 54 of FASB Statement No. 66	15%

The sale does not meet the minimum required down-payment test for full profit recognition.

Use of the installment method would result in profit recognition of—

$$\frac{\text{Adjusted cash down payment } \$3{,}000}{\text{Sales value } \$20{,}950} \times \$1{,}062 = \$152$$[6]

Syndication Fee Recognition

Same as in example 1a

B-5. ***Example 1d.*** The same facts apply as in example 1a, except that the syndicator agrees to fund cash-flow deficiencies for the first three years, up to a maximum of $1,500. In calculating the profit to be recognized based on performance of the services required (including reduction of rents by the one-third safety factor described in paragraph 29 of FASB Statement No. 66), there is a $1,100 exposure to loss. Current forecasts indicate discounted cash-flow losses of $500 in year 1, $300 in year 2, $200 in year 3, and positive cash flow thereafter. The partnership also pays an additional $200 of the $400 syndication fee in cash.

Sales Value	
Same as in example 1a	$20,950
Cash Down Payment	
Down payment as calculated in example 1a	$ 3,000
Additional cash	200
Adjusted cash down payment	$ 3,200
Gain Calculation	
Gain as calculated in example 1a	$ 950
Less: Syndicator's exposure to loss under paragraph 29 of FASB Statement No. 66	1,100
Gain	NONE

[6] Because the seller's receivable of $1,700 ($750 second mortgage plus $300 designated for syndication fees plus $650 designated for other fees) for the sales price and the fees exceeds the amount of deferred gain of $910 ($1,062 total gain less $152 profit recognized), no additional gain is currently recognized.

Gain Recognition

Down-payment test:

$$\frac{\text{Down payment } \$3{,}200}{\text{Sales value } \$20{,}950} = 15\%$$

Required minimum down payment set forth in paragraph 54 of FASB Statement No. 66	15%

Although the sale meets the minimum required down-payment test for full profit recognition, no gain is recognizable because the exposure to loss exceeds the gain.

Syndication Fee Recognition

The syndicator would recognize $250 in syndication fee income, which is equal to the $400 syndication fee less the $150 excess of the syndicator's expected funding obligation ($1,100) over other fee income ($950).

Example 2

B-6. The following example illustrates the adjustment of syndication fees when stated fees are not reasonable, as described in paragraphs .28 to .31 of this SOP. The property is an office building subject to lease on a long-term basis to parties with a satisfactory credit rating; cash flow is currently sufficient to service all indebtedness.

	Case 1	*Case 2*
Stated real estate sales price	$1,000	$ 900
Cost	$ 800	$ 800
Payments:		
Cash		
Stated syndication fees	$ 40	$ 140
Stated down payment	100	0
Total cash paid at closing	140	140
Assumption of existing noncourse debt for which the seller has no contingent liability	800	800
Second mortgage not payable to seller	100	100
Total payments	$1,040	$1,040
Required minimum down payment for full recognition of profit in conformity with FASB Statement No. 66	10%	10%
Reasonable fee[7]	$ 100	$ 100

[7] The syndication fee that is reasonable depends on circumstances unique to the individual transaction. The amount used in the example is not intended to serve as a benchmark for determining whether syndication fees are reasonable in practice.

	Case 1		Case 2	
	Syndication Fees	Real Estate Sale	Syndication Fees	Real Estate Fees
Stated terms	$ 40	$1,000	$140	$900
Reallocation of fees	60	(60)	(40)	40
Adjusted balances	$100	$ 940	$100	$940

	Case 1	Case 2
Syndication fee recognized in income at date of sale:		
Stated fee	$ 40	$140
Adjustment	60	(40)
Total	$100	$100

	Case 1	Case 2
Allocation of cash:		
Stated syndication fees	$ 40	$140
Syndication fee allocated from real estate sale	60	0
Syndication fee allocated to real estate sale	0	(40)
Adjusted syndication fee	100	100
Real estate down payment	40	40
Total Cash	$140	$140

	Case 1	Case 2
Cash down payment required for full profit recognition:		
10% of adjusted sales price	$ 94	$ 94
Real estate down payment	40	40
Additional cash required for full profit recognition	$ 54	$ 54
Total profit on real estate transaction:		
Adjusted sales price	$940	$940
Cost	800	800
Total profit	$140	$140
Profit on real estate sales transaction recognizable under installment method—greater of.[8]		
(a) ($40/$940) × $140	$ 6	$ 6
or		
(b) Total accounted for as real estate profit	$140	$140
Less: Second mortgage receivable	100	100
Less: Buyer's debt secured by the property for which the seller is contingently liable	0	0
Total profit recognizable on real estate sale	$ 40	$ 40

[8] The method used is consistent with FASB Emerging Issues Task Force Issue No. 88-24.

	Case 1	Case 2
Total profit recognizable at closing:		
Syndication fee	$100	$100
Real estate sale	40	40
Total	$140	$140

The remaining balance of $100 in profit is deferred and recognized as cash payments are received by the syndicator.

Example 3

B-7. The following example illustrates the recognition of syndication fees received from blind pool transactions, as described in paragraph .32 of this SOP. The terms of the transaction are as follows:

- In June 19X1, syndication A raises $50,000 for investment in real estate in a blind pool transaction; at the time the equity is raised, no properties have been acquired or identified for acquisition.
- The offering memorandum states that $45,000 will be available for investment in property after payment of the following items:
  - — $3,000 in syndication fees
  - — $1,000 in expenses
  - — $1,000 set aside for working-capital funds

  In addition, the offering memorandum states that it is anticipated that $15,000 of debt financing will be obtained in connection with the property acquisition.
- In July 19X1, a property is acquired for $15,000 cash and the assumption of an existing $5,000 first mortgage loan. The partnership is to use an additional $4,000 of its funds to renovate the property.

Syndication Fee Recognition

Assuming that the syndication fees to be recognized are nonrefundable and meet all conditions for recognition in income, as set forth in paragraphs .28 to .31 of this SOP, $1,200 should be recognized in July 19X1, as follows:

Cash purchase price	$15,000
Portion of purchase price financed with debt	5,000
Cash committed for renovation	4,000
Total invested	$24,000

$$\frac{\text{Total invested } \$24{,}000}{\text{Cash committed for investment } \$60{,}000} = 40\%$$

The syndication fee to be recognized in July 19X1 is $1,200 (40% × $3,000 total syndication fee).

The remaining syndication fee of $1,800 ($3,000 total less $1,200 recognized in July 19X1) would be recognized in income ratably as the syndication partnership invests in property acquisitions.

Accounting Standards Executive Committee (1989-1990)

Real Estate Committee (1989-1990)

Real Estate Committee's Syndications Task Force (1989-1990)

AICPA Staff

The Real Estate Committee gratefully acknowledges the contributions of Judith Weiss, a former AICPA staff member.

[The next page is 79,551.]

Section 10,520

Statement of Position 92-5 Accounting for Foreign Property and Liability Reinsurance

June 1, 1992

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Introduction

.01 The promulgation of rules and regulations by state insurance departments and the adoption of specialized insurance industry accounting standards by the Financial Accounting Standards Board (FASB) have resulted in considerable uniformity in accounting practices in the insurance industry in the United States. Outside the United States, insurance accounting and reporting practices vary widely. The diversity in insurance accounting and reporting practices of foreign insurance companies has led to questions on how U.S. insurance companies should account for property and liability reinsurance assumed from foreign companies (foreign reinsurance).

.02 Reinsurers assuming business from domestic companies have historically had sufficient information to monitor and account for contract results. In contrast, some reinsurers assuming business from foreign companies do not receive such information, because in some foreign jurisdictions, insurance companies' accounting and reporting practices concerning periodic recognition of revenue and incurred claims are substantially different from U.S. practices. Therefore, reinsurers assuming business from foreign ceding companies cannot always obtain sufficient information to periodically estimate earned premiums for the business assumed from the foreign ceding companies.

.03 A significant amount of reinsurance is transacted through syndicates organized by Lloyd's of London. Lloyd's syndicates report the amounts of premiums, claims, and expenses recorded in an underwriting account for a particular year to the assuming companies that participate in the syndicates. The syndicates generally keep accounts open for three years. Traditionally, three years have been necessary to report substantially all premiums associated with an underwriting year and to report most related claims, although claims may remain unsettled after the account is closed. A Lloyd's syndicate typically closes an underwriting account by reinsuring outstanding claims on that account with a syndicate for the next underwriting year. The ceding syndicate pays the assuming syndicate an amount based on the unearned premiums and outstanding claims in the underwriting account at the date of the assumption and distributes the remaining balance to its participants.

Current Practices

.04 Three methods are currently used in the United States to account for foreign property and liability reinsurance: the periodic method, the zero balance method, and the open year method.

Periodic Method

.05 The periodic method of accounting for reinsurance provides for current recognition of profits and losses. It is used when ultimate premiums and the period of recognition can be reasonably estimated currently. Premiums are recognized as revenue over the policy term, and claims, including an estimate of claims incurred but not reported, are recognized as they occur. The periodic method is consistent with current practice for primary insurance and domestic reinsurance for which sufficient information is available to reasonably estimate and recognize earned premiums and related claims. (Refer to FASB Statement of Financial Accounting Standards No. 60, *Accounting and Reporting by Insurance Enterprises*.)

.06 Some foreign ceding companies maintain the information necessary to estimate earned premiums, incurred claims, and related expenses currently. As a result, U.S. reinsurers doing business with these foreign ceding companies are able to account for reinsurance assumed by applying the same periodic method of accounting that they use to account for domestic reinsurance. Although not all foreign ceding companies maintain and report current information necessary to estimate earned premiums, incurred claims, and related expenses, some U.S. reinsurers have sufficient experience with the foreign business assumed to estimate earned premiums. When earned premiums can be estimated, sufficient information usually exists to estimate incurred claims and related expenses. Anticipated results based on either the reinsurer's experience or reported data make it possible to reasonably estimate underwriting results and use the periodic method.

Zero Balance Method

.07 Many foreign ceding companies do not maintain the information necessary to estimate earned premiums. As a result, U.S. reinsurers doing business with these foreign companies generally are not able to apply the periodic method of accounting. Some of these companies use the zero balance method, which is a modified cash basis of accounting. This method is similar to the cost recovery method described in FASB Statement No. 60, paragraph 14. Because of the inherent lag in reporting claims, profits reported by foreign ceding companies in early years often exceed the total profits that will ultimately be realized. To avoid reporting overstated profits, companies using this method adjust the records with arbitrary provisions for claims incurred in amounts that exactly offset the cash basis profits.

Open Year Method

.08 Under the open year method, underwriting results of foreign reinsurance are not included in the income statement until sufficient information becomes available to provide reasonable estimates of earned premiums. The open year method is similar to the deposit method as defined in FASB Statement No. 60. Because the measurement period extends over more than one accounting period, premiums, claims, and expenses are not immediately included in operating results. Instead, they are accumulated and reported in the balance sheet as an open underwriting balance. The underwriting balance is disaggregated and reported in the income statement as premiums, claims, and expenses only when earned premiums become reasonably determinable. If it is probable that a loss has been incurred before an underwriting balance is closed, a provision for a loss generally is recorded. Examples of situations in which a provision may be recorded before an underwriting balance is closed include catastrophic losses, higher-than-expected claim frequency, significant unanticipated adverse events, or a negative open year account. The accounting treatment is similar to that for premium deficiencies described in FASB Statement No. 60, paragraph 32.

Comparison With Practices in Other Industries

.09 Deferral of revenue occurs in industries that sell goods subject to rights of return. If a right of return exists, current recognition of a sale is not permitted unless the amount of future returns is reasonably estimable. If that amount is not reasonably estimable, recognition of income is postponed until the return privilege has substantially expired. Income recognition is also postponed for certain real estate sales through the use of the installment and cost recovery methods. Those methods are analogous to the open year method.

Discussion

.10 Methods that defer recognition of underwriting profits raise financial accounting issues concerning (*a*) whether premiums and claims should be reported as income currently, even though the related underwriting balance[1] is deferred, and (*b*) whether the underwriting balance should be recorded as deferred income or as an addition to claim liabilities. Most companies that follow the zero balance method record premium and claim amounts currently and defer recognition of profits by additions to claim liabilities. Although this presentation provides timely information on the volume of business being conducted by the enterprise, the usefulness of the information is limited because the related profit margins are not also reported.

.11 Current accounting literature supports alternative methods of financial presentation when profit recognition is deferred. For example, recognition as income of both revenues and related costs is deferred under the completed contract method until the contract is substantially completed. However, if either the installment method or cost recovery method is used to defer the recognition of gain on the sale of real estate, the sale and related costs are ordinarily reported on the date of the transaction. The deferred profit is reported separately in the income statement as a deduction from sales in the year the transaction occurs and as a separate item of revenue in future years' income statements, when the profit is recognized.

.12 Proponents of presenting premiums, claims, and expenses in the income statement when the amounts are reported to the reinsurer point out

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[1] The term *underwriting balance* refers to the excess of reported premiums over reported claims and expenses. This amount is not intended to represent income realized on a contract.

that excluding those amounts from the income statement until an underwriting year is closed does not reflect the economic substance of current period activities under the reinsurance contract. In response to criticism that presentation of the amounts in the income statement may cause profit margins to be misstated, they argue that disclosure of profits deferred and profits recognized provides sufficient information for users to evaluate operating results.

.13 Proponents of reporting deferred amounts in the balance sheet until the profits relating to the underwriting year are recognized point out that the income statement should reflect profit margins associated with the premium volume reported in the income statement, and that this can best be done by recognizing the related premiums in the periods the profits are recognized. They acknowledge that premiums, claims, and expenses associated with a contract in a period may be important information to users, but they argue that the information could be disclosed in the notes to the financial statements or in the statement of cash flows to avoid misstating the profit margins.

Conclusions

.14 The periodic method should be used to account for foreign reinsurance except in the circumstance described in paragraph .15.

.15 If, due to local revenue recognition policies, the foreign ceding company cannot provide the information required by the assuming company to estimate both the ultimate premiums and the appropriate periods of recognition in accordance with U.S. generally accepted accounting principles, then the open year method should be used.[2] The presence of uncertainties that may be inherent in estimating earned premiums is not an acceptable basis for using the open year method. As discussed in paragraph .08, premiums, claims, commissions, and related direct taxes should not be reported currently as income under the open year method; instead, they should be included in the open underwriting balance to which they pertain. The underwriting balances should be aggregated and included in the balance sheet as a liability. Each underwriting balance should be kept open until sufficient information becomes available to record a reasonable estimate of earned premiums. The underwriting balance should be disaggregated and reported in the income statement as premiums, claims, commissions, and related direct taxes when earned premiums are reasonably determinable.

.16 If it becomes probable that a loss has been incurred before an underwriting balance is closed, a provision for the loss should be recorded.

.17 The periodic and open year methods are not interchangeable in the same circumstances. The periodic method should be used to account for foreign reinsurance. Only if reasonable estimates cannot be made currently, for the reason discussed in paragraph .15, should the open year method be used. The periodic and open year methods are not alternative accounting principles as discussed in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*. Rather, one or the other is to be used depending on the circumstances. As such, changes between these methods are not accounting changes. In addition, changes from the periodic method to the open year method would be seldom.

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[2] If the foreign ceding company maintains supplementary records that are sufficient to reasonably estimate earned premiums currently, then the U.S. assuming company should obtain the necessary information and use the periodic method to account for the foreign reinsurance.

.18 The zero balance method should not be used because it results in misstatement of the income statement by arbitrarily recognizing revenues and costs. The method also causes the profit to be reported in periods other than those in which the related premiums, claims, and expenses are reported.

Disclosures

.19 Disclosure in the financial statements of an insurance company's accounting policies should include a description of the methods used to account for foreign reinsurance. In addition, for foreign reinsurance accounted for by the open year method, the following should be disclosed for each period for which an income statement is presented:

- The amounts of premiums, claims, and expenses recognized as income on closing underwriting balances
- The additions to underwriting balances for the year for reported premiums, claims, and expenses.

Also, the amounts of premiums, claims, and expenses in the underwriting account should be disclosed for each balance sheet presented.

Effective Date and Transition

.20 This SOP should be applied prospectively to contracts or arrangements covered by it and entered into in fiscal years beginning on or after December 15, 1992. Retroactive application, by restating all prior years presented, is encouraged but not required.

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The task force gratefully acknowledges the contributions of the late John E. Hart, formerly the task force chairman.

[The next page is 79,581.]

Section 10,530

Statement of Position 92-6 Accounting and Reporting by Health and Welfare Benefit Plans

August 3, 1992

NOTE

Statements of Position (SOPs) of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA SOPs as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this SOP should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

SOP 92-6 is amended by SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*. SOP 94-4 is effective for financial statements for plan years beginning after December 15, 1994, except that the application of SOP 94-4 to investment contracts entered into before December 15, 1993, is delayed to plan years beginning after December 15, 1995. Earlier application of SOP 94-4 is encouraged. Accounting changes adopted to conform to the provisions of SOP 94-4 should be made as of the beginning of the year in which the change is adopted. The effect of initially applying SOP 94-4 should be reported in a manner similar to the cumulative effect of a change in accounting principle (APB Opinion No. 20, *Accounting Changes*, paragraph 20). Pro forma effects of retroactive application (APB Opinion No. 20, paragraph 21) are not required. Restatement of financial statements of prior years is not permitted.

SOP 92-6 is also amended by SOP 99-3, *Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters*. SOP 99-3 is effective for financial statements for plan years ending after December 15, 1999. Earlier application is encouraged for fiscal years for which annual financial statements have not been issued. If the previously required "by fund" disclosures are eliminated, the reclassification of comparative amounts in financial statements for earlier periods is required.

SOP 92-6 is also amended by SOP 01-2, *Accounting and Reporting by Health and Welfare Benefit Plans*. SOP 01-2 is effective for financial statements for plan years beginning after December 15, 2000. Earlier application is encouraged. Financial statements presented for prior plan years are required to be restated to comply with the provisions of this SOP. The effect of restating the beginning balance of benefit obligations for the earliest year presented should be disclosed.

(continued)

SOP 92-6 is also amended by FASB Staff Position (FSP) AAG INV-1 and SOP 94-4-1, *Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans*. The financial statement presentation and disclosure guidance in paragraphs 8–11 of FSP AAG INV-1 and SOP 94-4-1 is effective for financial statements for plan years ending after December 15, 2006. The revised definition of fully benefit-responsive in paragraph 7 of the FSP shall be effective for all investment contracts as of the last day of the annual period ending after December 15, 2006. Earlier application is permitted for fiscal years in which annual financial statements have not been issued. If comparative financial statements are presented, the guidance in that FSP shall be applied retroactively to all prior periods presented. If an investment contract is considered fully benefit-responsive under the revised definition as of the last day of the annual period ending after December 15, 2006, that contract shall be considered fully benefit-responsive for all periods presented, provided that contract would have been considered fully benefit-responsive in accordance with the then existing provisions of this SOP.

Scope

.01 Health and welfare benefit plans include plans that provide—

a. Medical, dental, visual, psychiatric, or long-term health care; life insurance (offered separately from a pension plan); certain severance benefits; or accidental death or dismemberment benefits.

b. Benefits for unemployment, disability, vacations, or holidays.

c. Other benefits such as apprenticeships, tuition assistance, day care, dependent care, housing subsidies, or legal services.

This statement of position (SOP) applies to both defined-benefit and defined-contribution health and welfare benefit plans (referred to hereafter as *health and welfare benefit plans*).

.02 Defined-benefit health and welfare plans specify a determinable benefit, which may be in the form of a reimbursement to the covered plan participant or a direct payment to providers or third-party insurers for the cost of specified services. Such plans may also include benefits that are payable as a lump sum, such as death benefits. The level of benefits may be defined or limited based on factors such as age, years of service, and salary. Contributions may be determined by the plan's actuary or be based on premiums, actual claims paid, hours worked or other factors determined by the plan sponsor. Even when a plan is funded pursuant to agreements that specify a fixed rate of employer contributions (for example, a collectively bargained multiemployer plan), such a plan may nevertheless be a defined-benefit health and welfare plan if its substance is to provide a defined benefit. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.03 Defined-contribution health and welfare plans maintain an individual account for each plan participant. They have terms that specify the means of determining the contributions to participants' accounts, rather than the amount of benefits the participants are to receive. The benefits a plan participant will receive are limited to the amount contributed to the participant's account, investment experience, expenses, and any forfeitures allocated to the participant's account. These plans also include flexible spending arrangements.

.04 Health and welfare benefit plans generally are subject to certain fiduciary, reporting, and other requirements of the Employee Retirement Income Security Act of 1974 (ERISA). Plans that are unfunded (that is, those whose benefits are paid solely and directly out of the general assets of the employer), are fully insured (through the direct payment of premiums to the insurance company by the employer; see paragraphs .14 and .15), or are certain combinations thereof (for example, self-funded plans with stop-loss coverage; see paragraph .17) may not be required to include financial statements in their ERISA filings.[1] An understanding of the health and welfare benefit plan is needed to determine its accounting and reporting requirements. It is also important to consider the new forms of funding vehicles that are emerging, particularly with respect to postretirement health benefits.

.05 This SOP describes generally accepted accounting principles (GAAP) that are particularly important to defined-benefit and defined-contribution health and welfare plans. Generally accepted accounting principles other than those discussed in this SOP may also apply. This SOP does not address the preparation of financial statements on a comprehensive basis of accounting other than GAAP; however, the financial statements may be prepared on such bases as the cash basis or modified cash basis, as defined by the requirements of financial reporting to the Department of Labor (DOL). If the financial statements are prepared on a comprehensive basis of accounting other than GAAP, disclosure of the plan's benefit obligation information as described in paragraph .20 is necessary. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.06 The most significant changes in accounting and reporting by health and welfare benefit plans that this SOP, as amended, makes to the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide) are the following:

- The objective of financial reporting by a defined-benefit health and welfare plan has been clarified and is the same as the objective of financial reporting by a defined-benefit pension plan (see paragraph .19).
- Single-employer, multiemployer, and multiple-employer defined-benefit health and welfare plans should account for and separately report benefit obligations, including postretirement benefit obligations (see paragraphs .41 through .57). Information about the benefit obligation should be presented in a separate statement, combined with other information on another financial statement, or presented in the notes to the financial statements. Regardless of the format selected, the plan financial statements should present the benefit obligations information in its entirety in the same location (see paragraph .20).[*]
- The requirement to recognize claims incurred but not reported (IBNR) has been clarified. For a self-funded plan, the cost of IBNR includes the present value of the estimated ultimate cost of settling the claims, including estimated costs to be incurred after the financial statement date (for example, the cost of disability; see paragraph .44).

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[1] Refer to appendix A of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans.*

[*] SOP 01-2 [section 10,830] amends this SOP to provide accounting and reporting guidance in the following areas:

a. Presentation of benefit obligations information
b. Accounting for and reporting of postemployment benefit obligations
c. Measurement date for benefit obligations
d. Disclosure of information about retirees' relative share of the plan's estimated cost of providing postretirement benefits
e. Disclosure of discount rate used for measuring the plan's obligation for postemployment benefits
f. Disclosure of investments representing 5 percent or more of the net assets available for benefits

[Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of Statement of Position 01-2.]

- Benefit obligations should not include death benefits actuarially expected to be paid during the active service period of participants (see paragraph .41).
- Defined-contribution health and welfare plans are distinguished from defined-benefit health and welfare plans (see paragraphs .03 and .23).
- The calculation of the obligation for accumulated eligibility credits has been clarified and generally should consider mortality rates and the probability of employee turnover (see paragraph .48).

[Revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.07 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, does not apply to health and welfare benefit plans; however, as set forth in the guide, the methods of valuing plan investments and requirements for financial statement disclosures are the same as those specified in FASB Statement No. 35 and are not changed by this SOP.

.08 FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, establishes standards of financial accounting and reporting by *employers* for health and welfare benefits expected to be provided to a participant during retirement. While FASB Statement No. 106 does not apply to health and welfare benefit plans, this SOP adopts certain of its measurement concepts (see paragraphs .49 through .57). Terminology used in discussing postretirement benefits in this SOP is intended to follow usage and definitions provided in FASB Statement No. 106.

.09 FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*, establishes standards of financial accounting and reporting by employers for certain postemployment benefits provided to former or inactive employees after employment but before retirement. Benefits provided may include salary continuation, supplemental unemployment benefits, severance, disability-related job training and counseling, and continuation of health care and life insurance. While FASB Statement No. 112 does not apply to health and welfare plans, this SOP adopts certain of its measurement concepts (see paragraphs .58 through .60). Terminology used in discussing postemployment benefits in this SOP is intended to follow usage and definitions provided in FASB Statement No. 112. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 112.]

Background

.10 Plan participants may be active or terminated employees (including retirees), as well as covered dependents and beneficiaries, of a single employer or group of employers. Employer contributions may be voluntary or required under the terms of a collective bargaining agreement negotiated with one or more labor organizations. Plans may require contributions from employers and participants (contributory plans) or from employers only (noncontributory plans). During periods of unemployment, a noncontributory plan may require contributions by participants to maintain their eligibility for benefits. Benefits may be provided through insurance contracts paid for by the plan (an insured plan), from net assets accumulated in a trust established by the plan (a self-funded plan), or both.

.11 As noted above, a plan may establish a trust to hold assets to pay all or part of the covered benefits. The assets may be segregated and legally restricted under a trust arrangement (such as a voluntary employees' beneficiary association or a 501(c)(9) trust, a 401(h) account, or other funding vehicles). Generally, if a separate trust exists, financial statements are required under ERISA. A trust always exists for a multiemployer plan. Such trusteed plans with more than 100 participants generally will require an audit. For ERISA filings, the DOL will not accept an accountant's report that covers the assets of more than one plan. For example, where the assets of more than one plan are held in a 501(c)(9) Voluntary Employees' Beneficiary Association (VEBA) trust, separate reports must be prepared for each plan. Some plans may pay only a portion of the plan's benefit payments and other expenses through the VEBA. Plan transactions, including contributions, benefit payments, and expenses whether paid through the VEBA trust or otherwise, should be recorded in a plan's financial statements and subject to audit procedures. If the trustee of the VEBA is a bank or trust company, and the trust holds the assets of more than one plan sponsored by a single employer or by a group of companies under common control, it is a master trust subject to the DOL's master trust filing requirements. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.12 A health and welfare plan may process benefit payments directly or it may retain a third-party administrator (see paragraph .18). In either case, a plan that is fully or partially self-funded is obligated for the related benefits (see paragraphs .41 through .57). [Revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Arrangements With Insurance Companies

.13 The nature of, and method of accounting for, the assets and benefit obligations of a health and welfare benefit plan may be determined by the arrangement with the insurance company. The insurance company may assume all or a portion of the financial risk (see paragraphs .14 through .17), or it may provide only administrative services (see paragraph .18) or investment management services.[2] It is important to have an understanding of the insurance arrangement to determine whether any or all of the risks associated with benefit payments or claims have been transferred to the insurance company. Also, other arrangements are being developed that may involve new types of contracts that involve other parties, including those involving payments to providers, risk sharing of administrative expense with carriers, and so on. Details of these arrangements must also be reviewed carefully.

.14 In a fully insured, pooled arrangement, specified benefits are covered by the insurance company. The insurance company pools the experience of the plan with that of other similar businesses and assumes the financial risk of adverse experience. In such an arrangement, a plan generally has no obligation for benefits covered by the arrangement other than the payment of premiums due to the insurance company (see paragraph .45).

.15 In a fully insured experience-rated arrangement, specified benefits are paid by the insurance company that assumes all the financial risk. Contract experience is monitored by the insurance company. Contract experience may or may not include the experience of other similar contract holders. To the extent that

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[2] Refer to chapter 7 of the guide.

benefits incurred plus risk charges and administration costs are less than premiums paid, the plan is entitled to an experience-rating refund or dividend (see paragraphs .34 and .35). If the total of benefits incurred, risk charges, and administrative costs exceeds premiums, the accumulated loss is generally borne by the insurance company but may be carried over to future periods until it has been recovered (see paragraphs .46 and .47). The plan often has no obligation to continue coverage or to reimburse the carrier for any accumulated loss, although there are certain types of contracts that require additional payments by the plan.

.16 In a minimum premium plan arrangement, specified benefits are also paid by the insurance company. The insurance contract establishes a dollar limit, or *trigger point*. All claims paid by the insurance company below the trigger point are reimbursed by the plan to the insurance company. The insurance company is not reimbursed for benefits incurred that exceed the trigger point. This type of funding arrangement requires the plan to fund the full claims experience up to the trigger point. Minimum premium plan arrangements may have characteristics of both self-funded and fully insured experience-rated arrangements. Details of each arrangement must be reviewed carefully to determine the specific benefit obligations assumed by the insurance company.

.17 In a stop-loss insurance arrangement, a plan's obligation for any plan participant's claims may be limited to a fixed dollar amount, or the plan's total obligation may be limited to a maximum percentage (for example, 125 percent) of a preset expected claims level. These arrangements are commonly used with administrative service arrangements. The insurance company assumes the benefit obligation in excess of the limit. Stop-loss insurance arrangements may have characteristics of both self-funded and fully insured arrangements. Stop-loss arrangements of this type may be described by a variety of terms; therefore, details of all insurance or administrative arrangements should be reviewed carefully to determine if stop-loss provisions are included and to determine the specific benefit obligations assumed by the insurance company.

.18 In an administrative service arrangement, the plan retains the full obligation for plan benefits. The plan may engage an insurance company or other third party to act as the plan administrator. The administrator makes all benefit payments, charges the plan for those payments, and collects a fee for the services provided.

Financial Statements of Defined-Benefit Health and Welfare Plans

.19 The objective of financial reporting by defined-benefit health and welfare plans is the same as that of defined-benefit pension plans; both types of plans provide a determinable benefit. Accordingly, the primary objective of the financial statements of a defined-benefit health and welfare plan is to provide financial information that is useful in assessing the plan's present and future ability to pay its benefit obligations when due. To accomplish that objective, a plan's financial statements should provide information about (*a*) plan resources and the manner in which the stewardship responsibility for those resources has been discharged, (*b*) benefit obligations, (*c*) the results of transactions and events that affect the information about those resources and obligations, and (*d*) other factors necessary for users to understand the information provided.[3]

[3] It should be recognized that (*a*) information in addition to that contained in a plan's financial statements is needed in assessing the plan's present and future ability to pay its benefit obligations when due and (*b*) financial statements for several plan years may provide more useful information in assessing the plan's future ability to pay benefit obligations than can financial statements for a single year.

.20 The financial statements of a defined-benefit health and welfare plan prepared in accordance with GAAP[4] should be prepared on the accrual basis of accounting and include—

- A statement of net assets available for benefits as of the end of the plan year (see paragraphs .25 through .38).
- A statement of changes in net assets available for benefits for the year then ended (see paragraphs .39 and .40).
- Information regarding the plan's benefit obligations as of the end of the plan year (see paragraphs .41 through .57).
- Information regarding the effects, if significant, of certain factors affecting the year-to-year change in the plan's benefit obligations (see paragraphs .61 and .62).

Information about the benefit obligations should be presented in a separate statement, combined with other information on another financial statement, or presented in the notes to financial statements. Regardless of the format selected, the plan financial statements should present the benefit obligations information in its entirety in the same location. The information should be presented in such reasonable detail as is necessary to identify the nature and classification of the obligations.[5] [As amended, effective for financial statements for plan years beginning after December 15, 2000, by Statement of Position 01-2. Revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.21 FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, provides that employee benefit plans other than pension plans (such as health and welfare plans, both defined benefit and defined contribution) that provide information similar to that required by FASB Statement No. 35 are not required to provide a statement of cash flows. However, FASB Statement No. 102 encourages that a statement of cash flows be included in the financial statements of an employee benefit plan when such a statement would provide relevant information about the ability of the plan to meet future obligations (for example, when the plan invests in assets that are not highly liquid or obtains financing for investments).

Financial Statements of Defined-Contribution Health and Welfare Plans

.22 The objective of financial reporting by a defined-contribution health and welfare plan is to provide financial information that is useful in assessing the plan's present and future ability to pay its benefits. To accomplish that objective, a plan's financial statements should provide information about (*a*) plan resources and the manner in which the stewardship responsibility for those resources has been discharged, (*b*) the results of transactions and events that affect the information about those resources, and (*c*) other factors necessary for users to understand the information provided.[6] For example vacation,

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[4] Financial statements prepared on a comprehensive basis of accounting other than GAAP should disclose information regarding benefit obligations (see paragraphs 13.19 through 13.22 of the guide, which discuss auditor's report considerations).

[5] The appendix [paragraph .74] of this SOP provides illustrative financial statements of two health and welfare benefit plans.

[6] See footnote 3.

holiday, and legal are typical plans whose benefits are limited to the balance in the participant's accounts. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.23 The financial statements of a defined-contribution health and welfare plan prepared in accordance with GAAP[7] should be prepared on the accrual basis of accounting and include—

- A statement of net assets available for benefits of the plan as of the end of the plan year (see paragraphs .25 through .38).
- A statement of changes in net assets available for benefits of the plan for the year then ended (see paragraphs .39 and .40).

Because a plan's obligation to provide benefits is limited to the amounts accumulated in an individual's account, information regarding benefit obligations is not applicable.

ERISA Reporting Requirements

.24 ERISA established annual reporting requirements for employee benefit plans, including health and welfare benefit plans.[8] The financial statements required by ERISA are comparative statements of assets and liabilities and a statement of changes in net assets available for benefits. The schedules required by ERISA include Schedule H, line 4i—Schedule of Assets (Held at End of Year), Schedule H, line 4j—Schedule of Reportable Transactions, Schedule G, Part I—Schedule of Loans or Fixed Income Obligations in Default or Classified as Uncollectible, Schedule G, Part II—Schedule of Leases in Default or Classified as Uncollectible, and Schedule G, Part III, Nonexempt Transactions. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Statement of Net Assets Available for Benefits

Investments

.25 Plan investments, whether they are in the form of equity or debt securities, real estate, or other investments (*excluding insurance contracts*), should be reported at their fair value at the financial statement date.[9] The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value should be measured by the market price if there is an active market for the investment. If there is no active market for the investment but there is a market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows, discounted at a

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[7] See footnote 4.

[8] ERISA annual reporting requirements, as well as the common exemptions, are described in appendix A of the guide.

[9] The accrual basis of accounting requires that purchases and sales of securities be recorded on a trade-date basis. However, if the settlement date is later than the financial statement date and (*a*) the fair value of the securities purchased or sold just before the financial statement date does not change significantly from the trade date to the financial statement date and (*b*) the purchases or sales do not significantly affect the composition of the plan's assets available for benefits, accounting on a settlement-date basis for such sales and purchases is acceptable.

rate commensurate with the risk involved, may be used to estimate fair value.[10] [As amended, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4. Revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature. As amended, effective for financial statements for plan years ending after December 15, 2006; the revised definition of fully benefit-responsive is effective for all investment contracts as of the last day of the annual period ending after December 15, 2006, by FASB Staff Position AAG-INV-1 and SOP 94-4-1.]

.26 Insurance contracts, as defined by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, should be presented in the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to ERISA; that is, either at fair value or at amounts determined by the insurance enterprise (contract value). Plans not subject to ERISA should present insurance contracts as if the plans were subject to the reporting requirements of ERISA.[11] [As amended, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4.]

.27 Investment contracts held by defined-benefit health and welfare benefit plans should be reported at their fair values. [Paragraph added, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4.]

.28 Defined-contribution health and welfare benefit plans provide benefits based on the amounts contributed to employees' individual accounts plus or minus forfeitures, investment experience, and administrative expenses. In such plans, plan participants have a vested interest in monitoring the financial condition and operations of the plan since they bear investment risk under these plans, and plan transactions can directly affect their benefits (for example, investment mix, and risk and return). [Paragraph added, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4.]

.29 Plan assets of defined-contribution health and welfare benefit plans should be measured and reported at values that are meaningful to financial statement users including plan participants. The contract value of a *fully benefit-responsive* investment contract held by a defined-contribution health and welfare benefit plan is the amount a participant would receive if he or she were to initiate transactions under the terms of the ongoing plan. Defined-contribution health and welfare benefit plans should report fully benefit-responsive investment contracts (including derivative contracts) at fair value. However, contract value is the relevant measurement attribute for that portion of the net assets available for benefits of a defined-contribution health and welfare benefit plan attributable to fully benefit-responsive investment contracts. [Paragraph added, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4. As amended, effective for financial statements for plan years ending after December 15, 2006; the revised definition of fully benefit-responsive is effective for all

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[10] For an indication of the factors to be considered in determining the discount rate, see paragraph 27 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*. The fair value of an investment should be reported net of the brokerage commissions and other costs normally incurred in a sale, if significant (see also paragraphs 2.10 and 2.11 of the guide). [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

[11] [Footnote deleted, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

investment contracts as of the last day of the annual period ending after December 15, 2006, by FASB Staff Position AAG-INV-1 and SOP 94-4-1.]

.30 An investment contract is considered fully benefit-responsive for purposes of this SOP, if *all* of the following criteria are met for that contract, analyzed on an individual basis:

a. The investment contract is effected directly between the plan and the issuer and prohibits the plan from assigning or selling the contract or its proceeds to another party without the consent of the issuer.

b. Either (1) the repayment of principal and interest credited to participants in the plan is a financial obligation of the issuer of the investment contract or (2) prospective interest crediting rate adjustments are provided to participants in the plan on a designated pool of investments held by the plan or the contract issuer, whereby a financially responsible third party, through a contract generally referred to as a wrapper, must provide assurance that the adjustments to the interest crediting rate will not result in a future interest crediting rate that is less than zero. If an event has occurred such that realization of full contract value for a particular investment contract is no longer probable (for example, a significant decline in creditworthiness of the contract issuer or wrapper provider), the investment contract shall no longer be considered fully benefit-responsive.

c. The terms of the investment contract require all permitted participant-initiated transactions with the plan to occur at contract value with no conditions, limits, or restrictions. Permitted participant-initiated transactions are those transactions allowed by the plan, such as withdrawals for benefits, loans, or transfers to other funds within the plan.

d. An event that limits the ability of the plan to transact at contract value with the issuer (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives) that also limits the ability of the plan to transact at contract value with the participants in the plan must be probable of not occurring.

e. The plan itself must allow participants reasonable access to their funds.

If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. For example, if plan participants are allowed access at contract value to all or a portion of their account balances only upon termination of their participation in the plan, it would not be considered reasonable access and, therefore, investment contracts held by that plan would generally not be deemed to be fully benefit-responsive. However, in plans with a single investment fund that allow reasonable access to assets by inactive participants, restrictions on access to assets by active participants consistent with the objective of the plan (for example, retirement or health and welfare benefits) will not affect the benefit responsiveness of the investment contracts held by those single-fund plans. Also, if a plan limits participants' access to their account balances to certain specified times during the plan year (for example, semiannually or quarterly) to control the administrative costs of the plan, that limitation generally would not affect the benefit responsiveness of the investment contracts held by that plan. In addition, administrative provisions that place short-term restrictions (for example, three or six months) on transfers to competing fixed income investment options to limit arbitrage among those investment options (*equity wash* provisions) would not affect a contract's benefit responsiveness. [Paragraph added, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4. As amended, effective for financial statements for plan years ending after December 15, 2006; the revised definition of fully benefit-responsive is effective for all investment contracts as of the last day of the annual period ending after December 15, 2006, by FASB Staff Position AAG-INV-1 and SOP 94-4-1.]

.31 If a plan holds multiple contracts, each contract should be evaluated individually for benefit responsiveness. If a plan invests in pooled funds that hold investment contracts, each contract in the pooled fund should be evaluated individually for benefit responsiveness. However, if the pooled fund places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive. Contracts that provide for prospective interest adjustments may still be fully benefit-responsive provided that the terms of the contracts specify that the crediting interest rate cannot be less than zero. [Paragraph added, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4.]

.32 Information regarding a plan's investments should be presented in enough detail to identify the types of investments and should indicate whether reported fair values have been measured by quoted prices in an active market or have been determined otherwise (paragraph .64 specifies additional disclosures related to investments). [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Contributions Receivable

.33 Contributions receivable are the amounts due, as of the date of the financial statements, to the plan from employers, participants, and other sources of funding (for example, state subsidies or federal grants), each of which should be separately identified. They include amounts due pursuant to firm commitments, as well as legal or contractual requirements. With respect to employers' contributions, evidence of a formal commitment may include (*a*) a resolution by the employer's governing body approving a specified contribution; (*b*) a consistent pattern of making payments after the end of the plan year, pursuant to an established funding policy that attributes such subsequent payments to the preceding plan year; (*c*) a deduction of a contribution for federal income tax purposes for periods ending on or before the financial statement date; or (*d*) the employer's recognition as of the financial statement date of a contribution payable to the plan.[12] Contributions receivable should include an allowance for estimated uncollectible amounts. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

[The next page is 79,591.]

[12] The existence of an accrued liability in the employer's statement of financial position or a plan's benefit obligations exceeding its net assets available for benefit obligations does not, by itself, provide sufficient support for recognition of a contribution receivable by the plan.

Deposits With and Receivables From Insurance Companies and Other Service Providers

.34 Whether a premium paid to an insurance company represents payment for the transfer of risk or merely represents a deposit will depend on the circumstances of the arrangement. As noted earlier, the nature of payments made to an insurance company should be analyzed to determine the extent to which financial risk has been transferred from the plan to the insurance company. Insurance companies may require that a deposit be maintained that can be applied against possible future losses in excess of current premiums. These deposits should be reported as plan assets until such amounts are used to pay premiums. Similarly, premium stabilization reserves, which exist when premiums paid to an insurance company exceed the total of claims paid and other charges, are held by an insurance company and used to reduce future premium payments. Premium stabilization reserves generally should be reported as assets of the plan until such amounts are used to pay premiums. Disclosure of the nature of this type of deposit or reserve should be made. If such reserves are forfeitable when the insurance contract terminates, this possibility should be considered in recognizing this asset. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.35 Certain group insurance contracts covering health and welfare benefit plans include a provision for a refund, at the end of the policy year, of the excess of premiums paid over the total of paid claims, required reserves, and the fee charged by the insurance company. Often such experience-rating refunds (or dividends) are not determined by the insurance company for several months after the end of the policy year. In this event, and in cases when the policy year does not coincide with the plan's fiscal year, the refund due as of the financial statement date should be reported as a plan asset if it is probable that a refund is due and the amount can be reasonably estimated. If the amount of the refund cannot be reasonably estimated, that fact should be disclosed. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

.36 Service providers may require that deposits by the plan be applied against claims paid on behalf of plan participants. Such deposits should be reported as plan assets until the deposit is applied against paid claims. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

Operating Assets

.37 Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) should be reported at cost less accumulated depreciation or amortization. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

Accrued Liabilities

.38 A plan may have liabilities (other than for benefits) that should be accrued. Such liabilities may be for amounts owed for securities purchased, income taxes payable by the plan, or other expenses (for example, third-party administrator fees). These liabilities should be deducted to arrive at net assets available for benefits. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

Statement of Changes in Net Assets Available for Benefits

.39 The statement of changes in net assets available for benefits should be presented in enough detail to identify the significant changes during the year including, as applicable—

- Contributions from employers, segregated between cash and noncash contributions. A noncash contribution should be reported at fair value at the date of the contribution. The nature of noncash contributions should be described either parenthetically or in a note.
- Contributions from participants, including those collected and remitted by the sponsor.
- Contributions from other identified sources (for example, state subsidies or federal grants).
- The net appreciation or depreciation[13] in fair value for each significant class of investments, segregated between investments whose fair values have been measured by quoted prices in an active market and those whose fair values have been otherwise determined.
- Investment income, excluding the net appreciation or depreciation.
- Income taxes paid or payable, if applicable.
- Payments of claims, excluding payments made by an insurance company pursuant to contracts that are excluded from plan assets.
- Payments of premiums to insurance companies to purchase contracts that are excluded from plan assets.[14]
- Operating and administrative expenses.
- Other changes (such as transfers of assets to or from other plans), if significant.

[Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

.40 The list of minimum disclosures is not intended to define the degree of detail or the manner of presenting the information, and subclassifications or additional classifications may be useful. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

Benefit Obligations

.41 Benefit obligations[15] for single-employer, multiple-employer, and multiemployer defined-benefit health and welfare benefit plans should include the actuarial present value, as applicable, of the following:

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[13] Net appreciation or depreciation includes realized gains and losses on investments that were both purchased and sold during the period. Ordinarily, information regarding the net appreciation or depreciation in the fair value of investments is found in the notes to the financial statements.

[14] Refer to paragraphs 7.32 and 7.33 of the guide for further discussion of allocated insurance contracts. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

[15] Administrative expenses expected to be paid by the plan (but not those paid directly by the plan's participating employer(s)) that are associated with providing the plan's benefits should be reflected either by including the estimated costs in the benefits expected to be paid by the plan or by reducing the discount rate(s) used in measuring the benefit obligation. If the latter method is used, the resulting reduction in the discount rate(s) should be disclosed. [As amended, effective for financial statements for plan years beginning after December 15, 2000, by Statement of Position 01-2.]

a. Claims payable, claims IBNR,[16] and premiums due to insurance companies

b. Accumulated eligibility credits and postemployment benefits, net of amounts currently payable

c. Postretirement benefits for the following groups of participants:[16]

   (1) Retired plan participants, including their beneficiaries and covered dependents, net of amounts currently payable and claims IBNR[16]

   (2) Other plan participants fully eligible for benefits

   (3) Plan participants not yet fully eligible for benefits.

Aggregating claims payable and claims IBNR is often appropriate if adequate time has passed to provide sufficient data on costs incurred and the actuarially determined expected cost of long-term medical claims is insignificant. Benefits expected to be earned for future service by active participants (for example, vacation benefits) during the term of their employment should not be included. Benefit obligations should be reported as of the end of the plan year.[17] The effect of plan amendments should be included in the computation of the expected and accumulated postretirement benefit obligations once they have been contractually agreed to, even if some provisions take effect only in future periods. For example, if a plan amendment grants a different benefit level for employees retiring after a future date, that increased or reduced benefit level should be included in current-period measurements for employees expected to retire after that date. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. As amended, effective for financial statements for plan years beginning after December 15, 2000, by Statement of Position 01-2.]

.42 To the extent they exist, the amounts of benefit obligations in each of the three major classifications identified above should be shown as separate line items in the financial statements or notes to financial statements. Regardless of the format selected, the plan financial statements should present the benefit obligations information in its entirety in the same location. For negotiated plans, benefit obligations due during a plan's contract period may, but need not, be disclosed. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. As amended, effective for financial statements for plan years beginning after December 15, 2000, by Statement of Position 01-2.]

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[16] Claims IBNR may be computed in the aggregate for active participants and retirees. Alternatively, if claims IBNR are not calculated in the aggregate for active participants and retirees, the claims IBNR for retirees are included in the postretirement benefit obligation. [As amended, effective for financial statements for plan years beginning after December 15, 2000, by Statement of Position 01-2.]

[17] The financial status of the plan considers assets and obligations as of the same date. Because plan assets are required to be presented as of the plan's year end, the benefit obligations also should be measured and presented as of the plan's year end. That requirement does not, however, preclude the plan from using the most recent benefit obligations valuation rolled forward to the plan's year end to account for subsequent events (such as employee service and benefit payments), provided that it is reasonable to expect that the results will not be materially different from the results of an actuarial valuation as of the plan's year end. In rolling forward the benefit obligations to the plan's measurement date, the discount rates should be adjusted as appropriate to reflect current rates of return on high-quality fixed-income investments. For example, if a valuation was performed at September 30 and the plan has a calendar year end, the benefit obligations as of September 30 should be rolled forward to December 31, by making appropriate adjustments, such as for additional employee service; the time value of money; benefits paid; and changes in the number of participants, actuarial assumptions, discount rates, per capita claims costs, and plan terms. [As amended, effective for financial statements for plan years beginning after December 15, 2000, by Statement of Position 01-2.]

Claims

.43 In an insured health and welfare benefit plan, claims payable and currently due and claims incurred but not yet reported to the plan will be paid by the insurance company. Consequently, they should be excluded from the benefit obligations of the plan. Benefit obligations of a self-funded plan should present the amount of claims payable and currently due for active and retired participants, dependents, and beneficiaries and IBNR for active participants. IBNR for retired participants is included in the postretirement benefit obligation.[18] [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

.44 For a self-funded plan, the cost of IBNR should be measured at the present value, as applicable, of the estimated ultimate cost to the plan of settling the claims. Estimated ultimate cost should reflect the plan's obligation to pay claims to or for participants, regardless of status of employment, beyond the financial statement date pursuant to the provisions of the plan or regulatory requirements. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Premiums Due Under Insurance Arrangements

.45 Benefits to participants may be provided through insurance arrangements that transfer the risks of loss or liability to an insurance company (see paragraphs .14 through .17). Group insurance contracts for health and welfare plans are usually written for a one-year period, although the contract may provide for annual renewal. The contract generally specifies, among other things, the schedule of benefits, eligibility rules, premium rate per eligible participant, and the date that premiums are due. The benefit obligations should include any obligation for premiums due but not paid. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

.46 If the insurance contract requires payment of additional premiums (for example, retrospective premiums) when the loss ratio exceeds a specified percentage, an obligation for the estimated additional premiums should be included in the benefit obligations. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

.47 Experience ratings determined by the insurance company or by estimates (see paragraph .15) may result in a premium deficit. Premium deficits should be included in the benefit obligations if (*a*) it is probable that the deficit will be applied against the amounts of future premiums or future experience-rating refunds[19] and (*b*) the amount can be reasonably estimated. If no obligation is included for a premium deficit because either or both of the conditions are not met, or if an exposure to loss exists in excess of the amount accrued, disclosure of the premium deficit should be made if it is reasonably possible that a loss or an additional loss has been incurred. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

Accumulated Eligibility Credits

.48 Plans may provide for the payment of insurance premiums or benefits for a period of time for those participants who have accumulated a sufficient

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[18] See footnote 16.

[19] This determination should consider (*a*) the extent to which the insurance contract requires payment of such deficits and (*b*) the plan's intention, if any, to transfer coverage to another insurance company.

number of eligibility credits or hours i.e., bank of hours. Eligible participants are provided with insurance coverage during periods of unemployment, when employer contributions to the plan would not otherwise provide coverage or benefits. At the financial statement date, such accumulated eligibility credits represent an obligation of the plan arising from prior employee service for which employer contributions have been received. This benefit obligation is generally determined by applying current insurance premium rates to accumulated eligibility credits or, for a self-funded plan, by applying the average cost of benefits per eligible participant to accumulated eligibility credits. In either case, the obligation for accumulated eligibility credits should consider assumptions for mortality and expected employee turnover or other appropriate adjustments, to reflect the obligation at the amount expected to be paid. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Postretirement Benefit Obligations

.49 Health and welfare benefit plans may continue to provide benefits to participants after retirement (postretirement benefits). Those benefits may commence immediately upon termination of service or payment may be deferred until the participant attains a specified age. If a plan provides postretirement benefits to participants, an estimated amount for those benefits, as described below should be included in the benefit obligations. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

.50 The postretirement benefit obligation as of the measurement date is the actuarial present value of all future benefits attributed to plan participants' services rendered to that date, assuming the plan continues in effect and all assumptions about future events are fulfilled. Postretirement benefits comprise benefits expected to be paid to or on behalf of any retired or active participant, terminated participant, beneficiary, or covered dependent who is expected to receive benefits under the health and welfare benefit plan. Postretirement benefits expected to be paid to or for an active participant, beneficiary, or covered dependent who is still earning his or her postretirement benefits (that is, one who is not yet fully eligible) should be measured over the participant's credited period of service up to the date when full eligibility for benefits is attained.[20] [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

.51 If a multiemployer health and welfare benefit plan provides postretirement benefits, the benefit obligations must include the postretirement benefit obligation. Consideration should be given to the promises currently made to employees and the history of making such payments to retirees. The fact that benefits may be reduced or even potentially eliminated would not ordinarily affect the promise made as of the end of the plan year unless the change meets the substantive plan criteria of FASB Statement No. 106 (for example, an amendment is in place or has been communicated to employees). The fact that the contributing employers of a multiemployer plan do not record a similar obligation under FASB Statement No. 106 does not affect the accounting for the obligations by the plan. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

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[20] For example, if a participant has worked eight years and must work another sixteen to be fully eligible for benefits after retirement, one-third of the postretirement benefits have been earned and should be included in the postretirement benefit obligation if it is probable that the employee will work the remaining sixteen years.

.52 The postretirement benefit obligation should be measured using the plan's written provisions to the extent possible, as well as the substantive plan if it differs from the written plan. In many health and welfare benefit plans, postretirement benefits are not defined as a specified amount for each year of service. FASB Statement No. 106, paragraphs 23 through 44, describes the measurement of the postretirement benefit obligation. For multiemployer plans that do not have date-of-hire information as required by paragraph 44 of FASB Statement No. 106, reasonable estimates thereof should be used to measure the obligation. Death or disability benefits provided outside of a pension plan (when the employee is considered to be retired) should also be included in the calculation of the postretirement benefit obligation. Benefits that are provided through an insurance contract should be excluded.[21] [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

.53 In measuring the postretirement benefit obligation explicit assumptions must be used, each of which represents the best estimate of a particular future event. All assumptions should presume that the plan will continue in its present form, unless there is evidence to the contrary. Principal actuarial assumptions used should include—

- Discount rates, used to reflect the time value of money in determining the present value of future cash outflows currently expected to be required to satisfy the liability in the due course of business.
- The timing and amount of future postretirement benefit payments (taking into consideration per capita claims cost by age, health care cost-trend rates, current Medicare reimbursement rates, retirement age, dependency status, and mortality).
- Salary progression (for pay-related plans).
- The probability of payment (considering turnover, retirement age, dependency status, and mortality).
- Participation rates (for contributory plans).

[Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

.54 The postretirement benefit obligation information should include the following classifications:

- Obligations related to retired plan participants, including their beneficiaries and covered dependents
- Obligations related to active or terminated participants who are fully eligible to receive benefits
- Obligations related to other plan participants not yet fully eligible for benefits

Separate disclosure for each classification for each significant benefit (for example, medical and death) may be appropriate. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994.]

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[21] Insured plans should be reviewed carefully to determine the extent to which postretirement benefits are insured. Currently, except for single-premium life insurance contracts, few, if any, insurance contracts unconditionally obligate an insurance company to provide most forms of postretirement benefits.

.55 Certain retiree health benefits may be funded through a 401(h) account in a defined benefit pension plan, pursuant to Section 401(h) of the Internal Revenue Code (IRC). Refer to Chapter 2 of the guide for a detailed discussion of 401(h) accounts. The 401(h) account assets and liabilities used to fund retiree health benefits, and the changes in those assets and liabilities, should be reported in the financial statements of the health and welfare benefit plan. The 401(h) account assets and liabilities and changes in them can be shown in the health and welfare benefit plan financial statements in one of two ways. An entity can present that information either as a single line item on the face of the statements or included in individual line items with separate disclosure in the footnotes about the 401(h) amounts included in those individual line items. If the assets and liabilities are shown as a single line item in the statement of net assets, the changes in net assets also should be shown as a single line item in the statement of changes in net assets. If the assets and liabilities are included in individual asset and liability line items in the statement of net assets, the changes in individual 401(h) amounts should be included in the changes in the individual line items in the statement of changes in net assets, with separate disclosure in the footnotes about the 401(h) amounts included in those individual line items. The notes to the financial statements should disclose the significant components of net assets and changes in net assets of the 401(h) account. The 401(h) obligations are reported in the health and welfare benefit plan's statement of benefit obligations. Likewise, the health and welfare benefit plan's statement of changes in benefit obligations should include claims paid through the 401(h) account. [Paragraph added, June 2004, to reflect conforming changes necessary due to the issuance of Statement of Position 99-2.]

.56 If retiree health benefit obligations are funded partially through a 401(h) account of the defined benefit pension plan, the plan should also disclose the fact that the assets are available only to pay retiree health benefits. The notes to the financial statements should disclose the significant components of net assets and changes in net assets of the 401(h) account. Additionally, the notes should include a reconciliation of amounts reported in the financial statements to the amounts reported in the Form 5500. [Paragraph added, June 2004, to reflect conforming changes necessary due to the issuance of Statement of Position 99-2.]

.57 Because ERISA requires 401(h) accounts to be reported as assets of the pension plan, a reconciliation of the net assets reported in the financial statements to those reported in Form 5500 is required for the health and welfare benefit plan. Additionally, any assets held for investment purposes in the 401(h) account should be shown on Schedule H, line 4i—Schedule of Assets (Held at End of Year) and Schedule H, line 4j—Schedule of Reportable Transactions for the pension plan. [Paragraph added, June 2004, to reflect conforming changes necessary due to the issuance of Statement of Position 99-2.]

Postemployment Benefits

.58 Plans that provide postemployment benefits should recognize a benefit obligation for current participants, based on amounts expected to be paid in subsequent years, if all the following conditions are met:

a. The participants' rights to receive benefits are attributable to services already rendered.

b. The participants' benefits vest or accumulate.[22]

c. Payment of benefits is probable.

d. The amount can be reasonably estimated.

The postemployment benefit obligation should be measured as the actuarial present value of the future benefits attributed to plan participants' services rendered to the measurement date, reduced by the actuarial present value of future contributions expected to be received from the current plan participants. That amount represents the benefit obligation that is to be funded by contributions from the plan's participating employer(s) and from existing plan assets. The obligation is to be measured assuming the plan continues in effect and all assumptions about future events are met. Any anticipated forfeitures or integration with other related programs (for example, state unemployment benefits) should be considered. The benefit obligation should be discounted using rates of return on high-quality fixed-income investments currently available with cash flows that match the timing and amount of expected benefit payments and expected participant contributions. [Paragraph added, effective for financial statements for plan years beginning after December 15, 2000, by Statement of Position 01-2. Paragraph renumbered, June 2004, to reflect conforming changes necessary due to the issuance of Statement of Position 99-2.]

.59 For postemployment benefits that do not meet conditions (*a*) and (*b*) of the preceding paragraph, the plan should recognize a benefit obligation if the event that gives rise to a liability has occurred and the amount can be reasonably estimated. For example, if all participants receive the same medical coverage upon disability regardless of length of service (the benefits do not accumulate) and the benefits do not vest, medical benefits for disabled participants should be accrued at the date of disability and not over the participants' working lives. When participant contributions are required after the event triggering postemployment benefits occurs, the postemployment benefit obligation should be measured in a manner consistent with the preceding paragraph. As a result, in those situations the benefit obligation should represent the amount that is to be funded by contributions from the participating employer(s) and from existing plan assets. [Paragraph added, effective for financial statements for plan years beginning after December 15, 2000, by Statement of Position 01-2. Paragraph renumbered, June 2004, to reflect conforming changes necessary due to the issuance of Statement of Position 99-2.]

.60 If an obligation for postemployment benefits is not recognized in accordance with the two preceding paragraphs only because the amount cannot be reasonably estimated, the financial statements should disclose that fact. [Paragraph added, effective for financial statements for plan years beginning after December 15, 2000, by Statement of Position 01-2. Paragraph renumbered, June 2004, to reflect conforming changes necessary due to the issuance of Statement of Position 99-2.]

Changes in Benefit Obligations

.61 Information regarding changes in the benefit obligations within a plan period should be presented to identify significant factors affecting year-

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[22] For example, the supplemental unemployment benefit is fifty-two weeks' pay if a participant worked three years, seventy-eight weeks' pay if a participant worked five years, and 104 weeks' pay if a participant worked seven years. In this situation, the benefits would be considered accumulating. Benefits that increase solely as a function of wage or salary increases are not considered accumulating. [Footnote added, effective for financial statements for plan years beginning after December 15, 2000, by Statement of Position 01-2.]

to-year changes in benefit obligations. Changes in each of the three major classifications of benefit obligations should be presented in the body of the financial statements or in the notes to the financial statements; the information may be presented in either a reconciliation or narrative format. Providing such information in the following three categories will generally be sufficient: (*a*) claims payable, claims IBNR, and premiums due to insurance companies, (*b*) accumulated eligibility credits and postemployment benefits, net of amounts currently payable, and (*c*) postretirement benefits for retired plan participants, including their beneficiaries and covered dependents, net amounts currently payable and claims IBNR; other plan participants fully eligible for benefits; and plan participants not yet fully eligible for benefits. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Paragraph subsequently renumbered and amended, effective for financial statements for plan years beginning after December 15, 2000, by Statement of Position 01-2. Paragraph subsequently renumbered and revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.62 Minimum disclosure regarding changes in benefit obligations should include the significant effects of (*a*) plan amendments, (*b*) changes in the nature of the plan (mergers or spinoffs), and (*c*) changes in actuarial assumptions (health care cost-trend rate or interest rate). Changes in actuarial assumptions are to be considered as changes in accounting estimates and, therefore, previously reported amounts should not be restated. The significant effects of other factors may also be identified. These include, for example, benefits accumulated,[23] the effects of the time value of money (for interest), and benefits paid. If presented, benefits paid should not include benefit payments made by an insurance company pursuant to a contract that is excluded from plan assets. However, amounts paid by the plan to an insurance company pursuant to such a contract (including purchases of annuities with amounts allocated from existing investments with the insurance company) should be included in benefits paid.[24] If only the minimum disclosure is presented, presentation in a statement format will necessitate an additional unidentified "other" category to reconcile the initial and ultimate amounts. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Paragraph subsequently renumbered, June 2004, to reflect conforming changes necessary due to the issuance of Statement of Position 99-2.]

Additional Financial Statement Disclosures

.63 Disclosure of a health and welfare benefit plan's accounting policies should include—[25]

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[23] Actuarial experience gains or losses may be included with the effects of additional benefits accumulated rather than separately disclosed. If the effects of changes in actuarial assumptions cannot be separately determined, those effects should be included in benefits accumulated and described accordingly. [Footnote renumbered by the issuance of Statement of Position 01-2, April 2001.]

[24] Because of the use of different actuarial assumptions, the amount paid by the plan to an insurance company may be different from the previous measure of the actuarial present value of the related accumulated plan benefits. If that information is available, it should be presented as an actuarial experience gain or loss. [Footnote renumbered by the issuance of Statement of Position 01-2, April 2001.]

[25] See Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies*. [Footnote renumbered by the issuance of Statement of Position 01-2, April 2001.]

- A description of the methods and significant assumptions used to determine the fair value of investments and the reported value of insurance contracts.
- A description of the methods and significant actuarial assumptions used to determine the plan's benefit obligations. Any significant changes in assumptions made between financial statement dates and their effects should be described.

[Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Paragraph subsequently renumbered by the issuance of Statement of Position 01-2, April 2001. Paragraph subsequently renumbered, June 2004, to reflect conforming changes necessary due to the issuance of Statement of Position 99-2.]

.64 The plan's financial statements should also disclose other information.[26] Separate disclosures may be made to the extent that the plan provides both health and other welfare benefits. The disclosures should include, when applicable—

- A brief, general description of the plan agreement, including, but not limited to, participants covered, vesting, and benefit provisions. If a plan agreement or a description thereof providing this information is otherwise published or made available, the description in the financial statement disclosures may be omitted, provided that a reference to the other source is made.
- A description of significant plan amendments adopted during the period, as well as significant changes in the nature of the plan (for example, a plan spin-off or merger with another plan) and changes in actuarial assumptions.
- The funding policy and any changes in the policy made during the plan year. If the benefit obligations exceed the net assets of the plan, the method of funding this deficit, as provided for in the plan agreement or collective bargaining agreement, also should be disclosed.[27] For a contributory plan, the disclosure should state the method of determining participants' contributions. For each year for which a year-end statement of net assets available for benefits is presented, the plan should disclose a description of the portion of the plan's estimated cost[28] of providing postretirement benefits funded by retiree contributions. If the plan terms provide that a shortfall in attaining the intended cost sharing in the prior year(s) is to be recovered by increasing the retiree contribution in the current year, that incremental contribution should be separately disclosed. Similarly, if the plan terms provide that participant

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[26] Certain of the disclosures relate to plans with accumulated assets rather than those with trusts that act more as conduits for benefit payments or insurance premiums. [Footnote renumbered by the issuance of Statement of Position 01-2, April 2001.]

[27] If significant plan administration or related costs are being borne by the employer, that fact should be disclosed. [Footnote renumbered by the issuance of Statement of Position 01-2, April 2001.]

[28] The plan's estimated cost of postretirement benefits is the plan's expected claims cost for the year. It excludes benefit costs paid by Medicare and costs, such as deductibles and copayments, paid directly to the medical provider by participants. The portion of the plan's estimated cost that is funded by retiree contributions is determined at the beginning of the year based on the plan sponsor's cost-sharing policy. In determining that amount, the retirees' required contribution for the year should be reduced by any amounts intended to recover a shortfall (or increased by amounts intended to compensate for an overcharge) in attaining the desired cost-sharing in prior year(s). [Footnote added, effective for financial statements for plan years beginning after December 15, 2000, by Statement of Position 01-2.]

contributions in the current year are to be reduced by the amount by which participant contributions in prior year exceeded the amount needed to attain the desired cost-sharing, the resulting reduction in the current year contribution should be separately disclosed. The information about retiree contributions should be provided for each significant group of retired participants to the extent their contributions differ.

- The federal income tax status of the plan. There is no determination letter program for health and welfare plans; however a 501(c)(9) VEBA trust must obtain a determination letter to be exempt from taxation.
- The policy regarding the purchase of contracts with insurance companies that are excluded from plan assets. Consideration should be given to disclosing the type and extent of insurance coverage, as well as the extent to which risk is transferred (for example, coverage period and claims reported or claims incurred).
- Identification of investments that represent 5 percent or more of the net assets available for benefits as of the end of the year. Consideration should be given to disclosing provisions of insurance contracts included as plan assets that could cause an impairment of the asset value upon liquidation or other occurrence (for example, surrender charges and market value adjustments).
- The amounts and types of securities of the employer and related parties included in plan assets, and the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer and related parties.
- Significant real estate or other transactions in which the plan and any of the following parties are jointly involved: the sponsor, the plan administrator, employers, or employee organizations.
- Unusual or infrequent events or transactions occurring after the financial statement date, but before issuance of the financial statements, that might significantly affect the usefulness of the financial statements in an assessment of the plan's present and future ability to pay benefits. For example, a plan amendment adopted after the latest financial statement date that significantly increases future benefits attributable to an employee's service rendered before that date, a significant change in the market value of a significant portion of the plan's assets, or the emergence of a catastrophic claim should be disclosed. If reasonably determinable, the effects of such events or transactions should be disclosed. If such effects are not reasonably determinable, the reasons why they are not quantifiable should be disclosed.
- Material lease commitments, other commitments, or contingent liabilities.
- The assumed health care cost-trend rate(s) used to measure the expected cost of benefits covered by the plan for the next year, a general description of the direction and pattern of change in the assumed trend rates thereafter, the ultimate trend rate(s), and when that rate is expected to be achieved.
- For health and welfare benefit plans providing postretirement health care benefits, the effect of a one-percentage-point increase in the assumed health care cost-trend rates for each future year on the postretirement benefit obligation.

- Any modification of the existing cost-sharing provisions that are encompassed by the substantive plan(s) and the existence and nature of any commitment to increase monetary benefits provided by the plan and their effect on the plan's financial statements.
- Termination provisions of the plan and priorities for distribution of assets, if applicable.
- Restrictions, if any, on plan assets (for example, legal restrictions on multiple trusts).

SOP 94-4, as amended, contains the following financial statement presentation and disclosure requirements:

- The statement of net assets available for benefits of the plan shall present amounts for (1) total assets, (2) total liabilities, (3) net assets reflecting all investments at fair value, and (4) net assets available for benefits. The amount representing the difference between (3) and (4) shall be presented on the face of the statement of net assets available for benefits as a single amount, calculated as the sum of the amounts necessary to adjust the portion of net assets attributable to each fully benefit-responsive investment contract from fair value to contract value. The statement of changes in net assets available for benefits shall be prepared on a basis that reflects income credited to participants in the plan and net appreciation or depreciation in the fair value of only those investment contracts that are not deemed to be fully benefit responsive.
- Defined-contribution plans, including both health and welfare, and pension plans, shall disclose the following in connection with fully benefit-responsive investment contracts, in the aggregate:

  a. A description of the nature of those investment contracts, how they operate, and the methodology for calculating the interest crediting rate, including the key factors that could influence future average interest crediting rates, the basis for and frequency of determining interest crediting rate resets, and any minimum interest crediting rate under the terms of the contracts. This disclosure should explain the relationship between future interest crediting rates and the amount reported on the statement of net assets available for benefits representing the adjustment for the portion of net assets attributable to fully benefit-responsive investment contracts from fair value to contract value.

  b. The average yield earned by the plan for all fully benefit-responsive investment contracts (which may differ from the interest rate credited to participants in the plan) for each period for which a statement of net assets available for benefits is presented. This average yield shall be calculated by dividing the annualized earnings of all fully benefit-responsive investment contracts in the plan (irrespective of the interest rate credited to participants in the plan) by the fair value of all fully benefit-responsive investment contracts in the plan.

  c. The average yield earned by the plan for all fully benefit-responsive investment contracts with an adjustment to reflect the actual interest rate credited to participants in the plan for each period for which a statement of net assets available for benefits is presented. This average yield shall be calculated by dividing the annualized earnings credited to participants in the plan for all fully benefit-responsive investment contracts in the plan (irrespective of the actual earnings of those investments) by the fair value of all fully benefit-responsive investment contracts in the plan.

d. A description of the events that limit the ability of the plan to transact at contract value with the issuer (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives), including a statement as to whether the occurrence of those events that would limit the plan's ability to transact at contract value with participants in the plan is probable or not probable. [The term *probable* is used in this Statement consistent with its use in FASB Statement No. 5, *Accounting for Contingencies*.]

e. A description of the events and circumstances that would allow issuers to terminate fully benefit-responsive investment contracts with the plan and settle at an amount different from contract value.

- For ERISA-covered plans, if a fully benefit-responsive investment contract does not qualify for contract-value reporting in the DOL Form 5500 but is reported in the financial statements at contract value, and the contract value does not approximate fair value, the DOL's rules and regulations require that a statement explaining the differences between amounts reported in the financial statements and DOL Form 5500 be added to the financial statements.
- The weighted-average assumed discount rate used to measure the plan's obligation for postemployment benefits.

This list does not include information that, in accordance with ERISA requirements, must be disclosed in the schedules filed as part of a plan's annual report. It is important to note that any information required by ERISA to be disclosed in the schedules must be disclosed in the schedules; disclosure of the information in the footnotes to the financial statements but not in the schedules is not acceptable to the DOL. [Paragraph renumbered and amended, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4. As amended, effective for financial statements for plan years ending after December 15, 1999, by Statement of Position 99-3. Paragraph subsequently renumbered and amended, effective for financial statements for plan years beginning after December 15, 2000, by Statement of Position 01-2. Paragraph subsequently renumbered and revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, June 2006, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

[The next page is 79,603.]

.65 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. In April 2003 the FASB issued Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. This Statement amends and clarifies financial accounting and reporting for derivatives and hedging activities under FASB Statement No. 133. In particular, FASB Statement No. 149 says that a contract that is accounted for under either paragraph 4 of FASB Statement No. 110 or paragraph 12 of FASB Statement No. 35, as amended, is not subject to FASB Statement No. 133. Similarly, a contract that is accounted for under either paragraph 4 or 5 of SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plan*, is not subject to FASB Statement No. 133. Those exceptions apply only to the party that accounts for the contract under FASB Statement No. 35 and No. 110, or SOP 94-4. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Paragraph subsequently renumbered by the issuance of Statement of Position 01-2, April 2001. Paragraph subsequently renumbered and revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.66 FASB Statement No. 107, as amended by FASB Statement No. 126 and No. 133, requires all entities except for those covered by the exemption in FASB Statement No. 126,[†] for which the disclosure is optional, to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. Generally, financial instruments of a health and welfare plan are included in the scope of FASB Statement No. 107, as amended, and are subject to the disclosure requirements of paragraphs 10 through 14 of that Statement. [Paragraph added, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.67 FASB Statement No. 107, as amended, requires entities except for those covered by the exemption in FASB Statement No. 126,[†] for which the disclosure is optional, to disclose, within the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value. An entity also should disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Paragraph subsequently renumbered by the issuance of Statement of Position 01-2, April 2001. Paragraph subsequently renumbered and revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.68 FASB Statement No. 107, as amended, requires disclosure of all significant concentrations of credit risk arising from all financial instruments.

[†] FASB Statement No. 126 amends FASB Statement No. 107 to make the disclosures prescribed in FASB Statement No. 107 optional for plans that meet all of the following criteria:

a. The plan is a nonpublic entity.

b. The plan's total assets are less than $100 million on the date of the financial statements.

c. The plan has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, during the reporting period.

[Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

The following information shall be disclosed about each significant concentration:

- Information about the (shared) activity, region, or economic characteristic that identifies the concentration
- The maximum amount of loss due to credit risk that, based on the gross fair value of the financial instrument, the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments
- The entity's policy of entering into master netting arrangements to mitigate the credit risk of financial instruments, information about the arrangements for which the entity is a party, and a brief description of the terms of those arrangements, including the extent to which they would reduce the entity's maximum amount of loss due to credit risk

[Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Paragraph subsequently renumbered by the issuance of Statement of Position 01-2, April 2001. Paragraph subsequently renumbered and revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Terminating Plans

.69 The auditing interpretation "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting" (AICPA, *Professional Standards*, vol. 1, AU section 9508.33–.38) contains applicable guidance regarding the auditor's reporting responsibilities for terminating plans. For purposes of this discussion, a terminating plan includes all plans about which a termination decision has been made regardless of whether the terminating plan will be replaced. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Paragraph subsequently renumbered by the issuance of Statement of Position 01-2, April 2001. Paragraph subsequently renumbered, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.70 When the decision has been made to terminate a plan,[29] or a wasting trust—that is, a plan under which participants no longer accrue benefits but that will remain in existence as long as necessary to pay already accrued benefits—exists, complete and prominent disclosure of the relevant circumstances is essential in all subsequent financial statements issued by the plan. If the decision to terminate a plan is made before the end of the plan year, it is also necessary for the plan's year-end financial statements to be prepared on

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[29] See paragraph 12.11 of the guide, which states that the auditor should obtain from the plan trustee, administrator, or administrative agent written representation about whether there is a present intention to terminate the plan. Refer also to paragraph 10.33 of the guide, which states that the auditor should consider confirming with the plan's actuary knowledge of an intent on the part of the employer to terminate the plan. [Footnote renumbered by the issuance of Statement of Position 01-2, April 2001.]

the *liquidation* basis of accounting, as described below. If the decision is made after the year end but before the year-end financial statements have been issued, the decision is generally a *type two* subsequent event requiring the disclosure described in SAS No. 1, *Codification of Auditing Standards and Procedures* [section 560.05]. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Paragraph subsequently renumbered by the issuance of Statement of Position 01-2, April 2001. Paragraph subsequently renumbered, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.71 Plan financial statements for periods ending after the termination decision are prepared on the liquidation basis of accounting. For plan assets, changing to the liquidation basis will usually cause little or no change in values, most of which are current market values. Assets that may not be carried at market values include operating assets, insurance and certain investment contracts carried at *contract values*, or large blocks of stock or other assets that cannot be readily disposed of at their quoted market prices. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Paragraph subsequently renumbered by the issuance of Statement of Position 01-2, April 2001. Paragraph subsequently renumbered and revised, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.72 Benefit obligations should be determined on a liquidation basis, and their value may differ from the actuarial present value of benefit obligations reported for an ongoing plan. Consideration should be given upon termination to whether any or all benefits become vested. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Paragraph subsequently renumbered by the issuance of Statement of Position 01-2, April 2001. Paragraph subsequently renumbered, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Effective Date and Transition

.73 This SOP is effective for audits of financial statements of single-employer plans for plan years beginning after December 15, 1992, except that the application of this SOP to plans of single employers with no more than 500 participants in the aggregate is effective for plan years beginning after December 15, 1994. This SOP is effective for audits of financial statements of multiemployer plans for plan years beginning after December 15, 1995. Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this SOP shall be made retroactively. Financial statements of prior plan years are required to be restated to comply with the provisions of this SOP *only* if they are presented together with financial statements for plan years beginning after December 15, 1992. If accounting changes were necessary to conform to the provisions of this SOP, that fact shall be disclosed when financial statements for the year in which this SOP is first applied are presented either alone or with financial statements of prior years. [Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Paragraph subsequently renumbered by the issuance of Statement of Position 01-2, April 2001. Paragraph subsequently renumbered, June 2004, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

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Appendix

Illustrative Financial Statements and Disclosures of Employee Health and Welfare Benefit Plans

A-1. This appendix illustrates certain applications of the provisions of this SOP that apply to the annual financial statements of three hypothetical health and welfare benefit plans that have assets in underlying trusts. They are—

a. Allied Industries Health Care Benefit Plan, a multiemployer defined benefit health and welfare plan that provides an example of financial reporting where retirees contribute a portion of the cost for their medical coverage (exhibit A).

b. Classic Enterprises Benefit Plan, a single-employer plan that displays the benefit obligation information on the face of the financial statements along with the net asset information (exhibit B).

c. ABC Company Supplemental Unemployment Benefit Plan, a multiemployer plan that provides postemployment benefits to covered employees (exhibit C).

A-2. The plan in exhibit A pays all benefits directly from plan assets. The plan in exhibit B obtains insurance for current benefits from its assets. It is assumed that both plans provide health benefits and life insurance coverage to both active and retired participants. Exhibit A also assumes that the plan provides long-term disability benefits and limited coverage during periods of unemployment based on accumulated eligibility credits.

A-3. This appendix illustrates certain applications of the provisions of this Statement of Position (SOP). It does not illustrate other provisions of this SOP that might apply in circumstances other than those assumed in these examples. It also does not illustrate all disclosures required for a fair presentation in conformity with generally accepted accounting principles (GAAP). The formats presented and the wording of the accompanying notes are illustrative and are not necessarily the only possible presentations.

A-4. Although GAAP does not require comparative financial statements, the Employee Retirement Income Security Act of 1974 (ERISA) requires a comparative statement of net assets available for benefits. The illustrative financial statements are intended to comply with the requirements of ERISA.

A-5. ERISA and U.S. Department of Labor (DOL) regulations require that certain information be included in supplemental schedules, which are not required under GAAP. See appendix A of AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* for a further discussion of the ERISA and DOL requirements.

Exhibit A

ALLIED INDUSTRIES HEALTH CARE BENEFIT PLAN
Allied Industries Health Care Benefit Plan
Statements of Net Assets Available for Benefits
December 31, 20X2 and 20X1

	20X2	*20X1*
Assets		
Investments at fair value (see note 3)		
U.S. government securities	$5,000,000	$4,000,000
Corporate bonds and debentures	2,000,000	1,600,000
Common stock	1,000,000	600,000
Total investments	8,000,000	6,200,000
Receivables		
Participating employers' contributions	500,000	430,000
Participants' contributions	100,000	80,000
Accrued interest and dividends	50,000	40,000
Total receivables	650,000	550,000
Cash	140,000	115,000
TOTAL ASSETS	8,790,000	6,865,000
Liabilities		
Due to broker for securities purchased	250,000	240,000
Accounts payable for administrative expenses	25,000	25,000
TOTAL LIABILITIES	275,000	265,000
NET ASSETS AVAILABLE FOR BENEFITS	$8,515,000	$6,600,000

The accompanying notes are an integral part of the financial statements.

Allied Industries Health Care Benefit Plan
Statements of Changes in Net Assets Available for Benefits
Years Ended December 31, 20X2 and 20X1

	20X2	*20XI*
Contributions		
Participating employers	$15,000,000	$14,500,000
Participants	3,000,000	2,800,000
Total contributions	18,000,000	17,300,000
Investment income		
Net appreciation in fair value of investments	300,000	200,000
Interest	500,000	450,000
Dividends	50,000	50,000
	850,000	700,000
Less investment expenses	15,000	25,000
Net investment income	835,000	675,000
TOTAL ADDITIONS	18,835,000	17,975,000
Benefits paid to participants		
Health care	16,000,000	15,750,000
Disability and death	770,000	750,000
	16,770,000	16,500,000
Administrative expenses	150,000	175,000
TOTAL DEDUCTIONS	16,920,000	16,675,000
NET INCREASE DURING YEAR	1,915,000	1,300,000
Net assets available for benefits		
Beginning of year	6,600,000	5,300,000
End of year	$8,515,000	$6,600,000

The accompanying notes are an integral part of the financial statements.

Allied Industries Health Care Benefit Plan
Statements of Plan's Benefit Obligations
December 31, 20X1 and 20X0

	20X1	*20X0*
Amounts currently payable		
Claims payable, claims incurred but not reported, and premiums due to insurers	$ 1,200,000	$ 1,050,000
Postemployment benefit obligations, net of amounts currently payable		
Death and disability benefits for inactive participants	1,350,000	1,000,000
Postretirement benefit obligations, net of amounts currently payable		
Retired participants	2,000,000	1,900,000
Other participants fully eligible for benefits	4,000,000	3,600,000
Participants not yet fully eligible for benefits	5,000,000	4,165,000
	11,000,000	9,665,000
PLAN'S TOTAL BENEFIT OBLIGATIONS	$13,550,000	$11,715,000

The accompanying notes are an integral part of the financial statements.

Allied Industries Health Care Benefit Plan
Statement of Changes in Plan's Benefit Obligations
Year Ended December 31, 20X1

	20X1
Amounts currently payable	
Balance at beginning of year	$ 1,050,000
Claims reported and approved for payment, including benefits reclassified from benefit obligations	16,920,000
Claims paid	(16,770,000)
Balance at end of year	1,200,000
Postemployment benefit obligations, net of amounts currently payable	
Balance at beginning of year	1,000,000
Increase (decrease) in postemployment benefits attributable to: Benefits earned	600,000
Benefits reclassified to amounts currently payable	(450,000)
Interest	90,000
Changes in actuarial assumptions and other actuarial gains and losses	110,000
Balance at end of year	1,350,000
Postretirement benefit obligations, net of amounts currently payable	
Balance at beginning of year	9,665,000
Increase (decrease) in postretirement benefits attributable to: Benefits earned	1,150,000
Benefits reclassified to amounts currently payable	(650,000)
Interest	750,000
Plan amendment	(175,000)
Changes in actuarial assumptions and other actuarial gains and losses	260,000
Balance at end of year	11,000,000
PLAN'S TOTAL BENEFIT OBLIGATIONS AT END OF YEAR	$13,550,000

The accompanying notes are an integral part of the financial statements.

Allied Industries Health Care Benefit Plan
Notes to Financial Statements

NOTE 1: DESCRIPTION OF PLAN

The following description of the Allied Industries Benefit Plan (the Plan) provides only general information. Participants should refer to the Plan agreement for a complete description of the Plan's provisions.

General. The Plan provides health and other benefits covering all participants in the widgets industry in the Greater Metropolis area. The Plan and related trust were established on May 8, 1966, pursuant to a collective bargaining agreement between the Allied Employers' Trade Association and the Allied Union, Local 802. It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), as amended.

Benefits. The Plan provides health benefits (medical, hospital, surgical, major medical, and dental), permanent disability benefits, and death benefits to full-time participants (with at least 450 hours of work in the industry during a consecutive three-month period) and to their beneficiaries and covered dependents. Retired employees are entitled to similar health benefits (in excess of Medicare coverage) provided they have attained at least age sixty-two and have fifteen years of service with participating employers before retirement.

The Plan also provides health benefits to participants during periods of unemployment, provided they have accumulated in the current year or in prior years credit amounts (expressed in hours) in excess of the hours required for current coverage. Accumulated eligibility credits equal to one year's coverage may be carried forward.

Health, disability, and death claims of active and retired participants, dependents, and beneficiaries are processed by the Administrator Group, but the responsibility for payments to participants and providers is retained by the Plan.

In 20X2 the board of trustees amended the Plan to increase the deductible under major medical coverage from $100 to $300 and to extend dental coverage to employees retiring after December 31, 20X2. The amendment will not affect participating employers' contributions to the Plan in 20X3 under the current collective bargaining agreement.

Contributions. Participating employers contribute 5.5 percent of wages pursuant to the current collective bargaining agreement between employers and the union (expiring February 19, 20X5). Employees may contribute specified amounts, determined periodically by the Plan's actuary, to extend coverage to eligible dependents. The costs of the postretirement benefit plan are shared by the Plan's participating employers and retirees. In addition to deductibles and copayments, participant contributions in the current (and prior, if applicable) year were as follows:

Participants Retiring	*20X1 Retiree Contribution*	*20X0 Retiree Contribution*
(1) Pre-1990	(1) None	(1) None
(2) 1990–1994	(2) Retirees contribute 20% of estimated cost of providing their postretirement benefits‡	(2) Retirees contribute 20% of estimated cost of providing their postretirement benefits
(3) 1995–1999	(3) Retirees pay the cost of providing their postretirement benefits in excess of $200 per month "cap" (approximately 60% of the estimated cost)	(3) Retirees pay the cost of providing their postretirement benefits in excess of $200 per month "cap" (approximately 50% of the estimated cost)
(4) 2000 and after	(4) Retirees pay 100% of estimated cost of providing their postretirement benefits	(4) Retirees pay 100% of estimated cost of providing their postretirement benefits

Other. The Plan's board of trustees, as Sponsor, has the right under the Plan to modify the benefits provided to active employees. The Plan may be terminated only by joint agreement between industry and union, subject to the provisions set forth in ERISA.

NOTE 2: SUMMARY OF ACCOUNTING POLICIES

A. Valuation of Investments. The Plan's investments are stated at fair value. Securities traded on the national securities exchange are valued at the last reported sales price on the last business day of the plan year. Investments traded in the over-the-counter market and listed securities for which no sale was reported on that date are valued at the average of the last reported bid and asked prices. For certain corporate bonds that do not have an established fair value, the Plan's board of trustees has established a fair value based on yields currently available on comparable securities of issuers with similar credit ratings.

B. Postretirement Benefits. The amount reported as the postretirement benefit obligation represents the actuarial present value of those estimated future benefits that are attributed by the terms of the plan to employees' service rendered to the date of the financial statements, reduced by the actuarial present value of contributions expected to be received in the future from current plan participants. Postretirement benefits include future benefits expected to be paid to or for (1) currently retired or terminated employees and their beneficiaries and dependents and (2) active employees and their beneficiaries and dependents after retirement from service with participating employers. The postretirement benefit obligation represents

‡ Excluding $15 per month per capita increase in 20X1 due to adverse claims experience in 20X0. [Footnote added, effective for financial statements for plan years beginning after December 15, 2000, by Statement of Position 01-2.]

the amount that is to be funded by contributions from the plan's participating employers and from existing plan assets. Prior to an active employee's full eligibility date, the postretirement benefit obligation is the portion of the expected postretirement benefit obligation that is attributed to that employee's service in the industry rendered to the valuation date.

The actuarial present value of the expected postretirement benefit obligation is determined by an actuary and is the amount that results from applying actuarial assumptions to historical claims-cost data to estimate future annual incurred claims costs per participant and to adjust such estimates for the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as those for death, disability, withdrawal, or retirement) between the valuation date and the expected date of payment.

For measurement purposes, a 9.5 percent annual rate of increase in the per capita cost of covered health care benefits was assumed for 20X3; the rate was assumed to decrease gradually to 8.0 percent for 20X8 and to remain at that level thereafter. These assumptions are consistent with those used to measure the benefit obligation at December 31, 20X1.

The following were other significant assumptions used in the valuations as of December 31, 20X2 and 20X1.

Weighted-average discount rate	8.0%—20X2; 8.25%—20X1
Average retirement age	60
Mortality	1971 Group Annuity Mortality Table

The foregoing assumptions are based on the presumption that the Plan will continue. Were the Plan to terminate, different actuarial assumptions and other factors might be applicable in determining the actuarial present value of the postretirement benefit obligation.

C. Other Plan Benefits. Plan obligations at December 31 for health claims incurred by active participants but not reported at that date, for accumulated eligibility of participants, and for future disability payments to members considered permanently disabled at December 31 are estimated by the Plan's actuary in accordance with accepted actuarial principles. Such estimated amounts are reported in the accompanying statement of the Plan's benefit obligations at present value, based on an 8.0 percent discount rate. Health claims incurred by retired participants but not reported at year end are included in the postretirement benefit obligation.

NOTE 3: INVESTMENTS

The Plan's investments are held by a bank-administered trust fund. During 20X2 and 20X1 the Plan's investments (including investments bought, sold, and held during the year) appreciated in value by $300,000 and $200,000, respectively, as follows:

	20X2		*20X1*	
	Net Increase (Decrease) in Value During Year	*Fair Value at End of Year*	*Net Increase (Decrease) in Value During Year*	*Fair Value at End of Year*
Fair value as determined by quoted market price:				
U.S. government securities	$200,000	$5,000,000	$ (75,000)	$4,000,000
Corporate bonds and debentures	(25,000)	1,750,000	50,000	1,375,000
Common stocks	100,000	1,000,000	200,000	600,000
	275,000	7,750,000	175,000	5,975,000
Fair value as estimated by Plan's board of trustees:				
Corporate bonds	25,000	250,000	25,000	225,000
	$300,000	$8,000,000	$200,000	$6,200,000

The fair value of individual investments that represent 5.0 percent or more of the Plan's net assets are as follows:

	20X2	*20X1*
Commonwealth Power Co., 9.0% bonds due 2014 ($500,000 face amount)	$475,000	$450,000
ABC Company common stock (2,000 shares)	500,000	450,000
U.S. Treasury bond, 8.5% due 20X6 ($360,000 face amount)		350,000

NOTE 4: BENEFIT OBLIGATIONS

The Plans deficiency of net assets over benefit obligations at December 31, 20X2 and 20X1, relates primarily to the postretirement benefit obligation, the funding of which is not covered by the contribution rate provided by the current bargaining agreement. It is expected that the deficiency will be funded through future increases in the collectively bargained contribution rates.

The weighted-average health care cost-trend rate assumption (see note 2B) has a significant effect on the amounts reported in the accompanying financial statements. If the assumed rates increased by one percentage point in each year, it would increase the obligation as of December 31, 20X2 and 20X1, by $2,600,000 and $2,500,000, respectively.

NOTE 5: OTHER MATTERS

The trust established under the Plan to hold the Plan's assets is qualified pursuant to Section 501(c)9 of the Internal Revenue Code, and, accordingly, the trust's net investment income is exempt from income taxes. The Plan has obtained a favorable tax determination letter from the Internal Revenue Service, and the Plan sponsor believes that the Plan, as amended, continues to qualify and to operate as designed.

Exhibit B

CLASSIC ENTERPRISES BENEFIT PLAN

Classic Enterprises Benefit Plan
Statements of Benefit Obligations and Net Assets Available for Benefits
December 31, 20X2 and 20X1

	20X2	*20X1*
Benefit Obligations (see note 4)		
Amounts due insurance companies	$1,200,000	$1,000,000
Postretirement benefit obligations	11,000,000	9,665,000
Total benefit obligations	12,200,000	10,665,000
Net Assets		
Investments at fair value (see note 3)		
U.S. government securities	$5,000,000	$4,000,000
Corporate bonds and debentures	2,000,000	1,600,000
Common stock	1,000,000	600,000
Total investments	8,000,000	6,200,000
Receivables		
Sponsor's contributions	500,000	430,000
Participants' contributions	100,000	80,000
Accrued interest and dividends	50,000	40,000
Total receivables	650,000	550,000
Cash	75,000	60,000
Insurance premium deposits	65,000	55,000
TOTAL ASSETS	8,790,000	6,865,000
Liabilities		
Due to broker for securities purchased	250,000	240,000
Accounts payable for administrative expenses	25,000	25,000
TOTAL LIABILITIES	275,000	265,000
NET ASSETS AVAILABLE FOR BENEFITS	8,515,000	6,600,000
EXCESS OF BENEFIT OBLIGATIONS OVER NET ASSETS AVAILABLE FOR BENEFITS	$3,685,000	$4,065,000

The accompanying notes are an integral part of the financial statements.

Classic Enterprises Benefit Plan
Statement of Changes in Benefit Obligations and
Net Assets Available for Benefits
Years Ended December 31, 20X2 and 20X1

	20X2	*20X1*
Net Increase in Benefit Obligations		
Increase (Decrease) during the year attributable to:		
Benefits earned and other changes	$ 1,510,000	$ 1,000,000
Additional amounts payable to insurance company	200,000	100,000
Plan amendment	(175,000)	—
	1,535,000	1,100,000
Net Increase in Net Assets Available for Benefits		
Contributions		
Sponsor	15,000,000	14,500,000
Participants	3,000,000	2,800,000
Total contributions	18,000,000	17,300,000
Investment income		
Net appreciation in fair value of investments	300,000	200,000
Interest	500,000	450,000
Dividends	50,000	50,000
	850,000	700,000
Less investment expenses	15,000	25,000
Net investment income	835,000	675,000
TOTAL ADDITIONS	18,835,000	17,975,000
Insurance premiums paid for health benefits, net of experience-rating adjustments of $250,000 for 20X1 received in 20X2 and $275,000 for 20X0 received in 20X1	16,035,000	15,750,000
Insurance premiums paid for death benefits	780,000	750,000
	16,815,000	16,500,000
Administrative expenses	105,000	175,000
TOTAL DEDUCTIONS	16,920,000	16,675,000
NET INCREASE	1,915,000	1,300,000
Increase (Decrease) in Net Assets Available for Benefits Over Benefit Obligations	(380,000)	(200,000)
Excess of Benefit Obligations Over Net Assets Available for Benefits		
Beginning of year	4,065,000	4,265,000
End of year	$ 3,685,000	$ 4,065,000

The accompanying notes are an integral part of the financial statements.

Classic Enterprises Benefit Plan
Notes to Financial Statements

NOTE 1: DESCRIPTION OF PLAN

The following description of the Classic Enterprises Benefit Plan (the Plan) provides only general information. Participants should refer to the Plan agreement for a complete description of the Plan's provisions.

General. The Plan provides health and death benefits covering substantially all active and retired employees of Classic Enterprises (the Sponsor). It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), as amended.

Benefits. The Plan provides health benefits (medical, hospital, surgical, major medical, and dental) and death benefits to full-time employees of the Sponsor (with at least 1,000 hours of service each year) and to their beneficiaries and covered dependents. Retired employees are entitled to similar health and death benefits provided they have attained at least age fifty-five and have at least ten years of service with the Sponsor.

Current health claims of active and retired participants and their dependents and beneficiaries are provided under group insurance contracts with ABC Carrier, which are experience rated after the anniversary dates of the policies (generally March 31). Death benefits are covered by a group-term policy with DEF Carrier.

Contributions. The Sponsor's policy is to contribute the maximum amounts allowed as a tax deduction by the Internal Revenue Code. Under present law, the Sponsor is not permitted to deduct amounts for future benefits to current employees and retirees.

Employees and retirees may contribute specified amounts, determined periodically by the Plan's insurance companies, to extend coverage to eligible dependents.

In 20X2 the Plan was amended to increase the deductible under major medical coverage from $100 to $300 and to extend dental coverage to employees retiring after December 31, 20X2. The amendment is not expected to significantly affect the Sponsor's contribution to the Plan in 20X3.

Other. Although it has not expressed any intention to do so, the Sponsor has the right under the Plan to modify the benefits provided to active employees, to discontinue its contributions at any time, and to terminate the Plan subject to the provisions set forth in ERISA.

NOTE 2: SUMMARY OF ACCOUNTING POLICIES

A. Valuation of Investments. The Plan's investments are stated at fair value. Securities traded on the national securities exchange are valued at the last reported sales price on the last business day of the plan year. Investments traded in the over-the-counter market and listed securities for which no sale was reported on that date are valued at the average of the last reported bid and asked prices. For certain corporate bonds that do not have an established fair value, the Classic Enterprises Benefits Committee has established a fair value based on yields currently available on comparable securities of issuers with similar credit ratings.

B. Plan Benefits. The postretirement benefit obligation (see note 4) represents the actuarial present value of those estimated future benefits that are attributed to employee service rendered to December 31. Postretirement benefits include future benefits expected to be paid to or for (1) currently retired employees and their beneficiaries and dependents and (2) active employees and their beneficiaries and dependents after retirement from service with the Sponsor. Prior to an active employee's full eligibility date, the postretirement benefit obligation is the portion of the expected postretirement benefit obligation that is attributed to that employee's service rendered to the valuation date.

The actuarial present value of the expected postretirement benefit obligation is determined by an actuary and is the amount that results from applying actuarial assumptions to historical claims-cost data to estimate future annual incurred claims costs per participant and to adjust such estimates for the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as those for death, disability, withdrawal, or retirement) between the valuation date and the expected date of payment, and to reflect the portion of those costs expected to be borne by Medicare, the retired participants, and other providers.

For measurement purposes at December 31, 20X2, a 9.5 percent annual rate of increase in the per capita cost of covered health care benefits was assumed for 20X3; the rate was assumed to decrease gradually to 8.0 percent for 20X8 and to remain at that level thereafter. These assumptions are consistent with those used to measure the benefit obligation at December 31, 20X1.

The following were other significant assumptions used in the valuations as of December 31, 20X2 and 20X1.

Weighted-average discount rate	8.0%
Average retirement age	60
Mortality	1971 Group Annuity Mortality Table

The foregoing assumptions are based on the presumption that the Plan will continue. Were the Plan to terminate, different actuarial assumptions and other factors might be applicable in determining the actuarial present value of the postretirement benefit obligation.

NOTE 3: INVESTMENTS

The Plan's investments are held by a bank-administered trust fund. During 20X2 and 20X1, the plan's investments (including investments bought, sold, and held during the year) appreciated in value by $300,000 and $200,000, respectively, as follows:

	20X2		*20X1*	
	Net Increase (Decrease) in Value During Year	*Fair Value at End of Year*	*Net Increase (Decrease) in Value During Year*	*Fair Value at End of Year*
Fair value as determined by quoted market price:				
U.S. government securities	$200,000	$5,000,000	$ (75,000)	$4,000,000
Corporate bonds and debentures	(25,000)	1,750,000	50,000	1,375,000
Common stocks	100,000	1,000,000	200,000	600,000
	275,000	7,750,000	175,000	5,975,000
Fair value as estimated by Classic Enterprise Benefits Plan Investment Committee:				
Corporate bonds	25,000	250,000	25,000	225,000
	$300,000	$8,000,000	$200,000	$6,200,000

The fair value of individual investments that represent 5.0 percent or more of the Plan's net assets is as follows:

	20X2	*20X1*
Commonwealth Power Co., 9.0% bonds due 2014 ($500,000 face amount)	$475,000	$450,000
ABC Company common stock (2,000 shares)	500,000	450,000
U.S. Treasury bond, 8.5% due 20X6 ($360,000 face amount)		350,000

NOTE 4: BENEFIT OBLIGATIONS

Health costs incurred by participants and their beneficiaries and dependents are covered by insurance contracts maintained by the Plan. It is the present intention of the Sponsor and the Plan to continue obtaining insurance coverage for benefits. As stated in note 1, the Sponsor is not permitted under present tax law to deduct amounts for future benefits (beyond one year). Insurance premiums for future years in respect of the Plan's postretirement benefit obligation will be funded by Sponsor contributions to the Plan in those later years.

The postretirement benefit obligation at December 31, 20X2 and 20X1, principally health benefits, related to the following categories of participants (including their beneficiaries and dependents):

	20X2	*20X1*
Current retirees	$ 3,900,000	$3,500,000
Other participants fully eligible for benefits	2,100,000	2,000,000
Participants not yet fully eligible for benefits	5,000,000	4,165,000
	$11,000,000	$9,665,000

The health care cost-trend rate assumption (see note 2B) has a significant effect on the amounts reported. If the assumed rates increased by one percentage point in each year, that would increase the obligation as of December 31, 20X2 and 20X1, by $2,600,000 and $2,500,000, respectively.

NOTE 5: OTHER MATTERS

The trust established under the Plan to hold the Plan's net assets is qualified pursuant to Section 501(c)9 of the Internal Revenue Code, and, accordingly, the trust's net investment income is exempt from income taxes. The Sponsor has obtained a favorable tax determination letter from the Internal Revenue Service and the Sponsor believes that the Plan, as amended, continues to qualify and to operate as designed.

Exhibit C

ABC COMPANY SUPPLEMENTAL UNEMPLOYMENT BENEFIT PLAN

Supplemental Unemployment Benefit Plan for Employees of ABC Company Established Pursuant to Agreement With United Workers of America
Statements of Net Assets Available for Benefits
December 31, 20X1 and 20X0

	20X1	*20X0*
Assets		
Investments	$10,605	$ 80,750
Cash and cash equivalents	1,025	19,400
Accrued interest receivable	100	125
TOTAL ASSETS	11,730	100,275
Liability		
Accrued investment trustee fees	265	265
NET ASSETS AVAILABLE FOR BENEFITS	$11,465	$100,010

The accompanying notes are an integral part of the financial statements.

Supplemental Unemployment Benefit Plan for Employees of ABC Company Established Pursuant to Agreement With United Workers of America
Statement of Changes in Net Assets Available for Benefits
Year Ended December 31, 20X1

Additions:	
Contributions	$1,366,065
Interest income	1,960
TOTAL ADDITIONS	1,368,025
Deductions:	
Benefit payments	1,455,460
Investment trustee fees	1,110
TOTAL DEDUCTIONS	1,456,570
NET DECREASE DURING THE YEAR	(88,545)
Net assets available for benefits	
Beginning of year	100,010
End of year	$ 11,465

The accompanying notes are an integral part of the financial statements.

Supplemental Unemployment Benefit Plan for Employees of ABC Company Established Pursuant to Agreement With United Workers of America Notes to Financial Statements

NOTE 1: DESCRIPTION OF PLAN

In connection with a negotiated contract, the Supplemental Unemployment Benefit Plan for Employees of ABC Company Established Pursuant to Agreement With United Workers of America (the Plan) provides for payment of supplemental unemployment benefits to covered employees who have completed two years of continuous service. Payments are made to (*a*) employees on layoff and (*b*) certain employees who work less than 32 hours in any week. The following description is provided for general information purposes. The Plan document should be referred to for specific information regarding benefits and other Plan matters.

NOTE 2: SUMMARY OF ACCOUNTING POLICIES

Basis of Accounting. The financial statements of the Plan are prepared under the accrual method of accounting.

Investment Valuation. The Plan's investments consist of shares of a money market portfolio. The investments are reported at fair value.

Use of Estimates. The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Benefit Obligations. The Plan's obligation for accumulated eligibility credits is discounted using a weighted-average assumed rate of 7½ percent.

NOTE 3: FUNDING AND OPERATION OF THE PLAN

Funding of the Plan. Contributions funded by ABC Company, the Plan's sponsor, pursuant to the Plan are invested in assets held in a trust fund (the Fund). General Bank, the trustee of the Fund (the Trustee), invests the Fund's money as set forth in the Plan document. Investments consist of money market funds and are reported in the accompanying financial statements at fair value. Interest income from investments is recognized when earned.

Administration. The ABC Company Benefit Plan Administrative Committee has responsibility for administering the Plan. The ABC Company Benefit Plan Asset Review Committee has responsibility for the management and control of the assets of the Trust.

Benefits Under the Plan. The Plan provides for the payment of weekly and short-week supplemental unemployment benefits. The benefits payable are reduced by any state unemployment benefits or any other compensation received. Also, a "waiting-week" benefit of $100 will be payable if a participant fails to receive a state unemployment benefit solely because of the state's waiting-week requirement. Benefits paid for any week for which the employee received state unemployment benefits are limited to $180. Benefits paid for all other weeks are limited to $235. The Plan provides for a possible reduction of weekly benefits for employees with less than twenty years of service based upon a percentage determined generally by dividing the net assets of the Plan, as defined in the Plan document, by the "maximum financing" (see "ABC's Obligations Under the Plan"). Employees earn one-half credit unit for each week in which hours are worked or, in some situations, in which hours are not worked (vacation, disability, serving on grievance committee, and so on) up to a maximum of fifty-two credit units for employees with less than twenty years of service and 104 credit units for employees with twenty or more years of service. Generally, one credit unit is canceled for each weekly benefit paid and one-half credit unit is canceled for each short-week benefit paid.

ABC's Obligations Under the Plan. The "maximum financing" of the Plan at any month end is the lesser of (a) the product of $.40 and the number of hours worked by covered employees during the first twelve of the fourteen months next preceding the first day of the month and (b) 100 times the sum of the monthly benefits paid for the sixty of the preceding sixty-two months divided by sixty. ABC's monthly contribution to the Plan is computed as the lesser of (a) the product of $.175 and the number of hours worked by covered employees in the month and (b) the amount that, when added to the net assets of the Plan, as defined by the Plan document, as of the end of the preceding month, will equal the "maximum financing." In addition, ABC contributes an income security contribution of $.25 per hour worked by covered employees in the month. In the event of a plan deficit, ABC intends to make sufficient contributions to fund benefits as they become payable.

The following tables present the components of the plan's benefit obligations and the related changes in the plan's benefit obligations.

Benefit Obligations
December 31, 20X1 and 20X0

	20X1	*20X0*
Accumulated eligibility credits and total benefit obligations	$1,107,777	$1,095,620

Changes in Benefit Obligations
Year Ended December 31, 20X1

Benefit obligations, beginning of year	$1,095,620
Benefits earned	1,390,330
Interest	77,287
Claims paid	(1,455,460)
Benefit obligations, end of year	$1,107,777

Plan Expenses. ABC bears all administrative costs, except trustee fees, that are paid by the Plan.

NOTE 4: TAX STATUS

The Plan obtained its latest determination letter in 1990, in which the Internal Revenue Service stated that the Plan, as then designed, was in compliance with the applicable requirements of the Internal Revenue Code (IRC). The Plan has been amended since receiving the determination letter. Plan management and Plan's tax counsel believe that the Plan is currently designed and being operated in compliance with the applicable requirements of the IRC. Therefore, no provision for income taxes has been included in the Plan's financial statements.

NOTE 5: TRANSACTIONS WITH PARTIES IN INTEREST

ABC provides to the Plan certain accounting and administrative services for which no fees are charged.

NOTE 6: TERMINATION OF THE PLAN

Under certain conditions, the Plan may be terminated. Upon termination, the assets then remaining shall be subject to the applicable provisions of the Plan then in effect and shall be used until exhausted to pay benefits to employees in the order of their entitlement.

[Paragraph renumbered by the issuance of Statement of Position 94-4, September 1994. Paragraph subsequently renumbered and amended, effective for financial statements for plan years beginning after December 15, 2000, by Statement of Position 01-2.]

Employee Benefit Plans Committee (1990-1991)

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The Employee Benefit Plans Committee gratefully acknowledges the contributions of Dale L. Gerboth, Melissa A.R. Krause, and Harvey J. Nuland, former committee members; Daniel J. Cronin; the Office of Chief Accountant, Pension and Welfare Benefits Administration; and the Office of the Inspector General, U.S. Department of Labor.

[The next page is 79,631.]

Section 10,540

Statement of Position 93-1 Financial Accounting and Reporting for High-Yield Debt Securities by Investment Companies

January 28, 1993

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Introduction

.01 High-yield debt securities consist of high-yielding corporate and municipal debt obligations. These securities are frequently referred to as *junk bonds*. The issuance of high-yield debt securities has increased significantly over the past decade. They have supplied significant capital for business expansion and corporate restructuring. These securities are inherently different from investment-grade issues. They present additional credit, liquidity, and market risks for all participants in this marketplace: holders, issuers, underwriters, and broker-dealers.

.02 Recent estimates place the U.S. high-yield debt securities market at between $180 and $250 billion, with over 3300 individual security issues outstanding. Mutual funds and insurance companies each hold approximately 30 percent of such securities, and pension funds hold about 15 percent.

.03 High-yield debt securities are corporate and municipal debt securities having a lower-than-investment-grade credit rating (BB+ or lower by Standard & Poor's, or Ba or lower by Moody's). Because high-yield debt securities typically are used when lower-cost capital is not available, they have interest rates several percentage points higher than investment-grade debt and often have shorter maturities.

.04 High-yield debt securities typically are unsecured and subordinate to other debt outstanding. Many issuers of high-yield debt securities are highly leveraged, with limited equity capital. That, plus a market for such securities that may not always be liquid, may increase the market risk, liquidity risk, and credit risk of those securities.

.05 High-yield debt securities may be issued or traded at significant discounts from their face amounts (principal).

.06 Interest for some high-yield debt securities is not paid currently. Instead, interest may be deferred and paid at maturity (zero-coupon bonds) or in periodic interest payments that do not commence until a specific date in the securities' life cycle (step bonds), or interest may be paid in the form of additional debt securities of the issuer bearing similar terms (payment-in-kind bonds, or PIKs).

Market Risk

.07 In contrast to investment-grade bonds (the market prices of which change primarily as a reaction to changes in interest rates), the market prices of high-yield bonds (which are also affected by changes in interest rates) are influenced much more by credit factors and financial results of the issuer and by general economic factors that influence the financial markets as a whole.

.08 Such factors often make it difficult to substantiate the market valuation of high-yield bonds.

Liquidity Risk

.09 The market risk is often heightened by the absence of centralized high-yield bond exchanges and relatively thin trading markets, which make it more difficult to liquidate holdings quickly and increase the volatility of the market price. There is generally no centralized or regulated procedure for pricing high-yield debt issues.

Credit Risk

.10 Issues of high-yield debt securities are more likely to default on interest or principal than are issues of investment-grade securities. Most high-yield debt securities currently outstanding have been issued since 1985. Accordingly, there is little long-term record on how they perform over all parts of the business cycle.

.11 Adverse economic developments in 1990 and 1991 contributed to defaults on principal and interest payments by many issuers of high-yield debt securities. Those developments emphasized the need for taking great care in valuation, income recognition, and financial statement disclosure by holders of these securities.

Current Literature

.12 Although none of the current financial reporting or auditing literature specifically addresses the issues discussed in this statement of position (SOP), various sources in that literature provide indirect guidance, including the following:

- Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*

- FASB Statement No. 95, *Statement of Cash Flows*
- FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies*
- APB Opinion No. 29, *Accounting for Nonmonetary Transactions*
- FASB Emerging Issues Task Force (EITF) Issue No. 86-15, *Interest-Rate Debt*
- EITF Issue No. 89-4, *Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*
- AICPA Statement on Auditing Standards (SAS) No. 73, *Using the Work of a Specialist*
- AICPA Audit and Accounting Guide *Audits of Investment Companies*

Scope

.13 This SOP amends the Audit and Accounting Guide *Audits of Investment Companies* and is applicable to entities to which that guide applies.

.14 This SOP addresses the following reporting and accounting issues encountered by investment companies holding high-yield debt securities in their portfolios. Securities that have no credit rating should be classified as high-yield debt securities if they otherwise have the characteristics of such securities.

a. How should interest income from step bonds and payment-in-kind bonds be measured and reported in investment company financial statements?

b. How should previously recorded income and purchased interest be treated when recoverability becomes doubtful in connection with defaults or potential defaults by issuers?

c. How should additional expenditures made by investment companies in support of high-yield debt securities be accounted for?

d. What audit procedures to determine the reasonableness of valuations of high-yield debt securities should be considered?

Accounting for Income on Step-Interest and PIK Debt Securities

Discussion

.15 High-yield debt securities (junk bonds) take various forms. The most common forms may include zero-coupon bonds, PIK bonds, and deep-discount step bonds.

PIK Bonds

.16 Issuers of PIK bonds typically have the option at each interest payment date of making interest payments in cash or in additional debt securities. Those additional debt securities are referred to as *baby* or *bunny bonds.* Baby bonds generally have the same terms, including maturity dates and interest rates, as the original bonds (parent PIK bonds). Interest on baby bonds may also be paid in cash or in additional like-kind debt securities at the option of the issuer.

Step Bonds

.17 Step bonds generally are characterized by a combination of deferred-interest payment dates and increasing interest payment amounts over the bond lives. Thus, they bear some similarity to zero-coupon bonds and to traditional debentures.

Current Practices: Income Recognition

.18 Present income-recognition practices for high-yield debt securities vary.

PIK Bonds

.19 The most common methods currently used for revenue recognition on PIK bonds are the effective-interest method and the market-value method.

.20 *Effective-interest method.* Under the effective-interest method, also referred to in accounting literature as the interest method. PIK bonds and the additional debt securities issued in connection with interest payments on them are treated as a combined instrument, based on the assumption that all principal amounts will be paid at maturity. Interest income is recorded by the effective interest method, so that at final maturity the bonds' carrying amount will be equal to the aggregate principal amount of the original bonds and all baby bonds received. The realizable value of the bonds' interest previously accrued and recorded is evaluated periodically. Any adjustments are recorded as charges to interest income and reserves against interest receivable.

.21 *Market-value method.* Under the market-value method, interest income is accrued daily on the basis of the face value and the stated interest rate of the PIK bond. Each day, the related interest receivable is marked to market, thereby reflecting the current economic value of interest income recognized. The market price of the parent PIK bond generally includes accrued interest. To the extent that any accrued interest is determined to have been included in the quoted market price of the parent PIK bond, it is eliminated each day to avoid double counting of interest income.

.22 Further, the interest ex-date represents the first date that a PIK bond's market value does not include an interest component and interest income is fully accrued. From that date through the payment date, generally a period of one to two weeks, the bond theoretically trades without interest. (This is similar in concept to the ex-date for traditional equity securities paying periodic dividends.) Accordingly, from the interest ex-date through the interest payment date, no adjustment is necessary to reduce the bond market value for interest.

.23 At the payment date, the basis of the baby bonds actually received is compared with the amount accrued at the interest ex-date based on the current market value of the parent bond. Because interest receivable is being marked to market daily, no further adjustment to interest receivable generally is necessary. However, if the basis (that is, the current market value) of the baby bonds received and the accrued interest on the parent bond are different, the resulting adjustment is charged or credited to interest income.

.24 Should the reporting entity sell a PIK bond between interest payment dates, the proceeds received are allocated to interest accrued and bond basis in a manner that is consistent with the market valuation as of the trade date. The same is true for any purchases made between interest payment dates.

.25 One variation of the market-value method is to adjust the amount of interest income accrued by the interest method to the value of the bonds at the interest ex-date.

.26 A second variation is to accrue interest income daily on the basis of the coupon rate and adjust the interest income for the market value of the bonds received at the payment date only.

Step Bonds

.27 Currently, two methods are most commonly followed for revenue recognition on step bonds.

.28 *Effective-interest method.* Under the effective-interest method, also referred to in accounting literature as the interest method, total expected interest—the combination of the aggregate coupon-interest payments and the original issue discount—to be earned over the life of the bond is determined and the effective-interest rate is applied to recognize interest income daily for the bond. This method ignores any adjustment of interest rates and treats the bond as a zero-coupon instrument.

.29 *Bifurcation method.* The bifurcation method assumes that the bond is a discount bond only for the portion of its life during which payment of interest is deferred. During that period, an effective-interest rate is used. For the remainder of the bond's life for which a stated coupon rate exists, the stated interest rate is used to record interest income.

Views on the Issues

PIK Bonds

.30 Some believe that accounting for PIK bonds should follow the guidance for monetary assets that do not pay interest periodically, such as zero-coupon bonds, and that their interest should be accounted for by accretion by the effective-interest method. That is generally considered to be the method to use in recognizing income for tax purposes. It would allow consistency between tax and financial reporting treatments.

.31 Others contend that, because of the significant uncertainties concerning the realizability of income from PIK bonds, income should reflect the current values of the underlying investments regardless of stated coupon rates. They believe that the use of current value presents a more accurate picture of the current value of income received from PIK bonds.

Step Bonds

.32 Some believe that because there are differing interest payments throughout the lives of step bonds, including periods of no interest payments, step bonds have the same characteristics as zero-coupon bonds. They would therefore account for interest income by the effective-interest method.

.33 Others believe that the contractual nature of the interest payment schedules connected with these bonds should govern the accounting treatment. Thus, for periods of no interest payments, the effective-interest method should be used; when interest payments are being made, they should be used to account for income.

Conclusions

PIK Bonds

.34 Because PIK bonds generally possess many of the characteristics of zero-coupon bonds and because the effective-interest method provides the most analogous accounting treatment, it should be used to determine interest income. PIK bonds typically trade flat (that is, interest receivable is included in the market value quote obtained each day). Accordingly, that portion of the quote representing interest income needs to be identified. The sum of the acquisition amount of the bond and the discount to be amortized should not exceed the undiscounted future cash collections that are both reasonably estimable and probable. To the extent that interest income to be received in the form of baby bonds is not expected to be realized, a reserve against income should be established (that is, it should be determined periodically that the total amount of interest income recorded as receivable, plus the initial cost of the underlying PIK bond, does not exceed the current market value of those assets).

Step Bonds

.35 Income on step bonds should be recognized using the effective-interest method, which is a systematic and rational method for accruing income throughout a bond's life and is not affected by the timing of cash payments. Additionally, to the extent that interest income is not expected to be realized, a reserve against income should be established. The sum of the acquisition amount of the bond and the discount to be amortized should not exceed the undiscounted future cash collections that are both reasonably estimable and probable.

Securities and Exchange Commission (SEC) Yield Calculations

.36 SEC yield-formula calculations are required to be made using the specific guidelines presented in SEC Release No. 33-6753. Yields calculated that way may not be the same as the effective interest reported in the financial statements. The ultimate realizable value and the potential for early retirement of securities should be considered when computing SEC yields. Management's best estimates of ultimate realizable value must be reasonable. Because current values of many high-yield debt securities have declined significantly, computed yields for many of them may be higher than rates expected to be ultimately realized. To avoid unsound yield information, consideration should be given to capping yields of individual securities at some reasonable level and examining the underlying economic viability of the issuers.

.37 An investment company's portfolio should indicate all high-yield and restricted debt securities whose values have been estimated by its directors.

Accounting for Accrued Income and Purchased Interest in Connection With Defaulted Debt Securities

Discussion

.38 Interest receivable from debt securities generally comprises two distinct components: interest purchased from the previous bondholder and interest accrued by the investment company during the holding period. If market prices fluctuate significantly or issues of debt securities have defaulted, a judgment to write off interest receivable may be required. Both components of interest receivable must be evaluated.

.39 Writeoffs of interest receivable differ from traditional writeoffs of trade accounts receivable. They can significantly affect an investment company's statement of operations, the performance measurement ratios of expenses to average net assets, and net investment income to average net assets.

Current Practices

.40 Current practice for the writeoff of interest receivable is diverse. Most investment companies record the writeoff of accrued interest as a reduction of interest income. Many investment companies record the writeoff of purchased interest as an increase to the cost basis of securities, whereas others record such writeoffs as a reduction of interest income.

Views on the Issues

.41 Many believe that, to the extent that a writeoff is related to interest recognized by the investment company, it should be treated as a reduction of interest income. They further believe that treatment of interest writeoffs as expenses would present misleading expense ratios to users of financial statements of investment companies and cause difficulties in comparisons of performance information from different investment companies. They also believe that a writeoff of purchased interest is better presented as an adjustment to the cost basis of the security, because it was incurred simultaneously and integrally with the original purchase of the investment. Additionally, because purchased interest is not recorded as income, they believe it should not be treated as an offset to revenue.

Conclusion

.42 The portion of interest receivable on defaulted debt securities written off that was recognized as interest income should be treated as a reduction of interest income. Writeoffs of purchased interest should be reported as increases to the cost basis of the security and treated as unrealized losses until the security is sold.

.43 Those reserves should be recorded when they become probable and estimable in accordance with the guidance provided by FASB Statement No. 5, *Accounting for Contingencies*.

Accounting for Expenditures in Support of Defaulted Debt Securities

Discussion

.44 The market for many high-yield debt securities is relatively thin. When issuers of such securities default, the bondholders often become active in any negotiations and in the workout process. This process often results in new terms that restructure the high-yield obligations to allow the issuer to continue to meet its ongoing interest obligations and maintain some, if not all, of the principal value to the holders of the obligations.

.45 Adverse economic developments often lead to increases in the default rates of high-yield debt securities. In addition to occasional capital infusions, professional fees to legally restructure the investments are frequently incurred by the bondholders.

Current Practices

.46 Current accounting and disclosure practices concerning additional capital infusions to specific projects underlying a bond issue and professional fees incurred in connection with the restructuring of debt securities held as investments are diverse. Some record expenditures for both capital infusions and professional fees as additions to the original investment cost basis; others record expenditures for professional fees as operating expenses.

Views on the Issues

.47 Some believe that expenditures incurred to support the operations of a project or operator underlying a bond issue, either in the form of capital infusions or professional fees, should be charged to operations because such expenditures have no certain future economic benefit and do not increase the bond issuer's obligation payable to the bondholder. Others believe that such expenditures should be recorded as additions to the cost basis of the investment because they are made solely to enhance or protect the realizable value of the high-yield security.

Capital Infusions

.48 Capital infusions are expenditures made directly to the issuer to ensure that operations are completed, thereby allowing the issuer to generate cash flows to service the debt. Such expenditures are generally nonrecurring. In certain cases, bondholders may receive additional promissory notes, or the original bond instrument may be amended to provide for repayment of the capital infusions. However, regardless of whether or not additional promissory notes are received, some believe capital infusions generate a future economic benefit. They believe that such capital infusions should in all cases be considered additions to the cost of the investment. Further, they note that, because investment companies report their investment portfolios at market values, those additional capital infusions, if treated as additions to the cost of the investment and if unaccompanied by a corresponding increase in market value, will be reflected in net assets through an increase in unrealized losses. Thus, the issue is a matter of classification between gain or loss and net investment income in the statement of operations, and such expenditures generally are viewed as a part of the cost of the investment rather than as a cost of operations.

Workout Expenditures

.49 Workout expenditures under this SOP consist of professional fees (legal, accounting, appraisal) paid to entities unaffiliated with the investment company's advisor or sponsor, which generally are incurred in connection with (*a*) capital infusions, (*b*) restructurings or plans of reorganization, (*c*) ongoing efforts to protect or enhance an investment, or (*d*) the pursuit of other claims or legal actions. Some believe that such expenditures incurred to maintain an investment company's position in high-yield debt securities among other bondholders or with the issuer should be reported as operating expenses by the investment company. Others believe that such costs are also incurred principally to maintain or prevent substantial diminution in future realizable value and therefore should be reported as additions to the cost basis.

Conclusion

.50 All capital infusions, as defined in paragraph .48, should be recorded as additions to the cost bases of related securities because the nature of capital infusions is to enhance or prevent substantial diminution in the value of the investment.

.51 Workout expenditures that are incurred as part of negotiations of the terms and requirements of capital infusions, or that are expected to result in the restructuring of or a plan of reorganization for an investment should be recorded as realized losses. Ongoing expenditures to protect or enhance an investment, or expenditures incurred to pursue other claims or legal actions, should be treated as operating expenses.

Audit Procedures to Be Considered in Evaluating Valuations of High-Yield Debt Securities

Discussion

.52 Market-value risk for holders of high-yield debt securities is compounded by the relatively thin trading market in such securities, which increases price volatility and makes it difficult to liquidate holdings efficiently at any specific time. Determination of market prices is difficult given the illiquid or sometimes nonexistent trading market. Furthermore, there are no standardized procedures or central markets for pricing most high-yield debt securities. In addition, few third-party pricing services currently exist, except for those used by investment companies; these could be used by auditors to obtain market prices of issues in support of investment companies' valuations.

Current Practices

.53 Auditors generally corroborate market values of investment companies' high-yield debt securities with independent pricing services. Some auditors use one pricing service; others obtain at least two prices for each security by using two or more services. Some auditors perform extensive procedures to determine the reasonableness of valuations obtained from pricing services; others rely on the expertise of the independent pricing services and perform only exception reviews.

.54 Based on pricing, high-yield debt securities can be viewed as being one of three types:

a. Securities for which there is an active market and for which independent prices are readily available

b. Securities for which the market is less active and for which limited price information is available

c. Securities for which there is no market or a thin market and that are priced by the investment company

Views on the Issues

.55 Some believe that the current practice of monitoring prices on an exception basis in connection with obtaining prices from independent pricing services is adequate. They believe it is common knowledge that exact measures of individual high-yield bond values do not exist because there is no central exchange. They further believe that review procedures focused on significant changes in prices would identify unsound price valuations and that, for securities whose values are estimated by the investment company's directors, the combination of reviews of an investment company's portfolio by accounting managers acts as an adequate check to ensure that pricing practices are reasonable.

.56 Others believe that more specific guidance on reviewing the reasonableness of prices used is required for auditors. They also believe there is significant diversity in the extent and frequency of reviews of the methods applied by pricing services.

Conclusion

.57 Given the complexities of pricing high-yield debt securities, as well as the potentially volatile market conditions surrounding those securities, certain additional pricing valuation audit procedures should be considered by auditors when reviewing the valuations of high-yield debt securities. The auditor may conclude that additional procedures are not warranted based on an assessment of control procedures applied by the investment company.

.58 Pricing services may be evaluated in accordance with SAS No. 73, *Using the Work of a Specialist*. Such procedures may include the following:

- Review of the methods used for determining daily prices and the consistency of those methods from period to period
- Consideration of the experience of the individuals involved in determining prices and of the quality control procedures in place
- Review of recent trading volumes and comparison of prices to those obtained from market makers

.59 The SEC's Financial Reporting Release (FRR) 404.03(b) discusses directors' valuation of securities for which readily available market prices do not exist. FRR 404.03(c) suggests certain procedures that the auditor should consider when reviewing securities valued in good faith by directors. In addition to those procedures the auditor may also wish to consider the following:

- Review of the methods used by management to determine and update daily prices and of the consistency of this methodology from period to period and across similar securities
- Review of recent trading transactions subsequent to the reporting date to determine whether significant price changes have occurred
- Consideration of the experience of individuals involved in determining prices
- Review of procedures used to assess the credit risk of issuers

SAS No. 57, *Auditing Accounting Estimates*, provides guidance to auditors on obtaining sufficient competent evidential matter to support significant accounting estimates in audits of financial statements conducted in accordance with generally accepted auditing standards.

.60 Furthermore, good-faith security value estimates may present the auditor with unique reporting problems. The board of directors' fair valuation procedures are designed to approximate the values that would have been established by market forces and are therefore subject to uncertainties.

.61 The auditor should not modify the auditor's opinion if he or she concludes, based on an examination of the available evidence, that the process used to estimate value is reasonable, the documentation supportive, and the range of possible values not significant. The auditor may, however, choose to emphasize the existence of the matter by inserting an explanatory paragraph in the audit report.

Effective Date and Transition

.62 This SOP is effective for financial statements and for audits of such financial statements for fiscal years ending after December 15, 1993, and for interim periods within such years. This SOP need not be applied to financial statements for fiscal years ending before its effective date that, for comparative purposes, are provided with financial statements for fiscal years ending after its effective date. The effect of this SOP should be disclosed in the period in which it is first applied. Early application of this SOP is encouraged.

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Section 10,560

Statement of Position 93-3
Rescission of Accounting Principles Board Statements

March 19, 1993

> **NOTE**
>
> Statements of Position of the Accounting Standards Division present the conclusions of at least two thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Introduction

.01 The Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA) issued thirty-one Opinions. The APB also issued four Statements:

a. APB Statement No. 1, *Statement by the Accounting Principles Board*, April 1962

b. APB Statement No. 2, *Disclosure of Supplemental Financial Information by Diversified Companies*, September 1967

c. APB Statement No. 3, *Financial Statements Restated for General Price-Level Changes*, June 1969

d. APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, October 1970

Conclusions

.02 In order to make clear that APB Statement Nos. 1, 2, 3, and 4 do not, and never did, have standing as rules or standards under the AICPA's Rules of Conduct or Code of Professional Conduct and to eliminate misunderstanding and attendant confusion, and because those Statements[1] effectively have been superseded by pronouncements of the Financial Accounting Standards Board

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[1] APB Statements have not been included in the FASB's *Original Pronouncements*, paperback edition, for the past several years. However, they are included in the FASB's *Original Pronouncements* loose-leaf service.

(FASB), the Accounting Standards Executive Committee (AcSEC) of the AICPA hereby formally rescinds APB Statement Nos. 1, 2, 3, and 4 enumerated in paragraph .01 hereof.

Current Literature

.03 Opinions of the APB, to the extent that they have not been superseded by pronouncements of the FASB, are part of the literature encompassed by the AICPA's Code of Professional Conduct, specifically rule 203 thereof, and, as such, must be followed by an AICPA member's client in the preparation of its financial statements in order for the member to issue an unmodified report about whether the client's financial statements have been prepared in conformity with generally accepted accounting principles (GAAP). Thus, APB Opinions, to the extent that they have not been superseded by pronouncements of the FASB, are rules or standards that must be observed in the practice of public accountancy by members of the AICPA. The various APB Opinions contained legends explaining their authority. These are cited in appendix A [paragraph .12].

.04 In Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, APB Statements are not included in categories (*a*) through (*d*), which constitute pronouncements covered by rule 203 or by another source of established accounting principles. However, APB Statements are referred to as "other accounting literature" that may be considered in the absence of a pronouncement covered by Rule 203 or another source of established accounting principles. Other accounting literature includes, for example, FASB and Governmental Accounting Standards Board (GASB) Concepts Statements; APB Statements; AICPA Issues Papers; AICPA Technical Practice Aids; accounting textbooks; and articles. Paragraph 11 of SAS No. 69 states that FASB Statements of Financial Accounting Concepts would normally be more influential than other sources in the other accounting literature category.

.05 APB Statement Nos. 2, 3, and 4 carried the following legends:[2]

Statement 2

This Statement is not an "Opinion of the Accounting Principles Board" as contemplated in the Special Bulletin, *Disclosure of Departures from Opinions of the Accounting Principles Board*, October 1964. It is being issued as a special report for the information and assistance of members of the Institute and others interested in the subject. The Board may issue similar Statements in the future when it appears that preliminary analyses or observations on accounting matters should be issued in advance of research and study by the Board.

Statements 3 and 4

Statements of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles. This Statement is not an "Opinion of the Accounting Principles Board" covered by action of the Council of the Institute in the Special Bulletin, *Disclosures of Departures from Opinions of the Accounting Principles Board*, October, 1964.

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[2] APB Statement No. 1 was the APB's commentary on the AICPA's Accounting Research Studies 1 and 3 and, as such, neither required nor carried a legend.

.06 Statements issued by the APB were never rules or standards that had to be observed by members of the AICPA in the practice of public accountancy. APB Statements are not comprehended by rule 203 of the Code of Professional Conduct. Nonetheless, some who are not familiar with the distinction between Opinions and Statements issued by the APB have cited, and continue to cite, APB Statements as being rules or standards that must be observed by members of the AICPA in the practice of public accountancy.

.07 The FASB effectively superseded APB Statement No. 2 with Statement of Financial Accounting Standards No. 14, *Financial Reporting for Segments of a Business Enterprise*. FASB Statement No. 89, *Financial Reporting and Changing Prices*, effectively superseded APB Statement No. 3. The FASB's various Statements of Financial Accounting Concepts effectively superseded APB Statement No. 4.

.08 Although APB Statement No. 3 is being rescinded because of subsequent FASB action with regard to inflation accounting, it is recognized that the FASB addressed only the presentation of partial price-level data. Since APB Statement No. 3 provided guidance for a comprehensive application of price-level adjusted financial statements, this SOP is not precluding such a presentation (to the extent it is not inconsistent with guidance in FASB Statement No. 89 regarding historical cost/constant purchasing power accounting, such as the classification of assets and liabilities as monetary or nonmonetary) should a company wish to do so.[3]

.09 Various APB Opinions, FASB Statements, and AICPA publications refer to APB Statements. The FASB Concepts Statements subsequently issued discuss essentially the same matters, and, therefore, this SOP has no impact on those pronouncements. In a few instances, the matter in the APB Statement is not included elsewhere in FASB pronouncements, and as indicated in appendix B [paragraph .13], AcSEC agrees with the relevant comments from those APB Statements and this rescission is not expected to affect practice. Further, various FASB Concepts Statements also refer to APB Statements. The references are listed in appendix B [paragraph .13].

.10 AcSEC believes the rescission of the APB Statements should have no effect on financial reporting and should eliminate any confusion over the status of the pronouncements.

Effective Date and Transition

.11 This SOP is effective upon issuance.

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[3] AcSEC agrees with the conclusions of the APB, expressed in paragraph 26 of APB Statement No. 3, regarding general price-level financial statements of companies operating in hyperinflationary economies. Paragraph 26 states:

> The Board recognizes that the degree of inflation or deflation in an economy may become so great that conventional statements lose much of their significance and general price-level statements clearly become more meaningful, and that some countries have experienced this degree of inflation in recent years.[5] The Board concludes that general price-level statements reported in the local currency of those countries are in that respect in conformity with accounting principles generally accepted in the United States, and that they preferably should be presented as the basic foreign currency financial statements of companies operating in those countries when the statements are intended for readers in the United States.[6]
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> ---
>
> [5] Although the Board believes that this conclusion is obvious with respect to some countries, it has not determined the degree of inflation or deflation at which general price level statements clearly become more meaningful.
>
> [6] This paragraph applies only to statements prepared in the currency of the country in which the operations reported on are conducted. Only conventional statements of foreign subsidiaries should be used to prepare historical-dollar consolidated statements.

.12

Appendix A

Legends Included in APB Opinions 1 Through 31

A-1. APB Opinions 1 through 5, issued between 1962 and 1964, carried the following legend:

> Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter. Except where formal adoption by the Council or the membership of the Institute has been asked and secured, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from the Board's recommendations must be assumed by those who adopt other practices. Recommendations of the Board are not intended to be retroactive, nor applicable to immaterial items.

A-2. APB Opinions 6 through 15, issued between 1965 and 1969, carried the following legend:

> Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.
>
> Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.
>
> Action of Council of the Institute (Special Bulletin, *Disclosure of Departures from Opinions of the Accounting Principles Board*, October 1964) provides that:
>
> *a.* "Generally accepted accounting principles" are those principles which have substantial authoritative support.
>
> *b.* Opinions of the Accounting Principles Board constitute "substantial authoritative support."
>
> *c.* "Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.
>
> The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or in independent auditors' reports when the effect of the departure on the financial statements is material.
>
> Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

A-3. APB Opinions 16 through 27, issued between 1970 and 1972, carried the following legend:

> Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles.

Board Opinions are considered appropriate in all circumstances covered but need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered. Unless otherwise stated, Opinions of the Board are not intended to be retroactive. Council of the Institute has resolved that Institute members should disclose departures from Board Opinions in their reports as independent auditors when the effect of the departures on the financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements (Special Bulletin, *Disclosure of Departures from Opinions of the Accounting Principles Board*, October 1964). Members of the Institute must assume the burden of justifying any such departures.

A-4. APB Opinions 28 through 31, issued in 1973, carried the following legend:

Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board.

Board Opinions need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive.

Rule 203 of the Institute's Rules of Conduct prohibits a member from expressing his opinion that financial statements are presented in conformity with generally accepted accounting principles if the statements depart in a material respect from such principles unless he can demonstrate that due to unusual circumstances application of the principles would result in misleading statements—in which case his report must describe the departure, its approximate effects, if practicable, and the reasons why compliance with the established principles would result in misleading statements.

Pursuant to resolution of Council, this Opinion of the APB establishes, until such time as they are expressly superseded by action of FASB, accounting principles which fall within the provisions of Rule 203 of the Rules of Conduct.

.13

Appendix B

References in APB Opinions, FASB Statements, and AICPA Publications to APB Statements

Introduction

B-1. Various APB Opinions, FASB Statements, and AICPA publications refer to APB Statements. Those are listed below along with references to FASB Concepts Statements discussing essentially the same matters that were subsequently issued.

B-2. To use the reference to revenue recognition as an illustration, APB Statement No. 4, paragraph 150, stated:

> Realization principle—revenue is generally recognized when both of the following conditions are met: (1) the earning process is complete or virtually complete, and (2) an exchange has taken place . . . .

B-3. Paragraph 83 of the more recently issued FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, discusses revenues and gains. The FASB states that recognition involves consideration of two factors—(*a*) being realized or realizable and (*b*) being earned:

> (*a*) Revenues and gains generally are not recognized until realized or realizable.
>
> (*b*) Revenues are not recognized until earned . . . revenues are considered to have been earned when an entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

B-4. Another illustration is paragraph 35 of APB Statement No. 4, which lists "present characteristics and limitations of financial accounting and financial statements" and includes:

> *Substance Over Form*. Although financial accounting is concerned with both the legal and economic effects of transactions and other events and many of its conventions are based on legal rules, the economic substance of transactions and other events are usually emphasized when economic substance differs from legal form.

B-5. Subsequently issued FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, has several paragraphs on point.

> Paragraph 59—The reliability of a measure rests on the faithfulness with which it represents what it purports to represent . . . .
>
> Paragraph 63—Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent.

Paragraph 160 (appendix C)—Substance over form is an idea that also has its proponents, but it is not included [in the FASB Concepts Statement] because it would be redundant. The quality of reliability and, in particular, of representational faithfulness leaves no room for accounting representations that subordinate substance to form. Substance over form is, in any case, a rather vague idea that defies precise definition.

B-6. AcSEC believes the FASB Concepts Statements have effectively superseded the discussion of these matters in APB Statement No. 4 as well as substantially all of those listed on the following pages of this appendix.

B-7. In addition, the only reference to APB Statements in GASB rules appears in the *Codification of Governmental Accounting and Financial Reporting Standards* as a footnote to paragraph 1600.125, where, in a discussion of recognition of revenues and expenses in proprietary funds, a general reference is made to the more detailed discussion in APB Statement No. 4, paragraphs 147–163. Again, the rescission should have no impact.

FASB Concepts Statements

B-8. Various Concepts Statements refer to APB Statement No. 4, as listed below. However, since the Concepts Statements stand on their own, superseding APB Statement No. 4 has no impact on financial reporting.

Concepts Statement	*Topic*
No. 1, paragraph 3	Objectives—financial reporting
No. 1, paragraph 57	Background information
No. 2, paragraph 91	Conservatism
No. 2, paragraphs 82–83	Verifiability
No. 2, paragraph 145	Background information
No. 4, footnote 2	Nonreciprocal transfers
No. 5, footnote 1	Financial statements
No. 5, footnote 4	Financial disclosure
No. 5, footnote 50	Revenue recognition
No. 5, footnote 51	Revenue recognition
No. 5, footnote 52	Revenue recognition
No. 6, footnote 52	Transactions, events, circumstances
No. 6, footnote 53	Nonmonetary transactions
No. 6, footnote 57	Expense recognition
No. 6, paragraph 153	Background information

B-9. A footnote to Concepts Statement No. 5 indicates that pronouncements such as APB Statement No. 4 will continue to serve their intended purpose: “They describe objectives and concepts underlying standards and practices existing at the time of their issuance.” Since the issuance of APB Statement No. 4 in 1970, it has not been updated for any subsequently issued APB or FASB pronouncement.

References in APB Opinions, FASB Statements, and AICPA Publications to APB Statements

Literature Citing APB Statement	*APB Statement Reference*	*Topic*	*Similar Discussion in FASB Concepts Statement*
APB Opinion 22, footnote 1	APBS 4, chapters 6, 7, and 8	GAAP is on three levels: pervasive, broad operating, and detailed principles*	
APB Opinion 29, pars. 3a and 3b, footnote 2	APBS 3, pars. 17–19 and app. B	Monetary and nonmonetary items†	
APB Opinion 29, pars. 3c and 3d, footnote 3	APBS 4, pars. 180–183	Exchanges and nonreciprocal transfers†	FASBC No. 6, pars. 135 and 137
FASBS No. 2, par. 42‡	APBS 4, par. 57	Economic resources	FASBC No. 6, par. 25
FASBS No. 2, pars. 47–48‡	APBS 4, pars. 147 and 156–160	Expense recognition	FASBC No. 5, pars. 85–87 FASBC No. 6, pars. 144–152
FASBS No. 2, par. 50‡	APBS 4, par. 160	Expense recognition	FASBC No. 5, pars. 85–87 FASBC No. 6, pars. 144–152
FASBS No. 5, par. 67‡	APBS 4, par. 35	Financial accounting and reporting	FASBC No. 1, par. 21

APBS = APB Statement; FASBS = FASB Statement of Financial Accounting Standards; FASBC = FASB Statement of Financial Accounting Concepts.

* The footnote reference to APB Statement No. 4 is intended to provide background information and does not affect the Opinion. FASB Concepts Statements do not refer to three levels of principles.

† The footnote reference to definitions of certain terms in APB Opinion 29 indicates that a "more complete explanation" of the terms can be found in the APB Statement. Further monetary and nonmonetary items are discussed in FASB Statement No. 89, par. 96.

‡ Citation is in the Basis of Conclusions rather than the actual standard.

References in APB Opinions, FASB Statements, and AICPA Publications to APB Statements—continued

Literature Citing APB Statement	*APB Statement Reference*	*Topic*	*Similar Discussion in FASB Concepts Statement*
FASBS No. 5, par. 70‡	APBS 4, par. 58	Economic obligations	FASBC No. 6, par. 35
FASBS No. 5, par. 74(e)‡	APBS 4, par. 183	Impairment of assets when damaged	FASBC No. 6, par. 32
FASBS No. 5, pars. 77 and 78‡	APBS 4, pars. 147 and 156–160	Expense recognition and the matching concept	FASBC No. 5, pars. 85–87 FASBC No. 6, pars. 144–152
FASBS No. 5, pars. 82 and 83‡	APBS 4, pars. 35 and 171	Conservatism	FASBC No. 2, pars. 92–97
FASBS No. 7, par. 32 footnote 16‡	APBS 4, par. 160	Expense recognition	FASBC No. 5, pars. 85–87 FASBC No. 6, pars. 144–152
FASBS No. 14, par. 66‡	APBS 4, par. 90	Verifiability	FASBC No. 2, pars. 81–89
FASBS No. 14, par. 67‡	APBS 4, pars. 87–94	Other qualitative objectives	FASBC No. 2
FASBS No. 15, pars. 71, 72, 73, 75, 81, 92, 95, 96, and 112, and footnote 32‡	APBS 4, various	General discussion as background	FASBC Nos. 2, 5, and 6
FASBS No. 16, par. 27‡	APBS 4, par. 147	Matching	FASBC No. 5, pars. 85–87 FASBC No. 6, pars. 144–152
FASBS No. 19, par. 136‡	APBS 4, par. 152	Revenue recognition	FASBC No. 5, par. 84(e)
FASBS No. 19, pars. 179, 181, and 182‡	APBS 4, pars. 156–160	Expense recognition and the matching concept	FASBC No. 5, pars. 85–87 FASBC No. 6, pars. 144–152

APBS = APB Statement; FASBS = FASB Statement of Financial Accounting Standards; FASBC = FASB Statement of Financial Accounting Concepts.

‡ Citation is in the Basis of Conclusions rather than the actual standard.

References in APB Opinions, FASB Statements, and AICPA Publications to APB Statements—continued

Literature Citing APB Statement	*APB Statement Reference*	*Topic*	*Similar Discussion in FASB Concepts Statement*
FASBS No. 34, par. 37, footnotes 6 and 7[‡]	APBS 4, pars. 163 and 164	Monetary and nonmonetary items	FASBC No. 2, par. 65 FASBC No. 5, par. 67(a) FASBC No. 6, par. 246
SOP 75-2 (REITs), par. 27[||]	APBS 4, par. 183	Foreclosed assets are not subsequently written up[#]	
SOP 81-1 (Construction Contracts), par. 3	APBS 4, pars. 150, 152, and 174	Revenue recognition	FASBC No. 5, pars. 83 and 84(c), and footnote 53
SOP 85-3 (Agriculture), par. 24	APBS 4, par. 16	Revenue recognition	FASBC No. 5, pars. 84(c) and 84(e)
SOP 85-3, par. 32	APBS 4, par. 152	Inventories carried at market price[**]	
SOP 89-5 (Prepaid Health Care), par. 54	APBS 4, par. 157	Expense recognition	FASBC No. 5, par. 86(a) FASBC No. 6, par. 146
Audits of Airlines, chapter 3, par. 1 and footnote 1	APBS 4, par. 150	Revenue recognition	FASBC No. 5, par. 83
Audits of Employee Benefit Plans, chapter 13, footnote 40	APB 4, par. 133	Financial position	FASBC No. 5, par. 26

APBS = APB Statement; FASBS = FASB Statement of Financial Accounting Standards; FASBC = FASB Statement of Financial Accounting Concepts.

‡ Citation is in the Basis of Conclusions rather than the actual standard.

|| Paragraph .27 of Statement of Position 75-2, *Accounting Practices of Real Estate Investment Trusts,* has been effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.* [Footnote added, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

FASB Statement No. 15 contains the guidance on foreclosed assets. Also see SOP 92-3, *Accounting for Foreclosed Assets.*

** The same point is made in ARB 43, chapter 4, par. 16.

References in APB Opinions, FASB Statements, and AICPA Publications to APB Statements—continued

Literature Citing APB Statement	*APB Statement Reference*	*Topic*	*Similar Discussion in FASB Concepts Statement*
AU sec. 334.02	APB 4, par. 35	Substance over form	FASBC No. 2, pars. 58, 63, and 160
AU sec. 9508.33	APB 4, par. 117	Liquidation basis of accounting[††]	
AU sec. 420.02, footnote 2 and AU sec. 9420.53, footnote 4	APB 4, pars. 95–97	Comparability	FASBC No. 2, pars. 111–119
AU sec. 9410.16	APB 4, par. 106	Adequate disclosure	FASBC No. 5, pars. 7–9
AU sec. 411.02	APB 4, par. 138	Description of GAAP	Deletion has no effect on auditing guidance

APBS = APB Statement; FASBS = FASB Statement of Financial Accounting Standards; FASBC = FASB Statement of Financial Accounting Concepts.

[††] APBS 4, par. 117, states, "An enterprise is not viewed as a going concern if liquidation appears imminent." AcSEC agrees with this statement.

Accounting Standards Executive Committee (1992-1993)

AICPA Staff

[The next page is 79,711.]

Section 10,570

Statement of Position 93-4 Foreign Currency Accounting and Financial Statement Presentation for Investment Companies

April 22, 1993

> **NOTE**
>
> Statements of Position of the Accounting Standards Division present the conclusions of at least two thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Introduction

.01 The purpose of this statement of position (SOP) is to provide guidance on computing and reporting foreign currency (FC) transaction gains or losses under U.S. generally accepted accounting principles for investment companies that invest in (*a*) securities denominated or expected to settle in currencies other than the U.S. dollar or (*b*) currencies other than the U.S. dollar, and for companies that have FC transactions. For illustrative purposes, this SOP assumes that the U.S. dollar is the functional currency of the reporting investment company. This guidance on accounting and financial statement presentation applies to all investment companies covered by the AICPA Audit and Accounting Guide *Audits of Investment Companies* that follow U.S. generally accepted accounting principles.

.02 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 52, *Foreign Currency Translation*, requires that all assets, liabilities, and operations of a foreign entity be measured using the functional currency of that entity. *Functional currency* is defined as the currency of the primary economic environment in which the entity operates—that is, the currency in which the entity primarily generates and expends cash. Paragraphs 79 through 81 of FASB Statement No. 52 provide for two broad classes of foreign operations. The first class includes foreign operations that are relatively self-contained and integrated within a particular country or economic environment. For this class, the FC is the functional currency. In the second class, the day-to-day operations of the foreign entity are dependent on the economic environment of the parent's currency, and changes in the foreign entity's individual assets and liabilities directly affect the cash flows of the parent company. For this class, the functional currency of the foreign operation is the parent company's currency. Generally, the second class of foreign operations more closely resembles that of U.S. investment companies investing primarily in foreign securities than the first class does. For instance, U.S. closed-end single-foreign-country funds generate and expend cash primarily in their local currency, yet such funds have adopted the U.S. dollar as the functional currency for financial reporting purposes because, among other reasons, cash flows related to the funds' individual assets and liabilities directly affect the U.S. dollar cash flows to shareholders (sales of fund shares are to U.S. shareholders in U.S. dollars, and dividends and distributions are paid to shareholders in U.S. dollars).

.03 Inconsistent application of the functional currency concepts of FASB Statement No. 52 by funds investing in foreign securities has contributed to a diversity of accounting practices for FC transactions. However, because these funds follow value accounting, the net increase or decrease in net assets from operations is the same under each variation although the financial statement presentations of the FC transactions differ. For instance, some funds treat the FC rate variance between the trade and settlement dates as an adjustment to cost and proceeds, whereas other funds treat it as a component of net investment income or realized FC gain or loss. Similarly, some funds include the FC gain or loss resulting from income receivable or expense payable with the related income or expense, whereas others treat it as a separate component of net investment income or realized FC gain or loss. Because the U.S. dollar is generally the reporting currency of these funds, they typically adopt the U.S. dollar as their functional currency. If the facts and circumstances warrant otherwise, a fund may conclude that a currency other than the U.S. dollar should be its functional currency. However, in the value accounting environment, that distinction does not affect the reported amounts of U.S.-dollar-denominated net assets or net changes in net assets.

.04 FC transactions are denominated in a currency other than the fund's functional currency. These transactions may produce payables and receivables that are fixed in terms of the amount of FC that will be paid or received. A change in the exchange rate between the functional currency and the FC increases or decreases the expected functional currency value upon settlement of the transaction or disposition of the security.

.05 The ongoing revaluation of investments and receivables or payables representing unsettled FC transactions is classified as unrealized FC gain or loss. On settlement (when there is actual cash flow), a realized FC gain or loss is recorded. An FC gain or loss (whether realized or unrealized) results from one or more of the following sources:

- The cost of securities held versus their carrying value based on current exchange rates
- Payables or receivables for securities bought or sold at the transaction date versus actual amounts at settlement date or payable or receivable based on current exchange rates
- Interest, dividends, and withholding taxes accrued versus the amount received or receivable based on current exchange rates
- Expenses accrued versus the amount paid or payable in FC, based on current exchange rates

- Marking to market of forward exchange contracts or foreign exchange futures contracts

.06 Each of the sources of FC gain or loss identified in paragraph .05 is discussed later in this SOP.

Current Literature

.07 With the exception of the investment companies audit guide, FASB Statement No. 52 is the only current pronouncement available on the subject of this SOP. Paragraph 2.100 of the audit guide suggests that "foreign currency transaction gains and losses may be accounted for separately or may be combined for reporting purposes with the type of transaction that gave rise to the gain or loss." It also states, in paragraph 2.96, that the approach of not requiring separate disclosure of the portion of the changes in market value that results from FC rate changes continues to be followed in practice.

Scope

.08 This SOP provides guidance on measurement and financial statement presentation and disclosure for foreign currency transactions by investment companies. It amends the AICPA Audit and Accounting Guide *Audits of Investment Companies*.

.09 Some funds invest in countries that are highly inflationary, as that term is defined in FASB Statement No. 52, paragraph 11. Accordingly, the separate measurement and disclosure of the FC element may not be meaningful and the disclosures recommended by this SOP may not be appropriate for such situations.

Conclusions

.10 Each transaction denominated in an FC can initially be measured only in that currency. Any differences between originally recorded amounts and currently consummated or measured amounts in the reporting currency are a function of two factors—(*a*) foreign exchange rate changes and (*b*) changes in market prices. Those effects should be identified, computed, and reported other than for gains and losses on investments. The current guidance in paragraphs 2.96 and 2.100, which allows the practice of not separately disclosing the portion of the changes in market values of investments and realized gains and losses thereon that result from FC rate changes, continues to be permitted. However, separate reporting of such gains and losses is allowable and, if adopted by the reporting entity, should conform to the guidance presented herein.

Securities

Purchased Interest

.11 Purchased interest represents the interest accrued between the last coupon date and the settlement date of the purchase. It should be recorded in the functional currency as interest receivable at the spot rate on the purchase trade date, and marked to market using each valuation date's spot rate. After the settlement date, daily interest income should be accrued at the daily spot rate. It may be impractical to prepare the foregoing calculations daily, and, therefore, the use of a weekly or monthly average rate may be appropriate in many cases, especially if the exchange rate does not fluctuate significantly. However, if the exchange rate fluctuation is significant, the calculation should be made daily.

Marking to Market

.12 A fund investing in foreign securities generally invests in such securities to reap the potential benefits offered by the local capital market. It may also invest in such securities as a means of investing in the FC market or of benefiting from the FC rate fluctuation. The extent to which separate information regarding FC gains or losses will be meaningful will vary depending on the circumstances, and separate information may not measure with precision foreign exchange gains/losses associated with the economic risks of foreign currency exposures. An FC rate fluctuation, however, may be an important consideration in the case of foreign investments, and a reporting entity may choose to identify and separately report any resulting FC gains or losses as a component of unrealized market gain or loss on investments.

.13 The market value of securities should initially be determined in the FC and translated at the spot rate on the purchase trade date. The unrealized gain or loss between the original cost (translated on the trade date) and the market value (translated on the valuation date) comprises the following elements:

a. Movement in market price

b. Movement in FC rate

.14 Such movements may be combined as permitted by current guidance. If separate disclosure of the FC gains and losses is chosen, the movement in market prices should be measured as the difference between the market value in FC and the original cost in FC translated at the spot rate on the valuation date. The effect of the movement in the foreign exchange rate should be measured as the difference between the original cost in FC translated at the current spot rate and the historical functional currency cost. These values can be computed as follows:

a. (Market value in foreign currency minus original cost in foreign currency) times valuation date spot rate equals unrealized market value appreciation or depreciation.

b. (Cost in foreign currency times valuation date spot rate) minus cost in functional currency equals the unrealized foreign currency gain or loss.

It is recognized that the preceding formulas could be refined to isolate and report the rate change element in the changes in the gains or losses on investments between valuation dates. However, the cost of doing so would not be justified for the relatively minor improvement thereof. Furthermore, such refinement would (*a*) be a departure from the method required for federal income tax reporting for realized FC gains/losses on debt securities and (*b*) represent a departure from the practice of those investment companies that presently separately report in their financial statements the effects of foreign exchange on securities gains or losses.

.15 For short-term securities held by a fund that follows the amortized cost method of valuation, the amortized cost value should be substituted for market value in the formulas given in paragraph .14 if separate reporting is chosen by the reporting entity.

Sale of Securities

.16 If separate reporting of FC gains and losses on sales of securities is chosen by the reporting entity, the computation of the effects of market change and the FC rate change is similar to that described in paragraph .14 above. *Market value* in the formula given in paragraph .14 should be replaced with *sale proceeds* and *valuation date* should be replaced with *sale trade date*. Accordingly—

a. (Sale proceeds in foreign currency minus original cost in foreign currency) times sale trade date spot rate equals realized market gain or loss on sale of security.

b. (Cost in foreign currency times sale trade date spot rate) minus cost in functional currency equals realized foreign currency gain or loss.

.17 The sale of a security results in a receivable for the security sold. The related receivable should be recorded on the trade date at the spot rate. On the settlement date, the difference between the recorded receivable amount and the actual FC received converted into the functional currency at the spot rate is recognized as a realized FC gain or loss.

Sale of Interest

.18 Interest sold represents the accrued interest receivable between the last coupon date and the settlement date of sale of the security. The difference between the recorded interest receivable amount and the actual FC received (converted into the functional currency at the spot rate) should be recognized as a realized FC gain or loss.

Income

Interest

.19 Interest on securities denominated in an FC is calculated at the stated rate of interest in the FC. The interest should be accrued daily in the FC at the stated interest rate and translated into the functional currency at the daily spot rate. It may be impractical to prepare such a calculation daily, and, therefore, the use of a weekly or monthly average rate may be appropriate in many cases, especially if the exchange rate does not fluctuate significantly. However, if the exchange rate fluctuation is significant, the calculation should be made daily.

.20 The related receivable balance along with purchased interest, if any, should be accumulated in the FC and translated into the functional currency daily using the spot rate for that date. The difference between the income accrued in the functional currency and the FC receivable at the valuation date spot rate is unrealized FC gain or loss.

.21 When the interest is received and recorded in the functional currency at the spot rate on that date, the unrealized FC gain or loss should be reclassified as realized FC gain or loss.

Accretion and Amortization

.22 Accretion of discounts and amortization of premiums on bonds should be calculated daily in the FC. The resulting amount of income or offset to income should be translated into the functional currency using that day's spot rate. The same FC amount should be recorded as an addition to cost for accretion of discounts and a reduction to cost for amortization of premiums. Accordingly, cost consists of the original cost, translated at the spot rate in effect on the trade date the bond was bought and adjusted for discount accretion or premium amortization at the spot rate on the date of adjustment. As stated in paragraph .19 of this SOP, use of a weekly or monthly average rate may be appropriate in certain circumstances.

.23 On maturity, the carrying cost (including accretion or amortization) of the security in the FC equals the proceeds. However, this will not be the case in the functional currency. The original cost is translated into the functional currency at the spot rate on the trade purchase date and the accretion or amortization is translated at periodic spot rates. The proceeds are translated into the functional currency at the spot rate on the maturity date. The difference between the proceeds and the accumulated cost in the functional currency is realized FC gain or loss.

Dividends

.24 Dividend income on securities denominated in FC should be recorded on the ex-date, at the spot exchange rate of the FC to the reporting currency on that date. The related dividend receivable should be translated into the functional currency daily at the spot rate, and the difference between the dividend accrued in the functional currency and the FC receivable at the valuation date spot rate is unrealized FC gain or loss. When the dividend is received, the unrealized FC gain or loss should be reclassified as realized FC gain or loss.

.25 The preceding approach to measuring investment income ensures that investment income accrued on foreign securities reflects the investment transaction without regard to the FC gain or loss created in the time between the accrual and collection of the income.

Withholding Tax

.26 Whenever tax is withheld from investment income at the source, the amounts withheld that are not reclaimable should be accrued along with the related income on each income recognition date if the tax rate is fixed and known. If the tax withheld is reclaimable from the local tax authorities, it should be recorded as a receivable and not as an expense. When the investment income is received net of the tax withheld, a separate realized FC gain or loss should be computed on the gross income receivable and the accrued tax expense. If the tax rate is not known or estimable, such expense or receivable should be recorded on the date the net amount is received; accordingly, there would be no FC gain or loss. However, if a receivable is recorded, there may be an FC gain or loss through the date such receivable is collected.

Expenses

.27 The accounting for expenses payable in an FC is identical to that for investment income receivable in an FC. An expense should be accrued as incurred and translated into the functional currency at the spot rate each day. The use of an average weekly or monthly FC rate would be acceptable if the FC rate does not fluctuate significantly. The related accrued expense balance should be accumulated in the FC and translated into the functional currency daily, using the spot rate for that date. The difference between the expense accrued in the functional currency and the related FC accrued expense balance translated into the functional currency at the valuation date spot rate is unrealized FC gain or loss. When the expense is paid, the unrealized FC gain or loss should be reclassified as realized FC gain or loss.

Receivables and Payables

.28 All receivables and payables that are denominated in an FC and that may relate to income or expense, or to securities sold or purchased, should be translated into the functional currency each valuation date at the spot rate on that date. The difference between that amount and the functional currency amount that was recorded at various spot rates for income and expense items, and at the trade date spot rate in the case of sales and purchases of securities, is unrealized FC gain or loss. Upon liquidation of the receivable or payable balance in an FC, the difference should be reclassified as realized FC gain or loss.

Cash

.29 FC cash balances and movements should be accounted for in the same way that FC-denominated securities are. Every receipt of an FC should be treated as a purchase of a security and recorded in the functional currency at the spot rate on the cash receipt date. Similarly, every disbursement of an FC should be treated as a sale of a security and the appropriate functional currency cost should be released, depending on whether a specific identified cost, the first-in, first-out (FIFO) method, or an average cost is used.

.30 The acquisition of an FC does not result in any FC gain or loss. However, the disbursement of an FC results in a realized FC gain or loss that is the difference between the functional currency equivalent of the FC when it was acquired and the FC disbursement translated at the spot rate on the disbursement date. Also, as is the case with all other assets and liabilities denominated in an FC, FC cash balances should be translated on each valuation date at the spot rate on that date, resulting in unrealized FC gain or loss.

Forward Exchange Contracts

.31 A forward exchange contract is an agreement between two parties to exchange different currencies at a specified exchange rate at an agreed-upon future date. A forward exchange contract can be for either hedging or speculation purposes. Funds usually enter into such contracts for hedging purposes only.

.32 If a fund enters into a forward exchange contract, the forward contract should be recorded on the inception date at the forward rate and marked to market daily.

.33 The unrealized FC gain or loss on such a contract is the difference between the FC amount valued at the forward rate (on the valuation date) and the original contracted value of the forward contract (the amount to be received or paid at expiration or settlement date). On the expiration or settlement date, the unrealized FC gain or loss should be reclassified as realized FC gain or loss. If the forward contract is meant to hedge the payable for the purchase of a security denominated in an FC, the cost of the investment purchased and the related payable that has been hedged by the forward contract should still be recorded at the spot rate on the trade date, and the payable should be translated into the functional currency daily.

Financial Statement Presentation

.34 The current practice of not separately disclosing that portion of unrealized and realized gains and losses on investments that results from FC changes continues to be permitted. All other FC gains or losses should be reported under the realized and unrealized gain or loss on investments and foreign currency section in the statement of operations. For example, realized FC gain or loss on interest and dividends should be included in the realized FC gain or loss component of net realized gain or loss. All unrealized FC gain or loss, other than those on investments, should be reported as unrealized appreciation or depreciation on translation of assets and liabilities in foreign currencies. The statement of changes in net assets and the statement of assets and liabilities should reflect the same realized and unrealized gain and loss components. However, it is permissible (*a*) to combine the net realized gains or losses from investments with net realized gains or losses from foreign currency transactions and (*b*) to combine the net unrealized appreciation (depreciation) on investments with the net unrealized appreciation (depreciation) on translation of assets and liabilities in foreign currencies and to report them as single components in those statements.

.35 If separate reporting of the unrealized and realized FC gains or losses on investments is chosen, such gains and losses should be aggregated with all other FC gains and losses and reported as described above. Notes to the financial statements should state an entity's practice of either including or excluding that portion of realized and unrealized gains and losses on investments that results from foreign currency changes with or from other foreign currency gains and losses.

.36 Taxes withheld that are not reclaimable, if any, on foreign source income should be deducted from the relevant income item and be shown either parenthetically or as a separate contra item in the income section of the statement of operations. Taxes levied on the aggregate income or capital gains of the investment company itself should be presented in a manner that is similar to that used for income taxes. The normal withholding taxes should be presented as follows:

Interest or dividend income (net of withholding taxes of $ X)	$XXX
or	
Interest or dividend income	$XXX
Less withholding tax	(XXX)

Other Matters

.37 In addition to the FC risk associated with investing in foreign securities, such investments present additional risks that need to be assessed continuously by management and considered for financial statement disclosure:

- *Liquidity.* Since certain foreign markets are illiquid, market prices may not necessarily represent realizable value.
- *Size.* When market capitalization is low, a fund's share in the entire market (particularly when single-country funds are involved) or in specific securities may be proportionately very large, and the market price would not necessarily reflect the realizable value.

- *Valuation.* Because of liquidity and size problems as well as other factors, such as securities that are unlisted or securities that are thinly traded, funds would have to adopt specific fair valuation procedures for determining the values of such securities. Doing so may be difficult in a foreign environment; while others may perform the research and provide supporting documentation for fair values, the ultimate responsibility for determining the fair values of securities rests with the directors.

The disclosures suggested above are no different from those that might be required for domestic securities with the same attributes.

.38 The preceding risks may need to be disclosed in the notes to the financial statements if such factors exist in the markets in which the fund has material investments. It would also be incumbent on management to make sure that the prices provided by local sources (such as the last sale price, bid or ask, mean of bid and ask, closing price, and so on) do represent the market value of the securities. This is especially important for open-end funds or closed-end funds that allow limited redemption.

Effective Date and Transition

.39 This SOP is effective for financial statements for fiscal years beginning after December 15, 1993, and interim periods within such years. This SOP may, but need not be, applied to financial statements for fiscal years ending before its effective date that, for comparative purposes, are provided with financial statements for fiscal years ending after its effective date. Earlier application of this SOP is encouraged.

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Appendix A

Illustrations for Separately Calculating and Disclosing the Foreign Currency Element of Realized and Unrealized Gains and Losses

Illustrations A and B apply if separate disclosures of the FC elements of unrealized and realized gains and losses on investments are chosen by the reporting entity.

A. Purchases and Sales

ABC Fund uses US$ as its functional currency.

ABC buys 1,000 shares of XYZ £15.00 with a spot exchange rate of $1.75 = £1.00.

Foreign currency (FC) cost basis = £15.00 × 1,000 = £15,000

Functional currency cost basis = £15,000 × 1.75 = $26,250

Market gain/loss = (FC sale proceeds – FC cost) × foreign exchange (FX) rate on day of sale

Currency gain/loss = FC cost × (FX rate day of sale – FX rate day of purchase)

Assume a sale of 1,000 XYZ £12.00 and $1.50 = £1.00:

FC proceeds	= £12.00 × 1,000	=	£12,000
Functional currency proceeds	= £12,000 × 1.50	=	$18,000
Market loss	= (£12,000 – £15,000) × 1.50	=	($ 4,500)
Currency loss	= (£15,000 × 1.50 – 1.75)	=	($ 3,750)
Total loss			($ 8,250)

Proof

Functional currency proceeds	$18,000
Functional currency cost	($26,250)
	($ 8,250)

B. Securities—Mark to Market

DAY 1: 1,000 XYZ marked to market £16.00; spot rate: $1.85 = £1.00.

Market gain/loss = (FC current market value – FC cost) × current FX rate

Currency gain/loss = FC cost × (current FX rate – FX rate on day of purchase)

Market gain = (£16,000 – £15,000) × 1.85	=	$1,850
Currency gain = £15,000 × (1.85 – 1.75)	=	$1,500
Total gain in functional currency	=	$3,350

Total gain – (£16,000 × 1.85) – (£15,000 × 1.75) = $29,600 – $26,250 = $3,350

Mark-to-Market Journal Entries

[*Average rates may be used if fluctuations in exchange rates aren't significant*]

DAY 2: 1,000 XYZ marked to market £17.00; spot rate: $1.80 = £1.00.			
Market gain	= (£17,000 – £15,000) × 1.80	=	$3,600
Currency gain	= £15,000 × (1.80 – 1.75)	=	$ 750
Total functional currency gain			$4,350

Daily Journal Entries

Market gain/loss	= $3,600 – $1,850	=	$1,750
Currency gain/loss	= $750 – $1,500	=	($ 750)
Day 2 gain ($4,350 – $3,350)		=	$1,000

C. Other Assets/Liabilities—FX Mark to Market

Sale of 1,000 XYZ £12.00 = £12,000 receivable $1.50 = £1.00 =			$18,000
DAY 1: Spot rate moves to $1.55 = £1.00.			
Currency gain	= £12,000 × (1.55 – 1.50) .05	=	$ 600
DAY 2: Spot rate moves to $1.58 = £1.00.			
Currency gain	= £12,000 × (1.58 – 1.50) .08	=	$ 960
Currency gain	*Day 1*		*Day 2*
Daily Journal Entry	$600		$360

D. Changes Between Trade and Settlement Dates

Trade Date

Purchase 1,000 XYZ £15.00; exchange rate: $1.75 = .00.

Cost basis: $26,250 or £15,000

DR: sterling securities at cost	$26,250	
CR: payables for securities purchased		$26,250

Settlement Date

Spot rate: $1.80 = £1.00; £15,000 is purchased at the spot rate for $27,000.

DR: payables for securities purchased	$26,250	
DR: realized currency gain/loss	$ 750	
CR: cash		$27,000

E. Settlement Against Foreign Currency Cash Balances

£20,000 balance is available in London.

Lot a: £10,000 purchased $1.65 per £1.00
$US cost basis: $16,500

Lot b: £10,000 purchased $1.85 per £1.00
$US cost basis: $18,500

Assume lot b will be liquidated first at $1.80 per £1.00.

Lot b

DR: cash	$18,000	
DR: realized currency gain/loss	$ 500	
CR: sterling cash at cost		$18,500

Assume one half of lot a will be liquidated at $1.80 per £1.00.

Lot a

DR: cash	$ 9,000	
CR: sterling cash at cost		$ 8,250
CR: realized currency gain/loss		$ 750

Realized FX gain on payable remains the same.

Between Purchase Settlement and Sale Trade Dates

Mark the holding to market, based on both local market price and daily spot rate.

F. Sale of XYZ—Trade Date

Sell 1,000 XYZ £18.00; exchange rate: $1.90 = £1.00

Total proceeds: $34,200 or £18,000

FX gain is recognized on the sale trade date based on the holding period. Receivable is booked at the spot rate on sale trade date.

DR: receivable for securities sold	$34,200	
CR: sterling securities at cost (£15,000 × 1.75)		= $26,250
CR: realized market gain/loss (£18,000 – £15,000) × 1.90		= $ 5,700*
CR: realized currency gain/loss (£15,000 × 1.90) – 26,250		= $ 2,250*

Maintain local currency basis (£18,000) on the receivable record.

Between Sale Trade Date and Settlement Date

Mark the receivable to market based on the prevailing spot rate.

Sale Settlement Date

Spot rate: $1.85 = £1.00

£18,000 is converted at the spot rate to $33,300.

FX loss is recognized upon the receipt (settlement) of the receivable.

DR: cash	$33,300	
DR: realized currency gain/loss	$ 900	
CR: receivables from securities sold		$34,200

If foreign currency cash received is to be kept as local currency:

Purchase: £18,000 $1.85 = £1.00

Cost basis: $33,300

DR: sterling cash at cost	$33,300	
CR: cash		$33,300

* If separate disclosures of the FC elements of unrealized and realized gains and losses on investments are chosen by the entity.

.41

Appendix B

Sample Financial Statements

The ABC Fund
Statement of Operations
Year Ended December 31, 19X1

Investment income	
Interest (net of withholding taxes of $XXXX)	$XXXX
Dividends (net of withholding taxes of $XXXX)	XXXX
	XXXX
Expenses	
Investment advisory fee	XXXX
Interest	XXXX
Professional fees	XXXX
Custodian and transfer agent fees	XXXX
Distribution expenses	XXXX
Total expenses	XXXX
Net investment income	XXXX
Realized and unrealized gain (loss) from investments and foreign currency	
Net realized gain (loss) from:	
Investments	XXXX
Foreign currency transactions†	XXXX
Net increase (decrease) in unrealized appreciation or (depreciation) on:	
Investments	XXXX
Translation of assets and liabilities in foreign currencies†	XXXX
Net realized and unrealized gain (loss) from investments and foreign currency	XXXX
Net increase (decrease) in net assets resulting from operations	$XXXX

† If separate reporting is adopted, these captions would also include foreign currency effects of realized and unrealized gains and losses on investments. If separate reporting is not adopted, such foreign currency effects would be included in the investments captions.

See accompanying notes to financial statements.

The ABC Fund
Statement of Changes in Net Assets
Year Ended December 31, 19X1

From operations:	
Net investment income	$XXXX
Net realized gains (losses) from investments[‡]	XXXX
Net realized gains (losses) from foreign currency transactions[‡, ||]	XXXX
Net increase (decrease) in unrealized appreciation (depreciation) on investments[#]	XXXX
Net increase (decrease) in unrealized appreciation (depreciation) on translation of assets and liabilities in foreign currencies[||, #]	XXXX
Net increase (decrease) in net assets resulting from operations	XXXX
Dividends and distributions:	
From net investment income	(XXXX)
From net realized gains on investments and foreign currency transactions	(XXXX)
	(XXXX)
From share transactions:	
Net proceeds from sale of shares	XXXX
Cost of shares repurchased	XXXX
Dividends reinvested	XXXX
Net increase in net assets derived from share transactions	XXXX
Net increase (decrease) in net assets	XXXX
Net assets	
Beginning of period	XXXX
End of period (including undistributed net investment income of $XXXX)	$XXXX

[‡] It is also acceptable to combine these lines and present them as a single item: Net realized gains (losses) from investments and foreign currency transactions.

[||] If separate reporting is adopted, these captions would also include foreign currency effects of realized and unrealized gains and losses on investments. If separate reporting is not adopted, such foreign currency effects would be included in the investments captions.

[#] It is also acceptable to combine these lines and present them as a single item: Net increase (decrease) in unrealized appreciation (depreciation) on investments and translation of assets and liabilities in foreign currencies.

See accompanying notes to financial statements.

The ABC Fund
Statement of Assets and Liabilities[**]
Year Ended December 31, 19X1

Assets	
Investments in securities, at value (cost – $XXXX)	$XXXX
Cash denominated in foreign currencies (cost – $XXXX)	XXXX
Cash	XXXX
Receivable for investments sold	XXXX
Dividends and interest receivable	XXXX
Receivable for shares of beneficial interest sold	XXXX
Deferred organizational expense	XXXX
Other assets	XXXX
Total assets	$XXXX
Liabilities	
Payable for investments purchased	XXXX
Payable for shares repurchased	XXXX
Payable to affiliates	XXXX
Other liabilities	XXXX
Total liabilities	$XXXX
Net assets	
Beneficial interest—XXXX shares of $XXXX par value outstanding (unlimited amount authorized)	$XXXX
Undistributed net investment income	XXXX
Undistributed net realized gains from investments[††]	XXXX
Undistributed net realized gains (losses) from foreign currency transactions[**, ‡‡]	XXXX
Net unrealized appreciation (depreciation) of investments[||||]	XXXX
Net unrealized appreciation (depreciation) on translation of assets and liabilities in foreign currencies[‡‡, ||||]	XXXX
Net assets applicable to shares outstanding	$XXXX
Net asset value per share	$XXXX

** This SOP has been amended by SOP 98-5, *Reporting on the Costs of Start-Up Activities*. Changes to reflect the issuance of SOP 98-5 will be made closer to the SOP's effective date. See section 10,750.

†† It is also acceptable to combine these lines and present them as a single item: Undistributed net realized gains (losses) from investments and foreign currency transactions.

‡‡ If separate reporting is adopted, these captions would also include foreign currency effects of realized and unrealized gains and losses on investments. If separate reporting is not adopted, such foreign currency effects would be included in the investments captions.

|||| It is also acceptable to combine these lines and present them as a single item: Net unrealized appreciation (depreciation) on investments and translation of assets and liabilities in foreign currencies.

See accompanying notes to financial statements.

The ABC Fund
(A Single Country Fund)
Selected Notes to Financial Statements

1. *Foreign Currency*. Amounts denominated in or expected to settle in foreign currencies (FC) are translated into United States dollars (US$) at rates reported by a major New York City bank on the following basis:

a. Market value of investment securities, other assets and liabilities—at the closing rate of exchange at the balance sheet date.

b. Purchases and sales of investment securities, income and expenses—at the rate of exchange prevailing on the respective dates of such transactions (or at an average rate if significant rate fluctuations have not occurred).

[*The following paragraphs illustrate disclosures depending upon whether the fund chooses (i) to report or (ii) not to report the FC elements of realized and unrealized gains and losses on investments.*]

c(i). The Fund isolates that portion of the results of operations resulting from changes in foreign exchange rates on investments from the fluctuations arising from changes in market prices of securities held.

Reported net realized foreign exchange gains or losses arise from sales of portfolio securities, sales and maturities of short-term securities, sales of FCs, currency gains or losses realized between the trade and settlement dates on securities transactions, the difference between the amounts of dividends, interest, and foreign withholding taxes recorded on the Fund's books, and the U.S. dollar equivalent of the amounts actually received or paid. Net unrealized foreign exchange gains and losses arise from changes in the value of assets and liabilities including investments in securities at fiscal year end, resulting from changes in the exchange rate.

c(ii). The Fund does not isolate that portion of the results of operations resulting from changes in foreign exchange rates on investments from the fluctuations arising from changes in market prices of securities held. Such fluctuations are included with the net realized and unrealized gain or loss from investments.

Reported net realized foreign exchange gains or losses arise from sales and maturities of short-term securities, sales of FCs, currency gains or losses realized between the trade and settlement dates on securities transactions, the difference between the amounts of dividends, interest, and foreign withholding taxes recorded on the Fund's books, and the U.S. dollar equivalent of the amounts actually received or paid. Net unrealized foreign exchange gains and losses arise from changes in the value of assets and liabilities other than investments in securities at fiscal year end, resulting from changes in the exchange rate.

2.[##] The Fund has obtained the approval of the Central Bank for the registration and conversion into FC of all proceeds of the offering to be invested in the ABC country securities markets, which by its terms ensures repatriation of such investment and the remittance of profits and dividends accruing on the investment. Notwithstanding the foregoing, the right of the Fund to repatriate its investments in ABC country securities and to receive profits, capital gains, and dividends in foreign exchange is subject to the power of the Central Bank,

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[##] Should be considered, if applicable to the respective fund.

with the approval of the President of the ABC country, to restrict the availability of foreign exchange in the imminence of, or during, an exchange crisis or in times of national emergency.

There are nationality restrictions on the ownership of certain equity securities of the ABC country companies. Based on confirmations that the Fund received from the ABC country's governmental authorities, the Fund believes that it is permitted to make certain investments through the ABC country's Trust that are otherwise available only to the ABC country.

The Fund has significant investments in the equity securities of companies located in the ABC country. Future economic and political developments in the country could adversely affect the liquidity or value, or both, of the ABC country securities in which the Fund is invested.

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Appendix C

Bifurcation of Changes in Value of Foreign Securities

FASB Statement No. 8, *Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements*, appendix D, paragraphs 219 and 220, specifically states that the FASB did not intend to require investment companies to disclose separately the portion of the change in market value that results from foreign currency rate changes. Even though that exception is not specifically mentioned in FASB Statement No. 52, *Foreign Currency Translation*, practice has continued to follow this approach. This practice continues to be allowed by this SOP for the foreign exchange components of realized and unrealized gains or losses on securities.

On June 5, 1992, the AICPA issued a proposed SOP for comment that required, among other things, that investment companies report foreign exchange effects on realized and unrealized gains and losses separately from changes in market prices. Most commentators objected to that requirement and, accordingly, the Investment Companies Committee and AcSEC decided to make the practice voluntary and study the matter further.

The Investment Companies Committee intends to form a task force to solicit comments from preparers, auditors, regulators, and users of investment companies financial statements to address concerns of the costs to implement bifurcation of changes in value of foreign securities, to evaluate the relevance of the information provided by bifurcation, and to explore other approaches to reporting information if deemed necessary to help users assess foreign currency effects. After the task force submits its recommendations to the committee, the committee may decide to do one of the following:

- Draft an SOP to make bifurcation described in the current SOP mandatory
- Draft an SOP to modify the reporting in the current SOP and make it mandatory
- Not change the current guidance

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Section 10,580

Statement of Position 93-6 Employers' Accounting for Employee Stock Ownership Plans

November 22, 1993

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Scope

.01 This statement of position (SOP) provides guidance on employers' accounting for employee stock ownership plans (ESOPs). It applies to all employers with ESOPs, both leveraged and nonleveraged. It does not address financial reporting by ESOPs.[1]

.02 An ESOP is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock.

.03 This SOP supersedes American Institute of Certified Public Accountants (AICPA) SOP 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans* [section 10,130], and affects certain Emerging Issues Task Force (EITF) consensuses. A list of the documents affected is provided in appendix D [paragraph .102] of this SOP.

Background

.04 SOP 76-3 [section 10,130] was issued in December 1976, primarily to deal with accounting and reporting issues relevant to employers with leveraged ESOPs, and it has been the primary source of guidance on the subject.

.05 Since the issuance of SOP 76-3 [section 10,130], Congress has revised laws concerning ESOPs several times and the Internal Revenue Service (IRS) and the U.S. Department of Labor have issued many regulations covering the

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[1] Financial reporting by ESOPs is discussed in the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*.

operation of plans, which actions have resulted in changes in the way ESOPs may operate and the reasons they are established by companies. Those changes, the most significant of which are described in appendix C [paragraph .101], were factors in the growth in the number of plans from fewer than 2,500 plans in 1976 to nearly 10,000 at the end of 1990.[2]

.06 The increase in the number of ESOPs since the issuance of SOP 76-3 [section 10,130] was matched by an increase in their complexity. It is no longer possible to describe a typical ESOP. ESOPs are used for many purposes in addition to furthering employee ownership, some of which were not contemplated when SOP 76-3 [section 10,130] was issued. These include the following:

- To fund a matching program for a sponsor's 401(k) saving plan, formula-based profit-sharing plan, and other employee benefits
- To raise new capital or to create a marketplace for the existing stock
- To replace lost benefits from the termination of other retirement plans or provide benefits under postretirement benefit plans, particularly medical benefits
- To be part of the financing package in leveraged buy-outs
- To provide a tax-advantaged means for owners to terminate their ownership
- To be part of a long-term program to restructure the equity section of a plan sponsor's balance sheet
- To defend the company against hostile takeovers

.07 The borrowing arrangements used by leveraged ESOPs have also become more diverse. When SOP 76-3 [section 10,130] was issued, most leveraged ESOPs borrowed from outside lenders, and the loan terms were relatively simple. Since then, internally leveraged ESOPs (ESOPs that borrow from the sponsor) have become more common. Furthermore, some ESOP loans are now structured so that a large portion of the debt service will be paid with dividends on shares held by the ESOP rather than with employer contributions.

.08 Employers' accounting for ESOP transactions, particularly the measurement of compensation cost and the treatment of dividends on shares held by an ESOP, has been a source of accounting controversy for many years. Even when SOP 76-3 [section 10,130] was issued, there was disagreement about some ESOP issues.[3] Changes in laws and regulations that apply to ESOPs and the increased diversity in the structure and purpose of ESOPs have called new attention to the limitations of SOP 76-3 [section 10,130]. Furthermore, SOP 76-3 [section 10,130] does not address some of the accounting issues presented by the new ESOPs. Although the EITF has addressed a number of ESOP issues, it has done so on an ad hoc basis.

.09 Therefore, the Accounting Standards Executive Committee (AcSEC) undertook this project to reconsider SOP 76-3 [section 10,130] and to consider current ESOP issues that are not specifically addressed in the accounting liter-

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[2] Statistics from an unpublished study completed in 1991 by the National Center for Employee Ownership, Oakland, Calif.

[3] Paragraph 13 of SOP 76-3 [section 10,130.13] presents a minority view that disagrees with that SOP's recommendations on reporting dividends paid and earnings per share.

ature. AcSEC's objective in issuing this SOP is to enhance the relevance and representational faithfulness of financial statements of employers that sponsor ESOPs.

.10 There are two basic forms of ESOP: nonleveraged and leveraged. This SOP addresses the financial reporting for each separately.

Conclusions

.11 The following conclusions should be read in conjunction with the "Discussion of Conclusions" beginning with paragraph .59 of this SOP. That section explains considerations that were deemed significant by members of AcSEC in reaching the conclusions.

Leveraged ESOPs

.12 Unlike other kinds of employee benefit plans, an ESOP is permitted by ERISA to borrow from a related party or with the assistance of a related party. A leveraged ESOP borrows money to acquire shares of the employer company. The debt usually is collateralized by the employer's shares. The shares initially held by the ESOP in a suspense account are called *suspense shares.*[4] The debt is generally repaid by the ESOP from employer contributions and dividends on the employer's stock. As the debt is repaid, suspense shares are released from the suspense account, and the released shares must be allocated to individual accounts as of the end of the ESOP's fiscal year. The money can be borrowed by the ESOP from the sponsor, with or without a related outside loan, or directly from an outside lender. Outside loans to the ESOP are generally guaranteed by the sponsor.

Reporting the Purchase of Shares by ESOPs

.13 An employer should report the issuance of shares or the sale of treasury shares to an ESOP when they occur and should report a corresponding charge to unearned ESOP shares, a contra-equity account. That account should be presented as a separate item in the balance sheet. Furthermore, even if a leveraged ESOP buys outstanding shares of employer stock on the market rather than from the employer, the employer should charge unearned ESOP shares and credit either cash or debt, depending on whether the ESOP is internally or externally leveraged (see paragraph .24).

Reporting the Release of ESOP Shares

.14 ESOP shares are released for different purposes: to compensate employees directly, to settle employer liabilities for other employee benefits, and to replace dividends on *allocated shares* that are used for debt service. As ESOP shares are committed to be released, unearned ESOP shares should be credited and, depending on the purpose for which the shares are released, either (*a*) compensation cost, (*b*) dividends payable, or (*c*) compensation liabilities should be charged. Regardless of the account charged, the amount of the charge should be based on fair values[5] of *committed-to-be-released shares.*

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[4] Terms defined in the glossary [paragraph .103] are in italicized type the first time they appear in this SOP.

[5] Paragraph .20 of this SOP contains guidance on fair value.

.15 Under this SOP, when shares are committed to be released, rather than when shares are legally released, is significant for accounting purposes. That refinement was made in recognition of the fact that ESOP shares are legally released from an ESOP's suspense account (and from serving as collateral for ESOP debt) when debt payments are made, but the employee service to which the shares released relates is continuous. Accordingly, for purposes of reporting compensation cost and satisfaction of liabilities under this SOP, accounting recognition should occur when shares are committed to be released, which may occur before the shares are legally released. Shares that have not been legally released, but that relate to employee services rendered during an accounting period (interim or annual) ending before the related debt service payment is made, should be considered committed to be released. The periods of employee service to which shares relate is generally specified in the ESOP documents.

.16 Some employers establish ESOPs that are not linked to any other employee benefit or compensation promise; therefore, the ESOP shares directly compensate the employees. For ESOP shares committed to be released to compensate employees directly, the employer should recognize compensation cost equal to the fair value of the shares committed to be released. The shares generally should be deemed to be committed to be released ratably during an accounting period as the employees perform services, and, accordingly, average fair values should be used to determine the amount of compensation cost to recognize each reporting period (interim or annual). The amount of compensation cost recognized in previous interim periods should not be adjusted for subsequent changes in the fair value of shares.

.17 Some employers agree to provide a specified or determinable benefit, such as a contribution to a 401(k) plan or to a formula profit-sharing plan, to employees and use the ESOP to partially or fully fund the benefit. Employers should recognize compensation cost and liabilities associated with providing such benefits to employees in the same manner they would had an ESOP not been used to fund the benefit. For ESOP shares committed to be released to settle liabilities for such benefits, employers should report satisfaction of the liabilities when the shares are committed to be released to settle the liability. The number of shares released to settle the liability is based on the fair value of shares as of dates specified by the employers, which are usually specified in the ESOP documents.

.18 The IRC allows employers to use dividends on ESOP shares that have been allocated to participants for debt service if participants are allocated shares of employer stock with a fair value no less than the amount of the dividends used for debt service. If shares released will include shares designated to replace *dividends on previously allocated shares used for debt service*, employers should report the settlement of the dividend payable when the shares are committed to be released to replace the dividends on shares used for debt service. (See paragraphs .21 and .22; only dividends on allocated shares should be charged to retained earnings.) The number of shares committed to be released to replace the dividends on allocated shares used for debt service is based on the fair value of shares as of dates specified by the employer, which are usually specified in the ESOP documents based on the employer's interpretation of current IRS regulations.

.19 Unearned ESOP shares should be credited as shares are committed to be released based on the cost of the shares to the ESOP. Employers should charge or credit the difference between the fair value of shares committed to be released and the cost of those shares to the ESOP to shareholders' equity in the same manner as gains and losses on sales of treasury stock (generally to additional paid-in capital).

Fair Value

.20 The fair value of ESOP shares is needed to apply certain provisions of this SOP. The fair value of an ESOP share is the amount the seller could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than a forced or liquidation sale. For shares that are traded, the price in the most active market should be used to measure fair value. If there is no market price, the employer's best estimate of fair value should be used. The use of independent experts may be necessary to estimate fair value. For example, the amount determined in a recent (within twelve months of the employer's year-end) independent stock valuation report may aid in determining the best estimate of fair value.

Reporting Dividends on ESOP Shares

.21 Because employers control the use of dividends on unallocated shares, dividends on unallocated shares are not considered dividends for financial reporting purposes. Dividends on unallocated shares used to pay debt service should be reported as a reduction of debt or of accrued interest payable. Dividends on unallocated shares paid to participants or added to participant accounts should be reported as compensation cost.

.22 Dividends on allocated shares should be charged to retained earnings. The dividends payable may be satisfied either by contributing cash to the participant accounts, by contributing additional shares to participant accounts, or by releasing shares from the ESOP's suspense account to participant accounts (see paragraph .18).

Reporting Redemptions of ESOP Shares

.23 Regardless of whether an ESOP is leveraged or nonleveraged, employers are required to give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires employers to repurchase the shares at fair value. Furthermore, public company sponsors sometimes offer cash redemption options to participants who are eligible to withdraw traded shares from their accounts. Employers should report the satisfaction of such option exercises as purchases of treasury stock.

Reporting of Debt and of Interest

.24 For purposes of applying this SOP, ESOP debt is characterized as follows:

- *Direct loan*—A loan made by a lender other than the employer to the ESOP. Such loans often include some formal guarantee or commitment by the employer.
- *Indirect loan*—A loan made by the employer to the ESOP, with a related outside loan to the employer.
- *Employer loan*—A loan made by the employer to the ESOP, with no related outside loan.

ESOPs with indirect loans and employer loans are often referred to as internally leveraged.

.25 Employers that sponsor an ESOP with a direct loan should report the obligations of the ESOP to the outside lender as liabilities. Furthermore, employers should accrue interest cost on the debt and should report cash payments to the ESOP that are used by the ESOP to service debt, regardless of whether the source of cash is employer contributions or dividends, as reductions of the debt and accrued interest payable when the ESOP makes the payments to the outside lender.

.26 Employers that sponsor an ESOP with an indirect loan should report outside loans as liabilities. Employers should not report a loan receivable from the ESOP as an asset and should, therefore, not recognize interest income on such receivable. Employers should accrue interest cost on the outside loan and should report loan payments as reductions of the principal and accrued interest payable. Contributions to the ESOP and the concurrent payments from the ESOP to the employer for debt service would not be recognized in the employer's financial statements.

.27 Employers that sponsor an ESOP with an employer loan should not report the ESOP's note payable and the employer's note receivable in the employer's balance sheet. Accordingly, employers should not recognize interest cost or interest income on an employer loan.

Earnings per Share

.28 For purposes of computing basic and diluted earnings per share (EPS), ESOP shares that have been committed to be released should be considered outstanding. ESOP shares that have not been committed to be released should not be considered outstanding. [Revised, November 1998, to reflect conforming changes necessary due to the issuance of FASB Statement No. 128.]

.29 Employers with ESOPs that hold convertible preferred stock may encounter unique EPS issues for diluted EPS calculations. The remainder of this section provides guidance on how to deal with some of those issues, particularly the following:

- How to determine the number of shares assumed to be outstanding in the if-converted EPS computations
- How earnings applicable to common stock in if-converted EPS computations should be adjusted for dividends on allocated shares used for debt service
- Whether prior periods' EPS should be restated for changes in conversion rates

This SOP does not provide a step-by-step discussion of how to apply the if-converted method to compute diluted EPS and does not address all possible EPS questions that may arise. FASB Statement No. 128, *Earnings per Share*, and illustrations 4 and 5 in appendix A [paragraph .99] of this SOP provide additional guidance. [Revised, November 1998, to reflect conforming changes necessary due to the issuance of FASB Statement No. 128.]

[.30] [Paragraph deleted, November 1998, to reflect conforming changes necessary due to the issuance of FASB Statement No. 128.]

.31 *Number of Shares Outstanding.* Under this SOP, ESOP shares are not considered outstanding until they are committed to be released. The number of common shares that would be issued on conversion of the convertible shares held by an ESOP that have been committed to be released should be deemed outstanding in the if-converted EPS computations for diluted EPS if the effect is dilutive. Convertible preferred shares held by the ESOP that have not been committed to be released should not be considered outstanding and, accordingly, would be excluded from the if-converted computations for diluted EPS. [Revised, November 1998, to reflect conforming changes necessary due to the issuance of FASB Statement No. 128.]

.32 When participants withdraw account balances containing convertible preferred shares from an ESOP, they may be entitled to receive common shares or cash with a value equal to either the fair value of the convertible preferred shares or a stated minimum value per share. Accordingly, if the value of the common stock issuable is less than the stated minimum value or the fair value of the preferred, participants may receive common shares or cash with a value greater than the value of the common shares issuable at the stated conversion rate. In determining EPS, the employer should presume that such a shortfall will be made up with shares of common stock. However, that presumption may be overcome if past experience or a stated policy provides a reasonable basis to believe that the shortfall will be paid in cash.[6] In applying the if-converted method, the number of common shares issuable on assumed conversion, which should be included in the denominator of the EPS calculation, should be the greater of (*a*) the shares issuable at the stated conversion rate and (*b*) the shares issuable if the participants were to withdraw the shares from their accounts. Shares issuable on assumed withdrawal should be computed based on the ratio of (*a*) the average fair value of the convertible stock or, if greater, its stated minimum value, to (*b*) the average fair value of the common stock. [Revised, November 1998, to reflect conforming changes necessary due to the issuance of FASB Statement No. 128.]

.33 *Adjustments to Earnings.* Employers that use dividends on allocated ESOP shares to pay debt service should adjust earnings applicable to common shares in the if-converted computation for the difference (net of income taxes) between the amount of compensation cost reported and the amount of compensation cost that would have been reported if the allocated shares had been converted to common stock at the beginning of the period.

.34 *Changes in Conversion Rates.* Prior period EPS should not be restated for changes in the conversion rates. [Revised, November 1998, to reflect conforming changes necessary due to the issuance of FASB Statement No. 128.]

Accounting for Terminations

.35 Upon termination of a leveraged ESOP, either in whole or in part, all outstanding debt related to the shares being terminated must be repaid or refinanced. An ESOP may repay the debt using an employer contribution to the plan, dividends on ESOP shares, the proceeds from selling suspense shares to the employer or to another party, or some combination of these. The law limits the shares employers may reacquire to the number of shares with a fair value equal to the applicable unpaid debt and requires that the remaining shares, if any, be allocated to participants.

.36 If the employer makes a contribution to the ESOP or pays dividends on unallocated shares that are used by the ESOP to repay the debt, the employer should charge the debt and accrued interest payable when the ESOP

[6] [Footnote deleted, November 1998, to reflect conforming changes necessary due to the issuance of FASB Statement No. 128.]

makes the payment to the outside lender. Similarly, an employer sponsoring an ESOP with an indirect loan should report loan repayments as reductions of the debt and accrued interest payable.

.37 If the ESOP sells the suspense shares and uses the proceeds to repay the debt, the employer should report the release of the suspense shares as a credit to unearned ESOP shares based on the cost of the shares to the ESOP, charge debt, and accrued interest payable, and recognize the difference in paid-in capital. However, if there is a difference between the amount paid to an outside lender and the net carrying amount of the debt, paragraph 20 of APB Opinion No. 26, *Early Extinguishment of Debt*, as amended by FASB Statement of Financial Accounting Standards No. 4, *Reporting Gains and Losses from Extinguishment of Debt*,* requires that difference to be included in the employer's income when the debt is extinguished.

.38 If an employer reacquires the suspense shares from the ESOP, the purchase of the shares should be accounted for as a treasury stock transaction. The treasury stock should be reported at the fair value of the shares at the reacquisition date. Unearned ESOP shares should be credited for the cost of the shares, and the difference should be recognized in additional paid-in capital.

.39 If the fair value of the suspense shares on the termination date is more than the unpaid debt balance, the release of the remaining suspense shares to participants should be charged to compensation in accordance with paragraphs .14 to .18 of this SOP. That is, compensation cost should equal the fair value of the shares at the date the ESOP debt is extinguished, because that is when the shares are committed to be released.

Nonleveraged ESOPs

.40 An employer with a nonleveraged ESOP periodically contributes its shares or cash to its ESOP on behalf of employees. The shares contributed or acquired with the cash contributed, which may be outstanding shares, treasury shares, or newly issued shares, are allocated to participant accounts and held by the ESOP until distributed to the employees at a future date, such as on the date of termination or retirement. The shares of employer stock obtained by the nonleveraged ESOP must be allocated to individual participant accounts as of the end of the ESOP's fiscal year.

Reporting Purchase of Shares by ESOPs

.41 Employers with nonleveraged ESOPs should report compensation cost equal to the contribution called for in the period under the plan. Compensation cost should be measured as the fair value of the shares contributed to or committed to be contributed to the ESOP or as the cash contributed to or committed to be contributed to the ESOP, as appropriate under the terms of the plan.

Reporting Dividends on ESOP Shares

.42 Employers with nonleveraged ESOPs should charge dividends on shares held by the ESOPs to retained earnings, except that dividends on suspense account shares of a pension reversion ESOP should be accounted for the same way as dividends on suspense account shares of leveraged ESOPs.

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* FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*, supersedes FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*. As noted in paragraph A5 of FASB Statement No. 145, the rescission of FASB Statement No. 4 does not affect paragraph 20 of APB Opinion No. 26, *Early Extinguishment of Debt*. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 145.]

Reporting Redemptions of ESOP Shares

.43 Regardless of whether an ESOP is leveraged or nonleveraged, employers are required to give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires the employer to repurchase the shares at fair value. Furthermore, public company sponsors sometimes offer cash redemption options to participants who are eligible to withdraw traded shares from their accounts, which on exercise requires the employer to repurchase the shares at fair value. Employers should report the satisfaction of such option exercises as purchases of treasury stock.

Earnings per Share

.44 All shares held by a nonleveraged ESOP should be treated as outstanding in computing the employer's EPS, except the suspense account shares of a pension reversion ESOP, which should not be treated as outstanding until they are committed to be released for allocation to participant accounts. If a nonleveraged ESOP holds convertible preferred stock, the guidance in paragraphs .29 to .34 of this SOP for leveraged ESOPs should be considered.

Pension Reversion ESOPs

.45 An employer that terminates a defined benefit pension plan may avoid part of the excise tax on an asset reversion by transferring the assets to an existing or newly created ESOP, which could be either leveraged or nonleveraged. The reverted assets may be used either to purchase shares of the employer stock or to retire existing ESOP debt.

.46 If the assets from the pension plan are used by the ESOP to purchase employer shares, the employer should report the share issuance the same way as other share issuances to an ESOP. The issuance of shares or the sale of treasury shares to the ESOP should be recognized when it occurs, and a corresponding charge to unearned ESOP shares, a contra-equity account, should be reported. If the shares are purchased on the market, the employer should similarly charge unearned ESOP shares. (The credit would be to cash.)

.47 Because the number of shares the ESOP acquires in a pension plan reversion is usually more than the IRS permits to be allocated to participant accounts in a single year, some of the shares are held in a suspense account until they are committed to be released in future years for allocation to participant accounts. The guidance in this SOP, for shares held by leveraged ESOPs, should be applied to suspense account shares.

.48 If the assets from the pension plan reversion are used to repay the debt of an existing ESOP, ESOP shares are committed to be released from suspense. In such situations, the guidance for leveraged ESOPs in this SOP should be followed. The employer should reduce the debt as it is repaid and reduce unearned ESOP shares as shares are committed to be released. How the committed-to-be-released shares are used determines what accounts are charged upon release of shares (see paragraphs .14 to .18).

Issues Related to Accounting for Income Taxes

Leveraged ESOPs

.49 For employers with leveraged ESOPs, the amount of ESOP-related expense reported under this SOP for a period may differ from the amount of the ESOP-related income tax deduction (prescribed by income tax rules and regulations) for that period. Differences result if (*a*) the fair value of shares committed to be released differs from the cost of those shares to the ESOP and (*b*) the timing of expense recognition is different for income tax and financial reporting purposes. Such differences should be reported in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* Similar differences arise from employee stock options. Paragraph 36e of Statement No. 109 requires that the tax effects of expenses for employee stock options recognized differently for financial reporting and tax purposes be recognized in the related component of shareholders' equity.

.50 In accordance with paragraph 36e of Statement No. 109, if the cost of shares committed to be released is greater than their fair value, the employer should credit the tax effect of the amount by which the deductible expense exceeds the book expense to shareholders' equity. Conversely, if the cost of shares committed to be released is less than their fair value, the employer should charge the tax effect of the amount by which the book expense exceeds the deductible expense to shareholders' equity to the extent of previous credits to shareholders' equity related to cost exceeding fair value of ESOP shares committed to be released in previous periods.

.51 Furthermore, the tax benefit of tax-deductible dividends on allocated ESOP shares should be recorded as a reduction of income tax expense allocated to continuing operations. Under paragraph 36f of FASB Statement No. 109, the tax benefit of tax-deductible dividends on unallocated ESOP shares that are charged to retained earnings should be credited to shareholders' equity. However, because dividends on unallocated shares would not be charged to retained earnings under this SOP, paragraph 36f of Statement No. 109 would not apply to ESOP shares accounted for under this SOP.

Nonleveraged ESOPs

.52 Employers with nonleveraged ESOPs may accrue compensation cost for financial reporting purposes earlier than the cost is deductible for income tax purposes. Accruing the compensation cost earlier for financial reporting purposes creates a temporary difference under Statement No. 109.

Disclosures

.53 An employer sponsoring an ESOP should disclose the following information about the plan, if applicable:

a. A description of the plan, the basis for determining contributions, including the employee groups covered, and the nature and effect of significant matters affecting comparability of information for all periods presented. For leveraged ESOPs and pension reversion ESOPs, the description should include the basis for releasing shares and how dividends on allocated and unallocated shares are used.

b. A description of the accounting policies followed for ESOP transactions, including the method of measuring compensation, the classification of dividends on ESOP shares, and the treatment of ESOP shares for EPS computations. If the employer has both old ESOP shares for which it does not adopt the guidance in this SOP and new ESOP shares for which the guidance in this SOP is required (see paragraphs .54 and .55), the accounting policies for both blocks of shares shall be described.

c. The amount of compensation cost recognized during the period.

d. The number of allocated shares, committed-to-be-released shares, and suspense shares held by the ESOP at the balance-sheet date. This disclosure should be made separately for shares accounted for under this SOP and for grandfathered ESOP shares (see paragraphs .54 and .55).

e. The fair value of unearned ESOP shares at the balance-sheet date for shares accounted for under this SOP. (Future tax deductions will be allowed only for the ESOP's cost of unearned ESOP shares.) This disclosure need not be made for old ESOP shares for which the employer does not apply the guidance in this SOP (see paragraphs .55 and .56).

f. The existence and nature of any repurchase obligation, including disclosure of the fair value[7] of the shares allocated as of the balance-sheet date, which are subject to a repurchase obligation.

Effective Date and Transition

.54 This SOP is effective for fiscal years beginning after December 15, 1993. The SOP should be adopted in the first interim period of an employer's fiscal year. Early application is permitted. Prospective application of the guidance in the SOP is required for shares acquired by ESOPs after December 31, 1992 (new ESOP shares) but not yet committed to be released as of the beginning of the year in which the SOP is adopted. No cumulative effect adjustment should be reported under this approach. Restatement of previously issued annual financial statements is not permitted.

.55 Application of all of the guidance in this SOP may be elected, and is encouraged, for shares acquired by ESOPs on or before December 31, 1992 (old ESOP shares). (Selective adoption of the guidance in this SOP is not permitted.) However, employers with ESOPs that do not adopt this SOP for shares held by ESOPs on December 31, 1992, should make all of the applicable disclosures required by paragraph .53. Employers electing to adopt this SOP for old ESOP shares in the first fiscal year beginning after December 15, 1993, or in the preceding year should apply the SOP prospectively to the old ESOP shares that have not yet been committed to be released as follows:

- Employers that applied the shares allocated method described in EITF Issue No. 89-8[8] should apply this SOP prospectively to those shares that have not yet been committed to be released as of the beginning of the year in which the SOP is adopted. No cumulative effect adjustment should be reported under this approach.
- Employers that did not apply the shares allocated method described in EITF Issue No. 89-8 should recognize as an expense in the period of adoption the difference between (*a*) the cumulative ESOP expense

[7] See paragraph .20 for guidance on fair value.

[8] In EITF Issue No. 89-8, *Expense Recognition for Employee Stock Ownership Plans*, the EITF reached a consensus that ESOP shares purchased after December 15, 1989, should be accounted for under the shares allocated method, which is described in that consensus. However, the consensus allows employers with shares purchased before December 15, 1989, to account for such shares under their current methods in certain circumstances.

recognized prior to the period of adoption of this SOP and (*b*) the cumulative expense that would have been recognized prior to the period of adoption of this SOP under the shares allocated method ([total shares committed to be released multiplied by cost of the shares to the ESOP] less cumulative dividends on ESOP shares). That difference should be reported as the cumulative effect of a change in accounting principle in accordance with APB Opinion No. 20, *Accounting Changes*, by including the cumulative effect of the change in income and crediting unearned ESOP shares in the period the SOP is first applied. However, pro forma disclosures are not required.

Restatement of previously issued annual financial statements is not permitted.

.56 Employers electing to adopt this SOP for old ESOP shares in a fiscal year later than the first fiscal year beginning after December 15, 1993, should apply the SOP retroactively through restatement of previously issued financial statements for all years beginning after December 15, 1993. The restatement of the financial statements for the first year beginning after December 15, 1993 (the earliest year restated) should be performed in accordance with paragraph .55. If the earliest year restated is not presented in the financial statements, the beginning balance of retained earnings (and, if necessary, additional paid-in capital) for the earliest year presented should be adjusted for the effect of the restatement as of that date.

.57 For employers that adopt this SOP in a period other than the period the ESOP shares were purchased, certain shares considered outstanding for EPS computations in prior years will no longer be considered outstanding for EPS purposes in the year of adoption. As noted above, restatement is not permitted, however, such employers should disclose the number of shares considered outstanding for EPS purposes in prior periods that are no longer considered outstanding in the current period.

.58 An employer may have both (1) old ESOP shares for which it does not adopt the guidance in this SOP and (2) new ESOP shares for which the guidance in this SOP is required. The measure of compensation cost for the old and new shares in this circumstance will differ. The identification of the shares released each year for financial reporting purposes should be the same as the identification of the shares released for ERISA purposes.

Discussion of Conclusions

.59 This section discusses considerations that were deemed significant by members of AcSEC in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

Leveraged ESOPs

.60 AcSEC believes that all of the specific conclusions about employers' accounting for leveraged ESOP transactions follow from AcSEC's fundamental conclusion that the accounting for an ESOP's debt (financing element) should be separate from the accounting for an ESOP's shares (defined contribution element). Although the financing and defined contribution elements of leveraged ESOPs are related, each should be analyzed and reported separately, and the principles for reporting one element should not affect the principles for reporting the other. Under this SOP, each element is reported in accordance with its substance as it would be reported if it occurred as a separate transaction.

Accounting for Debt and Shares at the Inception of the ESOP

.61 When a leveraged ESOP is established, it borrows money and buys employer shares for cash. However, because the employer is the ultimate source of the cash to repay the debt and is the beneficiary of the financing, AcSEC believes that the substance of the transaction is that the cash is not a consideration to the employer for the shares but rather proceeds from a borrowing. The consideration to be received by the employer for placing the shares in the ESOP trust is future employee services. In fact, the ESOP acquires the shares before the employees have performed the services for which the shares are to compensate them.

.62 AcSEC believes that because the shares transferred from the employer to the ESOP when the ESOP is established are not exchanged for a receipt of assets or services, or for a reduction of liabilities, total shareholders' equity should remain unchanged. The transaction should be reported only as a change within equity until the shares are committed to be released for allocation to participant accounts for services provided. Furthermore, AcSEC believes that even if a leveraged ESOP buys shares on the market rather than from the employer and, therefore, the employer has no direct capital stock transaction and no direct cash inflow when establishing a leveraged ESOP, the employer should treat it as a leveraged ESOP. Such a situation is analogous to an employer selling newly acquired treasury stock to its ESOP. Therefore, shareholders' equity should be reduced by reporting the amount of the stock the ESOP acquires as unearned ESOP shares. Either cash or debt would be credited, depending on whether the ESOP is internally or externally leveraged.

.63 For employers with internally leveraged ESOPs (indirect and employer loans), AcSEC notes that the ESOP's note payable does not represent an obligation of the employer to transfer resources to the ESOP and that the employer's note receivable does not represent a claim by the employer on the ESOP's resources. Therefore, AcSEC concluded they should not be reported by the employer as a liability and as an asset, respectively.

Recognition and Measurement of Release of Shares

.64 AcSEC believes its conclusions on recognition and measurement follow from its conclusions that the debt and shares related to ESOP transactions should be accounted for separately. The substance of an employer's cash contribution to an ESOP is that the cash contribution is used for the payment of debt service on the employer's debt. It is the release of shares, not the employer's cash contribution, that represents the compensation of participants in connection with the defined contribution plan. AcSEC's objective is that the accounting reflect the terms of the exchange transactions that take place between an employer that provides compensation and the employees who render services in exchange for that compensation. To do that, AcSEC considered how the ESOP shares are used.

.65 A key concept introduced in this SOP is that employers may use ESOP shares for different purposes: to compensate employees directly, which was the primary use when SOP 76-3 [section 10,130] was issued; to settle liabilities for employee benefits, such as an employer's match under a 401(k) plan, that arise outside of the ESOP; or to replace dividends on allocated ESOP shares that are used for debt service. The accounting in each of those situations is discussed below.

.66 *Shares Used to Directly Compensate Employees.* For ESOP shares used to compensate employees directly, AcSEC addressed two issues: (*a*) when to record compensation and (*b*) when to measure compensation. AcSEC concluded that employers should record compensation when the shares are committed to be released, because AcSEC believes that is when the exchange between the employer and the employees of employer stock for services rendered occurs. Furthermore, AcSEC believes that the release of shares in a leveraged ESOP is analogous to the employer's contribution to a nonleveraged ESOP.

.67 In reaching its conclusion on when to record compensation, AcSEC also considered whether either the point at which ESOP shares are allocated or at which employees become vested in ESOP shares is significant for accounting purposes, but rejected both of those recognition dates.

.68 AcSEC notes that allocation is merely a mechanical process of assigning the released shares to individual participant accounts within the ESOP trust based on a known formula involving compensation, seniority, or both. AcSEC, therefore, believes that the allocation of shares is not significant for accounting purposes in recognizing compensation cost.

.69 Furthermore, AcSEC believes that vesting provisions, which determine *vested shares,* are not the most meaningful way for employers with ESOPs to relate compensation cost to services performed. ESOPs are defined contribution plans in which participants receive regular periodic awards subject to vesting provisions. AcSEC believes that, in plans such as ESOPs in which employees receive regular, periodic awards, the shares released each period are earned by providing that period's service even though the shares may not vest until later.[9] Furthermore, FASB Statement No. 87, *Employers' Accounting for Pensions*, states that for defined contribution plans, the pension cost should equal the contribution called for in the period. Vesting is not a factor in recognizing compensation costs for defined contribution pension plans.

.70 One of the most significant issues addressed in this SOP is the date on which compensation cost should be measured. Under current practice, compensation cost is measured at the date the ESOP purchases the shares, based on the ESOP's purchase price. AcSEC believes that compensation cost should be measured at the dates shares are committed to be released based on their current fair value, for the following reasons:

- APB Opinion 25, *Accounting for Stock Issued to Employees*, states that the measurement date for compensation is the first date on which the number of shares that an individual employee is entitled to receive is

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[9] Allocated shares that have not vested may be forfeited by certain participants and reallocated to others. Under this SOP, the reallocation of forfeited shares does not result in a cost in the period the shares are reallocated. In fact, the increase or decrease in the fair value of such shares between the date the shares were originally released and the date they are reallocated may affect the number of shares needed to satisfy the employer's obligation to employees. Nevertheless, AcSEC believes that the costs associated with maintaining the records necessary to determine the effects of forfeitures on the employer's obligations and costs would exceed the benefits derived.

known. For ESOPs, the number of shares individual employees will receive is not determinable until the shares are committed to be released. Furthermore, paragraph 11e specifically notes that transferring shares to a trustee does not establish a measurement date for measuring compensation, even if the transfer is irrevocable, unless the identity of the recipient is known. (The general definition of measurement date in APB Opinion 25 supports the allocation date as the measurement date for a leveraged ESOP. However, AcSEC believes the special situations described in paragraphs 11a and 11c of APB Opinion 25 support measurement of compensation at the date shares are committed to be released. The total number of shares committed to be released for the current year's employee service is known prior to allocation and the shares must be allocated to individual employees' accounts as of the end of the ESOP's fiscal year.) Although APB Opinion 25 was issued before SOP 76-3 [section 10,130], AcSEC believes that, because of the significant changes in ESOPs since SOP 76-3 [section 10,130] was issued, the accounting in that SOP contrary to APB Opinion 25 is no longer appropriate.

- Using the fair value of the shares when the shares are committed to be released more accurately reflects the value of the services received by the employer. AcSEC believes an employer that sponsors a leveraged ESOP has entered into a transaction similar to an employer that borrows funds to buy treasury stock and later exchanges those shares with employees for services. Neither transaction should fix the employer's cost of providing employee benefits in the future.
- The risks and rewards of ownership of the shares rests with the employer until the shares are committed to be released, because of the large degree of control employers have (*a*) over how the ESOP debt will be repaid (for example, in some situations, an employer may prepay or refinance debt to achieve certain compensation goals) and (*b*) over an employee's compensation (for example, in some situations, an employer has the ability to change other parts of an employee's compensation package in reaction to changes in the value of the shares being released to maintain an overall competitive level of compensation).
- Measuring compensation based on current fair value conforms the accounting for leveraged and nonleveraged ESOPs. Instead of forming a leveraged ESOP, an employer could borrow and use the funds to buy treasury stock. Then, as the debt is repaid, the employer could contribute the treasury shares to a nonleveraged ESOP. Compensation cost would be measured and recognized based on the fair value of the shares when they are contributed or committed to be contributed to the nonleveraged ESOP. AcSEC believes that a leveraged ESOP and the transaction described in this paragraph have more similarities than differences, and that compensation should be measured in the same way for both.

.71 *Shares Used to Fund Liabilities for Other Employee Benefits.* AcSEC believes the employer's cost and liabilities for employee benefits that are funded with ESOP shares should be measured and recognized in the same way as if some other means of funding were used. The shares committed to be released represent funding or settlement of the employer's obligation for the benefits. To illustrate, assume the following facts about an employer with a leveraged ESOP:

- The ESOP shares are used to fund an employer match under its 401(k) savings plan equal to 50 percent of employee contributions.
- The market value of ESOP shares on the release date is used to determine (*a*) how many shares are allocated to particular participants and (*b*) whether the employer must provide cash or additional shares to fund the difference between the market value of the shares committed to be released and the employer's obligation under the savings plan.
- In period 1, employees contribute $1,000 to their 401(k) accounts and, accordingly, the employer must match $500.
- The market value of shares committed to be released to those employee accounts is $450; the cost of the shares committed to be released is $425.
- The employer issues additional shares with a fair value of $50 to the ESOP (*top-up shares*).

Under current practice for ESOPs, the employer would report compensation cost of $475 ($425 cost of shares plus $50 top-up), although its obligation to employees is $500 (50 percent of the employee contribution). Under this SOP, the employer would report compensation cost of $500, which is the amount AcSEC believes more accurately reflects the substance of the transaction.

.72 *Shares Used to Replace Dividends.* Similarly, AcSEC believes that for ESOP shares used to replace dividends on allocated shares that were used for debt service, the dividend payable is measured and recognized in the same way as if it were paid in cash. The shares committed to be released represent funding or settlement of the dividend payable.

Dividends

.73 Legally, dividends on allocated shares belong to ESOP participants and are not controlled by employers. Although employers may use those dividends to pay debt service, they must allocate shares to participant accounts to replace such dividends. AcSEC believes that dividends on allocated shares have the attributes of dividends, because employers have a liability to pay such dividends to an identifiable outside party in proportion to shares of ownership. Therefore, AcSEC believes that dividends on allocated shares should be charged to retained earnings.

.74 Although legally the dividends on unallocated ESOP shares belong to the ESOP, employers control the use of such dividends, the shares have not been exchanged for employee services, and are not considered outstanding for EPS purposes. The use of dividends on unallocated shares is usually determined by the employer when the ESOP is established. The employer may decide to use such dividends to compensate participants by adding the value of the dividends to participant accounts. Or, more commonly, the employer decides to use such dividends to pay debt service on the ESOP's debt, which the employer has reported as a liability. In all those situations, the employer controls, and benefits from, the use of the dividends on unallocated shares.

.75 If the employer decides to pay the dividends to participants or add the value of the dividends to participant accounts, no linkage exists within the ESOP trust between the ownership of the shares and the amount of dividends paid to participants.[10] AcSEC concluded that such dividends lack the normal attributes of dividends and that the employers are providing additional compensation to participants. Accordingly, such dividends should be charged to compensation cost.

.76 If the employer decides to use the dividends to pay debt service, there is no requirement that the employer replace those dividends or allocate additional shares to participants. Therefore, from the employer's perspective, the only economic event that has occurred when the employer uses dividends on ESOP suspense shares to pay debt service is that cash is transferred to a creditor of the employer (indirect or direct loans) for debt service or is retained by the employer (employer loans); no distribution to shareholders has occurred. AcSEC concluded that such dividends lack the normal attributes of dividends and should be reported as reductions of debt and interest payable.

.77 Under this SOP, dividends on committed-to-be-released-but-unallocated shares are not charged to retained earnings although, for financial reporting purposes, such shares have been exchanged for employee service and are considered outstanding for EPS computations. However, because employers do not relinquish control over the use of the dividends on ESOP shares until the shares are allocated, AcSEC believes that dividends on committed-to-be-released-but-unallocated shares should be treated the same way as dividends on other unallocated shares. AcSEC also notes that the treatment of dividends in other situations does not necessarily correspond with whether the shares are outstanding for EPS purposes. For example, in practice, dividends on restricted shares issued in conjunction with a restricted stock compensation plan are charged to retained earnings although the shares may be only partially outstanding for EPS purposes under the treasury stock method.

Unearned ESOP Shares

.78 AcSEC considered whether the contra-equity account representing unearned ESOP shares should be adjusted to fair value at each reporting date with a corresponding entry to paid-in-capital. However, because the fair value of unearned ESOP shares must be disclosed and there would be no effect on equity, AcSEC decided against such a requirement.

Redemption of Shares

.79 AcSEC believes that employer redemptions of ESOP shares from participants are purchases of treasury stock, even if there is a put option on the shares, and therefore believes that compensation cost should not be adjusted as the value of allocated shares changes. Employers whose shares are not readily tradable are required to give participants a put option, often called a liquidity put. AcSEC notes that such put options are given and shares are purchased from participants to comply with legal requirements and to make a market for the employer's shares. For employers whose shares are readily tradable, AcSEC views the cash redemption options primarily as a convenience to participants, to save them the brokerage commissions involved in the sale of what often may be small holdings and odd lots. Furthermore, ESOPs are nondiscriminatory benefit plans for substantially all employees, and participants may

[10] Under the IRC, if employers choose to pay dividends on suspense account shares to participants or to add those dividends to participant accounts, the allocation of the dividends must be nondiscriminatory among plan participants.

redeem their shares only at times permitted by law, typically on termination, hardship, or retirement. Accordingly, AcSEC believes that the existence of such options does not change the nature of an ESOP to that of a cash plan as described in paragraph 11g of APB Opinion 25.

Earnings per Share

.80 AcSEC believes that ESOP shares committed to be released and, accordingly, exchanged for employee services, are the same as other outstanding shares and should be treated as outstanding for EPS purposes. By contrast, AcSEC believes that ESOP shares that have not been committed to be released and, accordingly, not exchanged for employee services, should not be treated as outstanding for EPS purposes. AcSEC believes that this conclusion is consistent with its conclusion on reporting the release of shares in that the shares are not treated as issued until they are committed to be released.

.81 AcSEC believes that ESOP shares that have not been committed to be released are analogous to unpaid stock subscriptions, and the related consideration the employer will receive is future employee services rather than cash proceeds. Accordingly, AcSEC also considered whether the treasury stock method should be used to determine EPS similar to the way it is applied to unpaid stock subscriptions. However, AcSEC rejected the treasury stock method in favor of the released shares outstanding method, because the number of shares outstanding would be the same under either method and the released shares outstanding method is simpler to understand and apply.

ESOPs That Hold Convertible Preferred Stock

[.82] [Paragraph deleted, November 1998, to reflect conforming changes necessary due to the issuance of FASB Statement No. 128.]

.83 *Computation of Shares Issuable on Assumed Conversion.* If participants withdrawing shares from their accounts are entitled to additional common shares because the fair value or the stated minimum value of the convertible preferred shares exceeds the fair value of the common shares issuable upon conversion, AcSEC believes that the additional shares should be assumed issued in the if-converted EPS computations. Some believe that because employers may have the ability to pay cash to the ESOP trustee (who would then buy employer common stock on the market for those participants who choose common stock) instead of issuing common stock to participants directly, the additional shares should be excluded from the EPS computations. However, AcSEC believes that any issuer of convertible securities has the ability to buy shares on the market to satisfy conversion requirements and that such ability does not change the requirement to reflect the potential dilution from the convertible securities in EPS computations.

.84 ESOP convertible preferred stock has unique attributes, which AcSEC believes make it similar to convertible securities with variable conversion rates. AcSEC's recommendations in this section are based on that analogy. Because the varying conversion rates are purely a function of changes in fair values, which are unknown before they occur, AcSEC concluded that the additional shares issuable should be computed based on current period fair values for diluted EPS computations. [Revised, November 1998, to reflect conforming changes necessary due to the issuance of FASB Statement No. 128.]

.85 *Adjustment of Earnings Applicable to Common Stock.* When dividends on allocated ESOP shares are used to pay debt service, participants receive their dividends in shares rather than in cash. In the normal situation, if the preferred stock were converted to common stock, the common stock dividend would be less than the preferred stock dividend, the proportion of committed-to-be-released shares needed to replace dividends on allocated shares would be smaller after the assumed conversion, and the proportion of committed-to-be-released shares used to compensate participants for services would be greater after the assumed conversion. AcSEC believes the availability of a greater proportion of released shares to compensate participants is a nondiscretionary adjustment, as described in paragraph 26 of FASB Statement No. 128. Accordingly, earnings applicable to common stock in the if-converted computations should reflect the additional compensation cost that would arise from the assumed conversion. (Illustrations 4 and 5 of appendix A [paragraph .99] include this calculation.) [Revised, November 1998, to reflect conforming changes necessary due to the issuance of FASB Statement No. 128.]

.86 AcSEC believes that cash dividends on allocated ESOP shares paid to participants or added to participant accounts should be treated the same way as dividends on non-ESOP convertible preferred stock, and, accordingly, concluded that adjustment of compensation cost for EPS computation purposes is unnecessary.

.87 Dividends on unallocated ESOP shares used to pay debt service are not treated as dividends for accounting purposes and, therefore, do not affect the if-converted EPS computations.

.88 Dividends on unallocated ESOP shares paid to participants or added to participant accounts are treated as compensation cost. That use of dividends and, consequently, the compensation provided to participants, is discretionary when the ESOP is established. Accordingly, AcSEC believes that the compensation cost arising from those dividends should not be adjusted in the if-converted EPS computations.

Terminations

.89 Although IRS and ERISA rules make it difficult, and often uneconomical, to terminate leveraged ESOPs and generally require a valid business reason—such as significant shrinkage in the work force or bankruptcy—for doing so, terminations and curtailments of ESOP plans occasionally occur. AcSEC believes that the conclusion that terminations or curtailments involving an ESOP's suspense shares should be accounted for as treasury stock transactions is consistent with the basic premise of this SOP—that the shares and debt should be accounted for separately. Another important consideration was that suspense shares are not considered outstanding for EPS computations.

.90 The accounting for terminations recommended in this SOP would result in a debit to paid-in capital when the fair value of the shares at the termination date is less than the cost of the shares to the ESOP and a credit to paid-in capital when the fair value of the shares at the termination date is more than the cost of the shares to the ESOP. AcSEC believes those debits or credits to equity are analogous to losses and gains on the employer's own stock, which should be excluded from income. Under this SOP, differences between the fair value and cost of ESOP shares used to settle employer liabilities are debited and credited to shareholders' equity. An ESOP termination is effectively the use of ESOP shares to settle the employer's liability for ESOP debt. Even if an employer has an internally leveraged ESOP with no related outside debt, AcSEC believes the reacquisition of the ESOP shares should be treated as a purchase of treasury stock because, under this SOP, the employer does not report the ESOP's note payable and does not report a note receivable from the ESOP, and the suspense shares have neither been considered outstanding for EPS nor exchanged for employee services.

.91 AcSEC provides the following example to illustrate the point. An ESOP borrows $1,000 and acquires 100 shares of employer stock for $10 per share (market price on the date acquired). The market price subsequently drops to $6 per share, and the employer decides to terminate its ESOP when there are 80 shares in suspense and an $800 debt balance. Accordingly, the employer would have to contribute an additional $320 ($800 less $6 multiplied by 80 shares) to retire the ESOP debt. AcSEC believes that the additional contribution is a result of a change in the value of the employer's shares, not of a change in the debt obligation. Therefore, the $320 should be charged to paid-in capital, not to income as an extinguishment loss or compensation expense. AcSEC believes the accounting treatment recommended for terminations is analogous to any company borrowing cash to buy shares of its own stock and later selling those shares to obtain cash to repay the debt. If the proceeds from the sale of the shares is insufficient to repay the debt because the fair value of the shares declined between the purchase and sale dates, the company will have to use additional cash to repay the debt. Such a transaction would have no impact on the company's income.

Nonleveraged ESOPs

.92 Although this SOP would not change how employers with nonleveraged ESOPs account for ESOP transactions, AcSEC believes it is helpful to include a discussion of nonleveraged ESOPs. The accounting described in this SOP for employers with nonleveraged ESOPs is based on the fact that nonleveraged ESOPs are defined contribution pension plans covered by FASB Statement No. 87. Therefore, the compensation cost for the period should generally equal the contribution called for in the period. The shares or cash that an employer contributes or commits to contribute to a nonleveraged ESOP for a period is consideration for employee services rendered during that period.

Pension Reversion ESOPs

.93 If the excess assets from a pension reversion are used to purchase ESOP shares, the shares in excess of the amount that may be allocated to participants in the year of the reversion are held in a suspense account and allocated in future years. The suspense account shares arising from a pension reversion do not collateralize a borrowing, and the release of such shares is not based on debt service payments. However, in most other respects, such suspense account shares are the same as the suspense account shares in a leveraged ESOP, and, accordingly, AcSEC concluded that they should be accounted for in the same way as suspense account shares of leveraged ESOPs.

Income Taxes

.94 Although FASB Statement No. 109, *Accounting for Income Taxes*, does not explicitly address how to treat differences between the fair value and the cost of ESOP shares committed to be released, it does address expenses for employee stock options recognized differently for financial reporting and tax purposes, which AcSEC believes is analogous to ESOPs. The FASB decided to make no changes to paragraph 17 of APB Opinion 25, which prohibits reporting the related tax effect of such differences as a part of income and requires that they be reported as charges or credits directly to related components of shareholders' equity.

Disclosures

.95 AcSEC notes that the disclosures in paragraph .53f related to repurchase obligations are a minimum requirement. AcSEC recognizes that employers may wish to disclose additional information about the obligation, particularly information about the timing of payments.

Transition

.96 AcSEC believes that transition, to a significant extent, is a practical matter. A major objective of transition is to minimize implementation costs and to mitigate disruption to the extent possible without unduly compromising the objectives of the accounting guidance in this SOP and consistency among reporting entities.

.97 In deciding to grandfather shares held by ESOPs as of December 31, 1992, AcSEC was most influenced by its perception that it would be unfair to employers with existing ESOPs to change their accounting for ESOPs currently in place. The decision to establish an ESOP is complex and involves the consideration of many factors, such as IRS and ERISA regulations, employee compensation matters, and possible other uses of debt proceeds, as well as how the ESOP will affect earnings during its term. ESOPs are long-term undertakings, they are costly to establish, and they cannot be undone easily. For many employers, the accounting treatment, which was covered in SOP 76-3 [section 10,130], was an important consideration in establishing their ESOPs.

Minority View

.98 Four AcSEC members dissent to the issuance of this SOP, because they believe that fair value of shares released should not be used to measure compensation cost of certain ESOPs. The dissenters believe there are two types of ESOPs, as follows:

- *Type I*—Shares are released to compensate employees directly. Such ESOPs are not used to fund other employee benefits and the fair value of the shares released is not a factor in determining the number of shares to be allocated to employees. These ESOPs are typical of the ESOPs that commonly existed at the time SOP 76-3 [section 10,130] was issued.

- *Type II*—Shares are released to settle or fund liabilities for other specified or determinable employee benefits, such as an employer's match of a 401(k) plan. The fair value of shares released is used to determine how many shares are needed to satisfy an obligation that arose outside the ESOP.

The dissenters believe that Type I ESOPs should be excluded from the scope of the SOP because the current accounting guidance for Type I ESOPs continues to be relevant and the costs of applying the SOP to Type I ESOPs are not justified. They believe this SOP on employers' accounting for ESOP transactions should cover only the ESOPs for which there is concern that the current accounting is inappropriate. The dissenters believe that the measurement date to recognize compensation expense for Type I ESOPs should continue to be the date the shares are purchased by the ESOP, because that is when the risks and rewards associated with the value of the ESOP shares are transferred from the employer to employees. In contrast, the dissenters agree with the accounting in this SOP for Type II ESOPs.

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Appendix A

Illustrations

This appendix contains illustrations of the requirements of this SOP for employers with the following kinds of ESOPs:

- *Illustration 1*—A common-stock leveraged ESOP with a direct loan
- *Illustration 2*—A common-stock leveraged ESOP used to fund the employer's match of a 401(k) savings plan with an indirect loan
- *Illustration 3*—A common-stock nonleveraged ESOP
- *Illustration 4*—A convertible-preferred-stock leveraged ESOP with a direct loan [Revised, November 1998, to reflect conforming changes necessary due to the issuance of FASB Statement No. 128.]
- *Illustration 5*—A convertible, preferred-stock, leveraged ESOP used to fund a 401(k) savings plan with an employer loan [Revised, November 1998, to reflect conforming changes necessary due to the issuance of FASB Statement No. 128.]

The illustrations do not address all possible circumstances that may arise in applying the SOP. The illustrations are for annual reporting periods and, accordingly, do not demonstrate the application of the SOP to interim financial statements. However, depending on the circumstances, many of the journal entries illustrated would be made for interim financial statements.

Illustration 1

Common Stock Leveraged ESOP With a Direct Loan

Assumptions

On January 1, Year 1, Company A establishes a leveraged ESOP as follows:

- The ESOP borrows $1,000,000 from an outside lender at 10 percent for five years and uses the proceeds to buy 100,000 shares of newly issued common stock of the sponsor for $10 per share, which is the market price of those shares on the date of issuance.
- Debt service is funded by cash contributions and dividends on employer stock held by the ESOP.
- Dividends on all shares held by the ESOP are used for debt service.
- Cash contributions are made at the end of each year.
- The year-end and average market values of a share of common stock follow:

Table 1-a

Year	*Year-end*	*Average*
1	$11.50	$10.75
2	9.00	10.25
3	10.00	9.50
4	12.00	11.00
5	14.40	13.20

- The common stock pays normal dividends at the end of each quarter of 12.5 cents per share ($50,000 for the ESOP's shares each year). Accordingly, in this illustration, the average fair value of shares is used to determine the number of shares used to satisfy the employers' obligation to replace dividends on allocated shares used for debt service.
- Principal and interest are payable in equal annual installments at the end of each year. Debt service is as follows:

Table 1-b

Year	*Principal*	*Interest*	*Total Debt Service*
1	$ 163,800	$100,000	$ 263,800
2	180,200	83,600	263,800
3	198,200	65,600	263,800
4	218,000	45,800	263,800
5	239,800	24,000	263,800
	$1,000,000	$319,000	$1,319,000

- The number of shares released each year is as follows:

Table 1-c

Year	*Dividends*	*Compensation*	*Total*
1	0	20,000	20,000
2	976	19,024	20,000
3	2,105	17,895	20,000
4	2,727	17,273	20,000
5	3,030	16,970	20,000

The number of shares released for dividends is determined by dividing the amount of dividends on allocated shares by the average fair value of a share of common stock (for year 2: $10,000 divided by $10.25 equals 976 shares). In this illustration, the remaining shares are released for compensation (for year 2: 20,000 less 976 equals 19,024 shares).

- Shares are released from the suspense account for allocation to participants' accounts based on a principal-plus-interest formula. The released shares are allocated to participant accounts the following year. Shares released and allocated follow:

Table 1-d

	Cumulative Number of Shares		*Average Shares*	*Year-End Suspense*
Year	*Released*	*Allocated*	*Released*	*Shares*
1	20,000	0	10,000	80,000
2	40,000	20,000	30,000	60,000
3	60,000	40,000	50,000	40,000
4	80,000	60,000	70,000	20,000
5	100,000	80,000	90,000	0

- Income before ESOP-related charges is as follows:

Table 1-e

Year	*Income*
1	$1,800,000
2	1,900,000
3	2,000,000
4	2,100,000
5	2,200,000

- All interest cost and compensation cost are charged to expense each year.
- Excluding ESOP shares, 1,000,000 shares are outstanding on average each year.
- Company A follows FASB Statement No. 109.
- Company A's combined statutory tax rate is 40 percent each year.
- Company A's only book/tax differences are those associated with its ESOP.

- No valuation allowance is necessary for deferred tax assets.

Results of Applying SOP

The following table sets forth Company A's ESOP-related information. All amounts represent changes (credits in parentheses) in account balances.

Year	*Principal*	*Unearned ESOP Shares*	*Paid-In Capital*	*Dividends*	*Interest Expense*	*Compensation Expense*	*Cash*
Notes	*(1)*	*(2)*	*(3)*	*(4)*	*(1)*	*(5)*	*(6)*
1	$ 163,800	$ (200,000)	$(15,000)	$ 0	$100,000	$215,000	$ (263,800)
2	180,200	(200,000)	(5,000)	10,000	83,600	195,000	(263,800)
3	198,200	(200,000)	10,000	20,000	65,600	170,000	(263,800)
4	218,000	(200,000)	(20,000)	30,000	45,800	190,000	(263,800)
5	239,800	(200,000)	(64,000)	40,000	24,000	224,000	(263,800)
Total	$1,000,000	$(1,000,000)	$(94,000)	$100,000	$319,000	$994,000	$(1,319,000)

Notes:

(1) See table 1-b.

(2) Total number of shares released for year (20,000) multiplied by the cost per share to ESOP ($10).

(3) Total number of shares released for year (20,000) multiplied by the difference between average fair value per share (see table 1-a) and cost per share to ESOP ($10). [Year 1: 20,000 shares multiplied by ($10.75-$10.00)]

(4) Cumulative number of allocated shares (see table 1-d) multiplied by the dividend per share. [Year 2: 20,000 shares multiplied by $.50]

(5) Number of shares released for compensation (see table 1-c) multiplied by the average fair value per share for the period (see table 1-a). The amounts in this column have been rounded.

(6) The cash disbursed each year is comprised of $213,800 contribution and $50,000 in dividends.

Journal Entries

Company A would record journal entries from inception through year 5 as follows:

January 1, Year 1 (inception)

Cash	1,000,000	
Debt		1,000,000
[To record the ESOP's loan]		
Unearned ESOP shares (equity)	1,000,000	
Common stock and paid-in capital		1,000,000
[To record the issuance of 100,000 shares to the ESOP at $10 per share]		
Year 1		
Interest expense	100,000	
Accrued interest payable		100,000
[To record interest expense]		

Accrued interest payable	100,000	
Debt	163,800	
Cash		263,800

[To record debt payment (The cash disbursement of $263,800 consists of $50,000 in dividends, none of which is charged to retained earnings in year 1, and $213,800 supplemental cash contribution to the ESOP)]

Compensation expense	215,000	
Paid-in capital		15,000
Unearned ESOP shares		200,000

[To record release of 20,000 shares at an average fair value of $10.75 per share (shares cost ESOP $10)]

Deferred tax asset	14,480	
Provision for income taxes	600,000	
Income taxes payable		614,480

[To record income taxes for year 1 (See tax computations following journal entries)]

Year 2

Interest expense	83,600	
Accrued interest payable		83,600

[To record interest expense]

Accrued interest payable	83,600	
Debt	180,200	
Cash		263,800

[To record debt payment (The cash disbursement of $263,800 consists of $50,000 in dividends, $10,000 of which is charged to retained earnings in year 2, and $213,800 supplemental cash contribution to the ESOP)]

Retained earnings	10,000	
Dividends payable		10,000

[To record declaration of $.50 per share dividend on the 20,000 allocated shares]

Compensation expense	195,000	
Dividends payable	10,000	
Paid-in capital		5,000
Unearned ESOP shares		200,000

[To record release of 20,000 shares (19,024 for compensation and 976 for dividends) at an average fair value of $10.25 per share (shares cost ESOP $10 per share)]

Deferred tax asset	7,920	
Provision for income taxes	646,560	
Income taxes payable		654,480

[To record income taxes for year 2 (See tax computations following journal entries)]

Year 3

Interest expense	65,600	
Accrued interest payable		65,600

[To record interest expense]

Accrued interest payable	65,600	
Debt	198,200	
Cash		263,800
[To record debt payment]		
Retained earnings	20,000	
Dividends payable		20,000
[To record declaration of $.50 per share dividend on the 40,000 allocated shares]		
Compensation expense	170,000	
Dividends payable	20,000	
Paid-in capital	10,000	
Unearned ESOP shares		200,000
[To record release of 20,000 shares (17,895 for compensation and 2,105 for dividends) at an average fair value of $9.50 per share (shares cost ESOP $10 per share)]		
Deferred tax asset	720	
Provision for income taxes	697,760	
Paid-in capital		4,000
Income taxes payable		694,480
[To record income taxes for year 3 (See tax computations following journal entries)]		

Year 4

Interest expense	45,800	
Accrued interest payable		45,800
[To record interest expense]		
Accrued interest payable	45,800	
Debt	218,000	
Cash		263,800
[To record debt payment]		
Retained earnings	30,000	
Dividends payable		30,000
[To record declaration of $.50 per share dividend on the 60,000 allocated shares]		
Compensation expense	190,000	
Dividends payable	30,000	
Paid-in capital		20,000
Unearned ESOP shares		200,000
[To record release of 20,000 shares (17,273 for compensation and 2,727 for dividends) at an average fair value of $11.00 per share (shares cost ESOP $10 per share)]		
Provision for income taxes	737,680	
Paid-in capital	4,000	
Deferred tax asset		7,200
Income taxes payable		734,480
[To record income taxes for year 4, see tax computations following journal entries]		

Year 5

Interest expense	24,000	
Accrued interest payable		24,000
[To record interest expense]		
Accrued interest payable	24,000	
Debt	239,800	
Cash		263,800
[To record debt payment]		
Retained earnings	40,000	
Dividends payable		40,000
[To record declaration of $.50 per share dividend on the 80,000 allocated shares]		
Compensation expense	224,000	
Dividends payable	40,000	
Paid-in capital		64,000
Unearned ESOP shares		200,000
[To record release of 20,000 shares (16,970 for compensation and 3,030 for dividends) at an average fair value of $13.20 per share (shares cost ESOP $10 per share)]		
Provision for income taxes	790,400	
Deferred tax asset		15,920
Income taxes payable		774,480
[To record income taxes for year 5, see tax computations following journal entries]		

Illustration of Termination

Assuming Company A terminates its ESOP at the end of year 2 (when the fair value of the suspense shares is $540,000 [60,000 shares multiplied by $9 per share], the unearned compensation balance is $600,000, and the unpaid debt balance is $656,000), and assuming the suspense shares are sold to pay down the debt, Company A would make the following journal entry:

Debt	656,000	
Additional paid-in capital	60,000	
Unearned ESOP shares		600,000
Cash		116,000
[To record repayment of the ESOP's loan and termination of the plan]		

Tax and EPS Computations

The following tables set forth Company A's tax (assuming no termination) and EPS computations:

	Year				
	1	*2*	*3*	*4*	*5*
Income before ESOP	$1,800,000	$1,900,000	$2,000,000	$2,100,000	$2,200,000
Interest expense	(100,000)	(83,600)	(65,600)	(45,800)	(24,000)
Compensation expense	(215,000)	(195,000)	(170,000)	(190,000)	(224,000)
Pretax income	1,485,000	1,621,400	1,764,400	1,864,200	1,952,000
Provision for income tax					
Currently payable	614,480	654,480	694,480	734,480	774,480
Deferred	(14,480)	(7,920)	(720)	7,200	15,920
Shareholders' equity	-0-	-0-	4,000†	(4000)†	-0-
Total	600,000	646,560	697,760	737,680	790,400
Net income	$ 885,000	$ 974,840	$1,066,640	$1,126,520	$1,161,600
Average shares outstanding	1,010,000	1,030,000	1,050,000	1,070,000	1,090,000
Earnings per share	$ .88	$ .95	$ 1.02	$ 1.05	$ 1.07

Tax Computations

	Year				
	1	*2*	*3*	*4*	*5*
Current provision:					
Income before ESOP	$1,800,000	$1,900,000	$2,000,000	$2,100,000	$2,200,000
ESOP contribution	(213,800)	(213,800)	(213,800)	(213,800)	(213,800)
ESOP dividends	(50,000)	(50,000)	(50,000)	(50,000)	(50,000)
Taxable income	1,536,200	1,636,200	1,736,200	1,836,200	1,936,200
Multiplied by 40 percent	$ 614,480	$ 654,480	$ 694,480	$ 734,480	$ 774,480
Deferred provision:					
Reduction in unearned ESOP shares for financial reporting	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000
Related tax deduction‡	163,800	180,200	198,200	218,800	239,800
Difference	(36,200)	(19,800)	(1,800)	18,000	39,800
Tax rate	40%	40%	40%	40%	40%
Deferred tax expense/ (benefit)	$ (14,480)	$ (7,920)	$ (720)	7,200	15,920

† See paragraph .50. In year 3, the amount is calculated as follows: 20,000 shares released multiplied by $.50 excess cost over average fair value per share multiplied by 40 percent tax rate.

‡ This amount is the principal repayment.

Reconciliation of Effective Tax Rate to Provision for Income Taxes

	Year				
	1	*2*	*3*	*4*	*5*
Pretax income	$1,485,000	$1,621,400	$1,764,400	$1,864,200	$1,952,000
Tax at 40 percent (statutory rate)	594,000	648,560	705,760	745,680	780,800
Benefit of ESOP dividends	-0-	(4,000)	(8,000)	(12,000)	(16,000)
Effect of difference between average fair value and cost of released shares	6,000	2,000	-0-	4,000	25,600
Provision as reported	$ 600,000	$ 646,560	$ 697,760	$ 737,680	$ 790,400

Illustrative Disclosure for End of Year 3

The company sponsors a leveraged employee stock ownership plan (ESOP) that covers all U.S. employees who work twenty or more hours per week. The company makes annual contributions to the ESOP equal to the ESOP's debt service less dividends received by the ESOP. All dividends received by the ESOP are used to pay debt service. The ESOP shares initially were pledged as collateral for its debt. As the debt is repaid, shares are released from collateral and allocated to active employees, based on the proportion of debt service paid in the year. The company accounts for its ESOP in accordance with Statement of Position 93-6. Accordingly, the debt of the ESOP is recorded as debt and the shares pledged as collateral are reported as unearned ESOP shares in the statement of financial position. As shares are released from collateral, the company reports compensation expense equal to the current market price of the shares, and the shares become outstanding for earnings-per-share (EPS) computations. Dividends on allocated ESOP shares are recorded as a reduction of retained earnings; dividends on unallocated ESOP shares are recorded as a reduction of debt and accrued interest. ESOP compensation expense was $170,000, $195,000, and $215,000 for years 3, 2, and 1, respectively. The ESOP shares as of December 31 were as follows:

	Year 3	*Year 2*
Allocated shares	40,000	20,000
Shares released for allocation	20,000	20,000
Unreleased shares	40,000	60,000
Total ESOP shares	100,000	100,000
Fair value of unreleased shares at December 31	$400,000	540,000

Illustration 2

Common Stock Leveraged ESOP Used to Fund the Employer's Match of a 401(k) Savings Plan With an Indirect Loan

Assumptions

On January 1, Year 1, Company B established an ESOP to fund the employer's match of its savings plan as follows:

- All of the assumptions are the same as those for Company A, except as follows.
- Company B loaned its ESOP $1,000,000 and concurrently obtained a related loan. The terms of both lending arrangements are the same as for Company A's outside loan.
- Company B uses shares released by the ESOP to satisfy its matching obligation of 50 percent of voluntary employee contributions to the savings plan. The average fair value of the shares for each year is used to determine the number of shares necessary to satisfy the matching obligation.
- If the fair value of the shares released is less than Company B's matching obligation, Company B contributes additional newly issued shares to the ESOP to satisfy the remaining obligation.
- Shares used to replace dividends on allocated shares used to service debt do not count toward the employer's match.
- The employee contributions, required employer match, and the number of shares needed to fund the employee match follow:

Table 2-a

Year	*Employee Contributions*	*Employer Match*	*Number of Shares*
1	$400,000	$200,000	18,605
2	410,000	205,000	20,000
3	420,000	210,000	22,105
4	430,000	215,000	19,545
5	440,000	220,000	16,667

Note: The number of shares needed to satisfy the employer's matching obligation is determined by dividing the matching obligation by the average fair value of a share of common stock [for year 1: $200,000 divided by $10.75 (See table 1-a for average fair values) equals 18,605 shares].

- The 20,000 shares released each year based on debt service payments follow:

Table 2-b

Year	*Number of Shares Needed to Settle 401(k) Liability*	*Total ESOP Shares Released*	*ESOP Shares Used for Dividends*	*ESOP Shares Available to Settle 401(k) Liability*	*Compensation (Additional Shares)*	*Top-Up (Additional Shares)*
Notes	*(1)*	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
1	18,605	20,000	-0-	20,000	1,395	-0-
2	20,000	20,000	976	19,024	-0-	976
3	22,105	20,000	2,105	17,895	-0-	4,210
4	19,545	20,000	2,727	17,273	-0-	2,272
5	16,667	20,000	3,030	16,970	303	0

Notes:

(1) See table 2-a.

(2) See assumptions.

(3) See table 1-c.

(4) Total ESOP shares released minus ESOP shares used for dividends.

(5) If the ESOP shares needed to settle the 401(k) liability (column 1) are less than the ESOP shares available to settle the liability (column 4), then the remaining shares are considered compensation (this is the case in years 1 and 5).

(6) If the ESOP shares needed to settle the 401(k) liability (column 1) are greater than the ESOP shares available to settle the liability (column 4), then the shortfall must be made up by the employer in the form of top-up shares (this is the case in years 2, 3, and 4).

- Cumulative share amounts follow:

Table 2-c

	Cumulative Number of Shares		*Total Suspense*
Year	*Released*	*Allocated*	*Shares*
1	20,000	-0-	80,000
2	40,976	20,000	60,000
3	65,186	40,976	40,000
4	87,458	65,186	20,000
5	107,458	87,458	-0-

Note: Dividends on top-up shares are paid in cash. Cumulative shares released include top-up shares.

Results of Applying SOP

The following table sets forth Company B's ESOP-related information. All amounts represent changes (credits in parentheses) in account balances.

Year	Principal	Unearned ESOP Shares	Paid-In Capital	Dividends	Interest Expense	Compensation Expense ESOP	Compensation Expense Top-Up	Cash
Notes	(1)	(2)	(3)	(4)	(1)	(5)	(6)	(7)
1	$ 163,800	$ (200,000)	$ (15,000)	$ -0-	$100,000	$215,000	$ -0-	$ (263,800)
2	180,200	(200,000)	(15,000)	10,000	83,600	195,000	10,000	(263,800)
3	198,200	(200,000)	(30,000)	20,500	65,600	170,000	40,000	(264,300)
4	218,000	(200,000)	(45,000)	32,600	45,800	190,000	25,000	(266,400)
5	239,800	(200,000)	(64,000)	43,700	24,000	224,000	-0-	(267,500)
Total	$1,000,000	$(1,000,000)	$(169,000)	$106,800	$319,000	$994,000	$75,000	$(1,325,800)

Notes:

(1) See table 1-b.

(2) Number of shares released during the year (20,000) multiplied by the cost per share to ESOP ($10).

(3) Number of shares released during the year (20,000) multiplied by the difference between average fair value per share (see table 1-a) and cost per share to the ESOP ($10) plus the additional paid-in capital that arises from the top-up shares contributed, which equals the compensation expense related to the top-up.

(4) Cumulative shares allocated (see table 2-c) multiplied by the dividend per share ($.50).

(5) Number of ESOP shares released for direct compensation plus number of shares released related to employer's match of 401(k) (see table 2-b) multiplied by the average fair value per share (see table 1-a).

(6) Additional shares contributed (top-up) to satisfy the 401(k) obligation (see table 2-b) multiplied by the fair value of shares contributed.

(7) The cash disbursed to the ESOP each year is composed of $213,800 contribution; $50,000 in dividends on original ESOP shares; and dividends on top-up shares of $500 in year 3, $2,600 in year 4, and $3,700 in year 5.

Journal Entries

Company B would record journal entries from inception through year 2 as follows:

January 1, Year 1 (inception)

Cash	1,000,000	
Debt		1,000,000
[To record loan]		
Unearned ESOP shares (equity)	1,000,000	
Common stock and additional paid-in capital		1,000,000
[To record the issuance of 100,000 shares to the ESOP at $10 per share]		
Year 1		
Interest expense	100,000	
Accrued interest payable		100,000
[To record interest expense]		

Accrued interest payable	100,000	
Debt	163,800	
Cash		263,800

[To record debt payment (The cash disbursement of $263,800 consists of $50,000 in dividends, none of which was charged to retained earnings in year 1, and $213,800 supplemental cash contribution to the ESOP)]

Compensation expense	200,000	
401(k) liability		200,000

[To record cost and liability related to employer's 401(k) match, which represents 50 percent of employee contributions]

401(k) liability	200,000	
Compensation expense	15,000	
Unearned ESOP shares		200,000
Paid-in capital		15,000

[To record release of 20,000 shares at an average fair value of $10.75 per share, 18,605 shares are used to satisfy 401(k) liability and the remaining 1,395 are used to compensate participants directly (shares cost ESOP $10 per share)]

Deferred tax asset	14,480	
Provision for income taxes	600,000	
Income taxes payable		614,480

[To record income taxes for year 1 (See illustration 1 for detailed tax computation)]

Year 2

Interest expense	83,600	
Accrued interest payable		83,600

[To record interest expense]

Accrued interest payable	83,600	
Debt	180,200	
Cash		263,800

[To record debt payment (The cash disbursement of $263,800 consists of $50,000 in dividends, $10,000 of which was charged to retained earnings in year 2, and $213,800 supplemental cash contribution to the ESOP)]

Compensation expense	205,000	
401(k) liability		205,000

[To record cost and liability related to employer's 401(k) match, which represents 50 percent of employee contributions]

Retained earnings	10,000	
Dividends payable		10,000

[To record declaration of $.50 per share dividend on the 20,000 allocated shares]

401(k) liability	205,000	
Dividends payable	10,000	
Unearned ESOP shares		200,000
Common stock/paid-in capital		15,000

[To record release of 20,000 shares plus contribution of an additional 976 shares to the ESOP at an average fair value of $10.25 per share, 20,000 shares are used to satisfy 401(k) liability and the remaining 976 shares are used to replace dividends on allocated shares used for debt service (shares cost ESOP $10 per share)]

Deferred tax asset	7,920	
Provision for income taxes	642,560	
Income taxes payable		650,480

[To record income taxes for year 2 (See illustration 1 for detailed tax computation)]

Note: Journal entry differs from Illustration 1 because Company B receives an additional $10,000 deduction ($4,000 tax benefit) for the 976 top-up shares.

Illustration of Termination

Assuming Company B terminated its ESOP at the end of year 4 (when the fair value of the suspense shares is $240,000, the unearned ESOP shares balance is $200,000, and the unpaid debt balance is $239,800), and assuming the employer buys back the suspense shares in an amount equal to the debt balance, there will be seventeen suspense shares left, which must be allocated to participants. (In this illustration the shares are used to partially satisfy the employer's 401(k) matching obligation.) Company B would make the following journal entry:

Treasury stock	39,800	
401(k) liability	204	
Additional paid-in-capital		40,004
Unearned ESOP shares		200,000

[To record repurchase of ESOP suspense shares and termination of the plan]

Debt	239,800	
Cash		239,800

[To record repayment of the ESOP's loan]

Tax and EPS Computations

Company B's taxes would be computed the same way as Company A's. For Company B the average number of ESOP shares outstanding would be as follows:

Year	*ESOP Shares Outstanding*
1	10,000
2	30,488
3	53,081
4	76,322
5	97,458

This represents the cumulative numbers of shares released at the beginning of the year plus the end of the year (see table 2-c) divided by 2.

Illustrative Disclosure for End of Year 3

The company sponsors a 401(k) savings plan under which eligible U.S. employees may choose to save up to 6 percent of salary income on a pre-tax basis, subject to certain IRS limits. The company matches 50 percent of employee contributions with company common stock. The shares for this purpose are provided principally by the company's employee stock ownership plan (ESOP), supplemented as needed by newly issued shares. The company makes annual contributions to the ESOP equal to the ESOP's debt service less dividends received by the ESOP. All dividends received by the ESOP are used to pay debt service. The ESOP shares initially were pledged as collateral for its debt. As the debt is repaid, shares are released from collateral and allocated to employees who made 401(k) contributions that year, based on the proportion of debt service paid in the year. The company accounts for its ESOP in accordance with Statement of Position 93-6. Accordingly, the shares pledged as collateral are reported as unearned ESOP shares in the statement of financial position. As shares are released from collateral, the company reports compensation expense equal to the current market price of the shares, and the shares become outstanding for EPS computations. Dividends on allocated ESOP shares are recorded as a reduction of retained earnings; dividends on unallocated ESOP shares are recorded as a reduction of debt and accrued interest.

Compensation expense for the 401(k) match and the ESOP was $210,000, $205,000, and $215,000 for years 3, 2, and 1, respectively. The ESOP shares as of December 31 were as follows:

	Year 3	*Year 2*
Allocated shares	40,976	20,000
Shares released for allocation	24,210	20,976
Unreleased shares	40,000	60,000
Total ESOP shares	105,186	100,976
Fair value of unreleased shares at December 31	$400,000	$540,000

Illustration 3

Common Stock Nonleveraged ESOP

Assumptions

On January 1, Year 1, Company C established a nonleveraged ESOP as follows:

- Company C contributed 10 percent of pretax profit before ESOP-related charges to the ESOP at the end of each of years 1 through 5; the ESOP bought newly issued employer stock with the contribution.
- The number of shares, earnings, tax, and other relevant assumptions are the same as those for Company A.

Results of Applying SOP

The following chart sets forth Company C's ESOP-related information:

Year	*Compensation Expense*	*Dividends*	*Number of ESOP Shares Purchased*	*Cumulative ESOP Shares*
1	$180,000	$ -0-	15,652	15,652
2	190,000	7,830	21,111	36,763
3	200,000	18,380	20,000	56,763
4	210,000	28,380	17,500	74,263
5	220,000	37,130	15,278	89,541

The year-end market value is used in this illustration to determine the number of ESOP shares purchased. [Year 1: $180,000 divided by $11.50 (See table 1-a) equals 15,652]

Journal Entries

Company C would record journal entries for years 1 and 2 as follows:

Year 1

Compensation expense	180,000	
Common stock/paid-in capital		180,000

[To record contribution, sale of shares, and compensation expense]

Provision for income taxes	648,000	
Income taxes payable		648,000

[To record income taxes at 40 percent for year 1 on earnings of $1,620,000 ($1,800,000 pre-ESOP income less ESOP compensation of $180,000)]

Year 2

Compensation expense	190,000	
Retained earnings	7,830	
Common stock/paid-in capital		190,000
Dividends payable		7,830

[To record contribution, sale of shares, declaration of dividends, and compensation expense]

Dividends payable	7,830	
Cash		7,830
[To record payment of dividends]		
Provision for income taxes	684,000	
Income taxes payable		684,000

[To record income taxes at 40 percent for year 2 on earnings of $1,710,000 ($1,900,000 pre-ESOP income less ESOP compensation of $190,000)]

Illustration 4

Convertible Preferred Stock Leveraged ESOP With a Direct Loan

Assumptions

On January 1, Year 1, Company D established an ESOP with convertible preferred stock as follows:

- The borrowing, debt service, earnings, and tax assumptions are the same as those for Company A.
- On January 1, Year 1, the ESOP used the proceeds of the debt to buy 80,000 shares of newly issued convertible preferred stock of Company D for $12.50 per share.
- The preferred stock pays dividends quarterly at an annual rate of $1.25 per share ($100,000 each year for the ESOP's shares). Accordingly, in this illustration the average fair value of the shares is used to determine the number of shares used to satisfy the employer's obligation to replace dividends on allocated shares used for debt service.
- All dividends on ESOP shares are used for debt service.
- The preferred stock is convertible into common stock at 1:1 ratio.
- Participants may not withdraw the convertible preferred stock from the ESOP. When participants become eligible to withdraw shares from their account, they must either convert to common stock or redeem the preferred shares.
- The preferred stock has a guaranteed minimum redemption value of $12.50 per share, to be paid in shares of common stock.
- The preferred stock is callable at $13.00 per share.
- There is one vote per preferred share.
- The year-end and average fair values of a share of preferred stock (fair value is assumed to be greater than or equal to minimum value) follow:

Table 4-a

Year	*Year-end*	*Average*
1	$12.50	$12.50
2	12.50	12.50
3	12.50	12.50
4	12.50	12.50
5	14.40	13.20

- The shares released each year follow:

Table 4-b

Year	*Dividends*	*Compensation*	*Total Released*	*Total Allocated*
1	0	16,000	16,000	-0-
2	1,600	14,400	16,000	16,000
3	3,200	12,800	16,000	16,000
4	4,800	11,200	16,000	16,000
5	6,061	9,939	16,000	16,000

Note: The number of shares released for dividends is determined by dividing the amount of dividends on allocated shares (16,000 multiplied by $1.25 in year 2; 32,000 multiplied by $1.25 in year 3; etc.) by the average fair value of a share of preferred stock ($12.50 in years 2 and 3). In this illustration the remaining shares are released for compensation (16,000 less 1,600 in year 2, 16,000 less 3,200 in year 3, etc.).

- Additional share information follows:

Table 4-c

Year	*Cumulative Number of Shares*		*Year-End Suspense Shares*
	Released	*Allocated*	
1	16,000	-0-	64,000
2	32,000	16,000	48,000
3	48,000	32,000	32,000
4	64,000	48,000	16,000
5	80,000	64,000	-0-

Results of Applying SOP

The following chart sets forth Company D's ESOP-related information. All amounts represent changes (credits in parentheses) in account balances.

Year	*Principal*	*Unearned ESOP Shares*	*Paid-In Capital*	*Dividends*	*Interest Expense*	*Compensation Expense*	*Cash*
Notes	*(1)*	*(2)*	*(3)*	*(4)*	*(1)*	*(5)*	*(6)*
1	$ 163,800	$ (200,000)	$ -0-	$ -0-	$100,000	$200,000	$ (263,800)
2	180,200	(200,000)	-0-	20,000	83,600	180,000	(263,800)
3	198,200	(200,000)	-0-	40,000	65,600	160,000	(263,800)
4	218,000	(200,000)	-0-	60,000	45,800	140,000	(263,800)
5	239,800	(200,000)	(11,200)	80,000	24,000	131,200	(263,800)
Total	$1,000,000	$(1,000,000)	$(11,200)	$200,000	$319,000	$881,200	$(1,319,000)

Notes:

(1) See table 1-b.

(2) Total number of shares released during the year (16,000) multiplied by the cost per share to ESOP ($12.50).

(3) Total number of shares released during the year (16,000) multiplied by the difference between average fair value per share at the release date (see table 4-a) and cost-per-share to the ESOP ($12.50).

(4) Cumulative shares allocated (see table 4-c) multiplied by the dividend per share ($1.25).

(5) Total number of ESOP shares released for compensation (see table 4-b) multiplied by the average fair value per share to ESOP (see table 4-a).

(6) The cash disbursed each year is composed of $163,800 in contributions and $100,000 in dividends.

Journal Entries

The journal entries to reflect the accounting for Company D's ESOP from inception through year 2 are as follows:

January 1, Year 1 (inception)

Cash	1,000,000	
Debt		1,000,000
[To record the ESOP's loan]		
Unearned ESOP shares (equity)	1,000,000	
Preferred stock		1,000,000
[To record the issuance of shares to the ESOP]		
Year 1		
Interest expense	100,000	
Accrued interest payable		100,000
[To record interest expense]		
Accrued interest payable	100,000	
Debt	163,800	
Cash		263,800
[To record debt payment (The cash disbursement of $263,800 consists of $100,000 in dividends, none of which was charged to retained earnings in year 1, and $163,800 supplemental cash contribution to the ESOP)]		
Compensation expense	200,000	
Unearned ESOP shares		200,000
[To record release of 16,000 shares at an average fair value of $12.50 per share (shares cost ESOP $12.50 per share)]		
Deferred tax asset	14,480	
Provision for income taxes	600,000	
Income taxes payable		614,480
[To record income taxes for year (See tax computations following journal entries)]		

Year 2

Interest expense	83,600	
Accrued interest payable		83,600

[To record interest expense]

Accrued interest payable	83,600	
Debt	180,200	
Cash		263,800

[To record debt payment (The cash disbursement of $263,800 is made up of $100,000 in dividends, $20,000 of which was charged to retained earnings in year 2, and $163,800 supplemental cash contribution to the ESOP)]

Retained earnings	20,000	
Dividends payable		20,000

[To record declaration of $1.25 per share dividend on the 16,000 allocated shares]

Compensation expense	180,000	
Dividends payable	20,000	
Unearned ESOP shares		200,000

[To record release of 16,000 shares at an average fair value of 12.50 per share (shares cost ESOP $12.50 per share)]

Deferred tax asset	7,920	
Provision for income taxes	646,560	
Income taxes payable		654,480

[To record income taxes for year (See tax computations following journal entries)]

Tax and EPS Computations

The tax and EPS calculations for Company D follow:

	Year				
	1	*2*	*3*	*4*	*5*
Income before ESOP	$1,800,000	$1,900,000	$2,000,000	$2,100,000	$2,200,000
Interest expense	(100,000)	(83,600)	(65,600)	(45,800)	(24,000)
Compensation expense	(200,000)	(180,000)	(160,000)	(140,000)	(131,200)
Pretax income	1,500,000	1,636,400	1,774,400	1,914,200	2,044,800
Provision for income tax					
Currently payable	614,480	654,480	694,480	734,480	774,480
Deferred	(14,480)	(7,920)	(720)	7,200	15,920
Total	$ 600,000	$ 646,560	$ 693,760	$ 741,680	$ 790,400
Net income	$ 900,000	$ 989,840	$1,080,640	$1,172,520	$1,254,400
Preferred stock dividends	-0-	$ 20,000	40,000	60,000	80,000
Earnings applicable to common stock	$ 900,000	$ 969,840	$1,040,640	$1,112,520	$1,174,400
Common shares outstanding	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Basic EPS without conversion	$ .90	$ .97	$ 1.04	$ 1.11	$ 1.17
Diluted EPS if converted	$ .89	$ .95	$ 1.01	$ 1.07	$ 1.13

If-converted computation:

	Year 1	2	3	4	5
Earnings applicable to common stock	$ 900,000	$ 969,840	$1,040,640	$1,112,520	$1,174,400
Add—					
Preferred dividends net of tax	-0-	12,000	24,000	36,000	48,000
Tax benefit on "as if" converted common dividend (1)	-0-	3,902	8,421	10,909	12,800
Less—					
Additional compensation (2)	-0-	(6,146)	(11,368)	(19,636)	(28,800)
Adjusted earnings	$ 900,000	$ 979,596	$1,061,693	$1,139,793	$1,206,400
Shares outstanding					
Non-ESOP	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
ESOP as if converted (3)	9,302	29,268	52,632	63,636	72,000
Total	1,009,302	1,029,268	1,052,632	1,063,636	1,072,000
If-converted diluted EPS	$ .89	$ .95	$ 1.01	$ 1.07	$ 1.13

Computations for (1), (2), and (3) follow:

	Year 1	2	3	4	5
(1) Allocated preferred shares	-0-	16,000	32,000	48,000	64,000
Conversion ratio	1:1	1:1	1:1	1:1	1:1
Redemption ratio	12.50/10.75	12.50/10.25	12.50/9.50	12.50/11.00	1:1
If converted allocated common shares	-0-	19,512	42,105	54,545	64,000
Dividends at $.50 per common share	$ -0-	$ 9,756	$21,053	$27,273	$ 32,000
Tax benefit on common dividends	$ -0-	$ 3,902	$ 8,421	$10,909	$ 12,800
(2) Preferred dividends at $1.25 per share	$ -0-	$20,000	$40,000	$60,000	$ 80,000
Dividends at $.50 per common share	$ -0-	(9,756)	(21,053)	(27,273)	(32,000)
Additional compensation gross	$ -0-	$10,244	$18,947	$32,727	$ 48,000
Net of tax	$ -0-	$ 6,146	$11,368	$19,636	$ 28,800
(3) Computation					
Average preferred shares released	8,000	24,000	40,000	56,000	72,000
Conversion ratio	1:1	1:1	1:1	1:1	1:1
Redemption ratio	12.50/10.75	12.50/10.25	12.50/9.50	12.50/11.00	1:1
If converted average released common shares	9,302	29,268	52,632	63,636	72,000

Reconciliation of Effective Tax Rate to Provision for Income Taxes

	Year				
	1	*2*	*3*	*4*	*5*
Pretax income	$1,500,000	$1,636,400	$1,774,400	$1,914,200	$2,044,800
Tax at 40 percent (Statutory rate)	$ 600,000	$ 654,560	$ 709,760	$ 765,680	$ 817,920
Benefit of ESOP dividends	-0-	(8,000)	(16,000)	(24,000)	(32,000)
Effect of difference between fair value and cost of released shares	-0-	-0-	-0-	-0-	4,480
Provision as reported	$ 600,000	$ 646,560	$ 693,760	$ 741,680	$ 790,400

Illustration 5

Convertible Preferred Stock Leveraged ESOP Used to Fund a 401(k) Savings Plan With an Employer Loan

Assumptions

On January 1, Year 1, Company E established a leveraged ESOP with convertible preferred stock as follows:

- The ESOP borrowed $1,000,000 from the employer at 10 percent for five years and used the proceeds to buy 80,000 shares of newly issued convertible preferred stock of Company E for $12.50 per share.
- Debt service is funded by cash contributions and dividends on employer stock held by the ESOP.
- Dividends on all of the original 80,000 shares held by the ESOP are used for debt service.
- Cash contributions are made at the end of each year.
- The preferred stock pays dividends quarterly at an annual rate of $1.25 per share ($100,000 each year for the ESOP's shares). Accordingly, in this illustration, the average fair value of the shares is used to determine the number of shares used to satisfy the employer's obligation to replace dividends on allocated shares used for debt service.
- The preferred stock is convertible at a 1:1 ratio into common stock.
- Participants may not withdraw the convertible preferred stock from the ESOP. When participants become eligible to withdraw shares from their account, they must either convert to common stock or redeem the preferred shares.
- The preferred stock has a guaranteed minimum redemption value of $12.50 per share, to be paid in shares of common stock.
- The preferred stock is callable at $13.00 per share.
- There is one vote per preferred share.
- The year-end and average fair values of a share of preferred stock (fair value is assumed to be greater than or equal to minimum value) follow:

Table 5-a

Year	*Year-end*	*Average*
1	$12.50	$12.50
2	12.50	12.50
3	12.50	12.50
4	12.50	12.50
5	14.40	13.20

- Company E uses shares released by the ESOP to satisfy its matching obligation of 50 percent of voluntary employee contributions to the savings plan. The fair value of the shares at the end of each month is used to determine the number of shares necessary to satisfy the matching obligation. (Accordingly, in this illustration, average fair values are used to determine the number of shares needed to satisfy the employer's liabilities.)

- If the fair value of the shares released is less than Company E's matching obligation, Company E contributes additional newly issued shares (top-up shares) to the ESOP to satisfy the remaining obligation. The top-up shares are issued at the end of the year. Dividends on the top-up shares are paid in cash.
- Shares that replace dividends on allocated shares used to service debt do not count toward the employer's match.
- The employee contributions, required employer match, and the number of shares needed to fund the employee match follow:

Table 5-b

Year	*Employee Contributions*	*Employer Match*	*Number of Shares*
1	$400,000	$200,000	16,000
2	410,000	205,000	16,400
3	420,000	210,000	16,800
4	430,000	215,000	17,200
5	440,000	220,000	16,667

Note: The number of shares needed to satisfy the employer's matching obligation is determined by dividing the matching obligation by the average fair value of a share of common stock (for year 1: $200,000 divided by $12.50 equals 16,000 shares).

- Principal and interest are payable in annual installments at the end of each year. Debt service is as follows:

Table 5-c

Year	*Principal*	*Interest*	*Total Debt Service*
1	$ 110,000	$100,000	$ 210,000
2	150,000	89,000	239,000
3	200,000	74,000	274,000
4	250,000	54,000	304,000
5	290,000	29,000	319,000
Total	$1,000,000	$346,000	$1,346,000

- Shares are released from the suspense account for allocation to participants' accounts based on a principal-plus-interest formula. The released shares are allocated to participants' accounts at the beginning of the following year. Shares are assumed to be released ratably throughout the year.
- The shares released each year follow:

Table 5-d

Year	*Number of Shares Needed to Satisfy 401(k) Liability*	*Total Released*	*Shares Released for Dividends*	*ESOP Shares Available to Satisfy 401(k) Liability*	*Additional Shares (Top-Up)*
1	16,000	12,481	-0-	12,481	3,519
2	16,400	14,205	1,248	12,957	3,443
3	16,800	16,286	2,669	13,617	3,183
4	17,200	18,068	4,297	13,771	3,429
5	16,667	18,960	5,780	13,180	3,487

Note: The number of shares released for dividends is determined by dividing the amount of dividends on allocated shares (12,481 multiplied by $1.25 in year 2; 26,686 multiplied by $1.25 in year 3, etc.) by the average fair value of a share of preferred stock ($12.50 in years 2 and 3). In this illustration, the remaining shares are released for compensation (14,205 less 1,248 in year 2; 16,286 less 2,669 in year 3, etc.).

- Additional share information follows:

Table 5-e

	Initial ESOP Shares Cumulative Shares		*Top-Up Shares Cumulative Shares*				
Year	*Released*	*Allocated*	*Issuable*	*Issued*	*Average Shares Released/ Issuable*	*Total Shares Allocated*	*Year-End Suspense Shares*
1	12,481	0	3,519	0	8,000	0	67,519
2	26,686	12,481	6,962	3,519	24,824	16,000	53,314
3	42,972	26,686	10,145	6,962	43,383	33,648	37,028
4	61,040	42,972	13,574	10,145	63,866	53,117	18,960
5	80,000	61,040	17,061	13,574	85,838	74,614	0

- The pre-ESOP income, shares outstanding, and income tax assumptions are the same as for illustrations 1 through 4.

Results of Applying SOP

The following chart sets forth Company E's ESOP-related information. All amounts represent changes (credits are in parentheses) in account balances.

Year	*Unearned ESOP Shares*	*Paid-In Capital*	*Dividends—Original Shares*	*Dividends Top-Up Shares*	*Compensation Expense ESOP*	*Compensation Expense Top-Up*
Notes	*(1)*	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
1	$ (156,000)	$ (44,000)	$ -0-	$ -0-	$156,000	$ 44,000
2	(177,600)	(43,000)	15,600	4,400	162,000	43,000
3	(203,600)	(39,800)	33,400	8,700	170,200	39,800
4	(225,800)	(42,900)	53,700	12,700	172,100	42,900
5	(237,000)	(59,300)	76,300	17,000	174,000	46,000
Total	$(1,000,000)	$(229,000)	$179,000	$42,800	$834,300	$215,700

Notes:

(1) Total number of shares released during the year multiplied by the cost per share to ESOP ($12.50).

(2) Total number of shares released during the year multiplied by the difference between average fair value per share at the release date (see table 5-a) and cost per share to the ESOP ($12.50) plus the additional paid-in capital that arises from the top-up shares contributed, which equals the compensation expense related to the ESOP.

(3) Cumulative shares allocated from original 80,000 shares (see table 5-e) multiplied by the dividend per share ($1.25).

(4) Cumulative top-up shares issued (see table 5-e) multiplied by the dividend per share ($1.25).

(5) Total number of ESOP shares released for compensation (see table 5-d) multiplied by the average fair value per share (see table 5-a).

(6) Top-up shares (see table 5-d) multiplied by the average fair value per share (see table 5-a).

Journal Entries

The journal entries to reflect the accounting for Company E's ESOP from inception through year 2 are as follows:

January 1, Year 1 (inception)

Unearned ESOP shares (equity)	1,000,000	
Preferred stock		1,000,000

[To record the issuance of shares to the ESOP]

Year 1

Compensation expense	200,000	
401(k) liability		200,000

[To record cost and liability related to 401(k) match]

401(k) liability	200,000	
Preferred stock		44,000
Unearned ESOP shares		156,000

[To record release of 12,481 shares at an average fair value of $12.50 per share (shares cost ESOP $12.50 per share) and issuance of 3,519 additional shares at $12.50 per share for top-up]

Deferred tax asset	18,400	
Provision for income taxes	600,000	
Income tax payable		618,400

[To record income taxes for year 1 (See tax computations following journal entries)]

Year 2

Retained earnings	15,600	
Dividends payable		15,600

[To record declaration of $1.25 per share dividend on the 12,481 allocated shares]

Retained earnings	4,400	
Cash		4,400

[To record declaration and payment of $1.25 per share dividend on the 3,519 issued top-up shares]

Compensation expense	205,000	
401(k) liability		205,000

[To record cost and liability related to 401(k) match]

401(k) liability	205,000	
Dividends payable	15,600	
Unearned ESOP shares		177,600
Preferred stock		43,000

[To record release of 14,205 shares at an average fair value of $12.50 per share (shares cost ESOP $12.50 per share) and issuance of 3,443 additional shares at $12.50 per share for top-up]

Deferred tax asset	11,040	
Provision for income taxes	636,160	
Income tax payable		647,200

[To record income taxes for year 2 (See tax computations following journal entries)]

Tax and EPS Computations

The tax and EPS computations for Company E follow:

	Year				
	1	*2*	*3*	*4*	*5*
Income before ESOP	$1,800,000	$1,900,000	$2,000,000	$2,100,000	$2,200,000
Interest expense	100,000	89,000	74,000	54,000	29,000
Compensation—ESOP	156,000	162,000	170,200	172,100	174,000
Compensation—top-up	44,000	43,000	39,800	42,900	46,000
Pretax income	1,500,000	1,606,000	1,716,000	1,831,000	1,951,000
Provision for income tax					
Currently payable	618,400	647,200	674,480	701,240	734,000
Deferred	(18,400)	(11,040)	(1,440)	9,680	21,200
Total	600,000	636,160	673,040	710,000	755,200
Net income	900,000	969,840	1,042,960	1,120,080	1,195,800
Preferred stock dividends	0	20,000	42,100	66,400	93,300
Earnings applicable to common stock	$ 900,000	$ 949,840	$1,000,860	$1,053,680	$1,102,500
Common shares outstanding	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Basic EPS without conversion	$ .90	$ .95	$ 1.00	$ 1.05	$ 1.10
Diluted EPS if converted	$ .89	$ .93	$ .97	$ 1.01	$ 1.06

If-Converted EPS Computation

	Year 1	Year 2	Year 3	Year 4	Year 5
Earnings applicable to common shares	$ 900,000	$ 949,840	$1,000,860	$1,053,680	$1,102,500
Add—					
Preferred dividends net of tax	0	12,000	25,260	39,840	55,980
Tax benefit on "as if" converted common dividend (1)	0	3,902	8,855	12,072	14,923
Less—					
Additional compensation (2)	0	4,795	9,481	17,579	27,468
Adjusted earnings	$ 900,000	$ 960,947	$1,025,494	$1,088,013	$1,145,935
Shares outstanding Non-ESOP	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
ESOP as if converted (3)	9,302	30,273	57,083	72,575	85,838
Total	1,009,302	1,030,273	1,057,083	1,072,575	1,085,838
If-converted diluted EPS	$ .89	$ .93	$ .97	$ 1.01	$ 1.06

	Year 1	Year 2	Year 3	Year 4	Year 5
Calculation 1:					
Allocated and issued preferred shares	0	16,000	33,648	53,117	74,614
Conversion ratio	1:1	1:1	1:1	1:1	1:1
Redemption ratio	12.50/10.75	12.50/10.25	12.50/9.50	12.50/11.00	1:1
If-converted allocated and issued common shares	0	19,512	44,274	60,360	74,614
Dividends at $.50 per common share	$0	$ 9,756	$22,137	$30,180	$ 37,307
Tax benefit on common dividends	$0	$ 3,902	$ 8,855	$12,072	$ 14,923
Calculation 2:					
Allocated preferred shares (excluding top-up shares)	0	12,481	26,686	42,972	61,040
Preferred dividends at $1.25 per share	$0	$15,601	$33,358	$53,715	$76,300
If-converted allocated common shares (excluding top-up shares)	0	15,221	35,113	$48,832	$61,040
Dividends at $.50 per common share	$0	$ 7,610	$17,557	$24,416	$30,520
Additional compensation					
Gross	$0	$ 7,991	$15,801	$29,299	$45,780
Net of tax	$0	$ 4,795	$ 9,481	$17,579	$27,468

	Year 1	2	3	4	5
Calculation 3:					
Average preferred shares released and issuable	8,000	24,824	43,383	63,866	85,838
If-converted average released and issuable common shares	9,302	30,273	57,083	72,575	85,838

Tax Computation

	Year 1	2	3	4	5
Current provision:					
Income before ESOP	$1,800,000	$1,900,000	$2,000,000	$2,100,000	$2,200,000
ESOP contribution	110,000	139,000	174,000	204,000	219,000
ESOP dividends	100,000	100,000	100,000	100,000	100,000
Top-up contribution	44,000	43,000	39,800	42,900	46,000
Taxable income	1,546,000	1,618,000	1,686,200	1,753,100	1,835,000
Tax rate	40%	40%	40%	40%	40%
	618,400	647,200	674,480	701,240	734,000
Deferred provision:					
Reduction in unearned ESOP shares	156,000	177,600	203,600	225,800	237,000
Related tax deduction	110,000	150,000	200,000	250,000	290,000
Difference	(46,000)	(27,600)	(3,600)	24,200	53,000
Tax rate	40%	40%	40%	40%	40%
Deferred tax expense/(benefit)	(18,400)	(11,040)	(1,440)	9,680	21,200
Total provision	$ 600,000	$ 636,160	$ 673,040	$ 710,920	$ 755,200

Reconciliation of Effective Tax Rate to Provision for Income Taxes

	Year 1	2	3	4	5
Pretax income	$1,500,000	$1,606,000	$1,716,000	$1,831,000	$1,951,000
Tax at 40 percent	600,000	642,400	686,400	732,400	780,400
Benefit of ESOP dividends	0	(6,240)	(13,360)	(21,480)	(30,520)
Effect of difference between fair value and cost of released shares	0	0	0	0	5,320
Provision as reported	$ 600,000	$ 636,160	$ 673,040	$ 710,920	$ 755,200

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Appendix B

Discussion of Comments Received on Exposure Draft

An exposure draft of a proposed statement of position, "Employers' Accounting for Employee Stock Ownership Plans," was issued for public comment in December 1992 and distributed to a variety of interested parties to encourage comment by those that would be affected by the proposal. Sixty-five comment letters were received on the exposure draft.

The most significant and pervasive comments received were in three areas: (*a*) measurement of compensation cost, (*b*) pro forma disclosures, and (*c*) effective date.

Measurement of Compensation Cost

A majority of respondents asked AcSEC to reconsider, for some or all ESOPs, the requirement in the SOP that the fair value of shares committed to be released be used to measure compensation cost. Many of them supported the minority view in this SOP. Three primary objections were raised in the comment letters.

The most frequent reason stated in comment letters for objecting to the proposed measurement of compensation was that debt payments or contributions, that is the cash payments, are a better measure of the value of employees' services than the fair value of shares released.

The second most frequent reason for objecting was disagreement with the argument in the proposed SOP that the risks and rewards of ownership of the shares rest with the employer, not the employees, until the shares are committed to be released. Some respondents disagreed with that statement in general. Other respondents disagreed with a related notion that employers have control over the employees' total compensation package and can make changes in other parts of compensation in response to unanticipated changes in the value of the unreleased shares. Most of those making those arguments support the minority view—that is, they believe that the risks and rewards remain with the employer for type II ESOPs, but believe that is not the case for type I ESOPs.

AcSEC had considered such arguments during the process leading up to the exposure draft, and continues to believe that the reasons for measuring compensation cost based on the fair value of the shares when committed to be released as stated in paragraph .70 of the SOP support its conclusion. Furthermore, AcSEC notes that the conclusion on measurement of compensation cost is consistent with AcSEC's fundamental conclusion that the debt and shares related to ESOP transactions should be accounted for separately. AcSEC believes that the fact that employers may, and often do, establish internally leveraged ESOPs that involve no net cash flows by the employer to the ESOP (the financing element is eliminated), supports its view that the fair value of shares when released is a more relevant measure of the employee's services than the value of the shares when they are placed in an ESOP trust. From the employer's perspective, the economic substance of such transactions is that shares are placed in a trust and released to employees over time; no net cash is ever disbursed or received.

AcSEC continues to believe that the risks and rewards of ownership of the unreleased shares remain with the employer, even when there is no explicit use of the fair value of the shares in determining whether the employer has satisfied an obligation. Though many commentators said that employers do not adjust other compensation to reflect unanticipated changes in the fair value of employer shares, AcSEC has seen ESOP transactions in which the employer effectively controls compensation through its ability to control the debt terms and the rate at which shares are released. Further, AcSEC notes that many employers maintain control over the number of ESOP shares released through the ESOP loans with flexible terms, which allow for no or minimal principal payments before maturity and no prepayment penalties.

The third most frequent reason for objecting was that using the fair value of shares released penalizes companies whose share values increase and rewards companies whose share values decrease. AcSEC believes that the important issue is whether the measure of compensation cost is appropriate, not whether the amount is more or less than it would be under a different method.

Pro Forma Disclosures

The proposed SOP would have required public companies that under the grandfathering provisions elected not to adopt the provisions of the SOP to disclose pro forma income before extraordinary items, net income, and EPS as if the employer had adopted the provisions of the SOP. Many respondents objected to those pro forma disclosures. The reasons most often cited for not requiring such disclosures follow:

- Such disclosures would add unnecessary complexity to the financial statements and would confuse rather than inform users.
- Such disclosures generally have not been required in the past for other accounting pronouncements with grandfathering provisions and would set a precedent for such disclosures in the future.
- Such disclosures are inconsistent with the grandfathering provisions and would discredit the amounts reported in the financial statements.
- The costs of making such disclosures would outweigh the benefits.
- It is unfair to require such disclosures only for public companies.

AcSEC found those arguments persuasive and deleted the disclosure requirement.

Effective Date

In the exposure draft the grandfathering cutoff date was September 23, 1992, the date the FASB cleared the proposed SOP for exposure. Many respondents noted that a later date connected with a year end would be more appropriate. In response to those comments the cutoff date was changed to December 31, 1992.

Many respondents considered the effective date for years ending on or before December 15, 1993, in the exposure draft unreasonable. AcSEC agreed and extended the effective date by one year.

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Appendix C

Law Changes

The following is a list of the most significant revisions to laws concerning ESOPs since 1976.

- The tax deduction limits were expanded from 15 percent of pay to 25 percent of pay, plus interest in certain cases.[1] This change prompted more small companies to use ESOPs and larger companies to increase the portion of employee benefits covered by ESOPs.
- ESOP sponsors were permitted to deduct dividends paid on ESOP shares from taxable income if the dividends were applied to debt service or distributed to plan participants.[2] This change increased the economic appeal of leveraged ESOPs. For example, it increased the amount of debt that could be covered for employers whose compensation base was too low to amortize the ESOP debt under the contribution limits of the Internal Revenue Code (IRC).
- Under certain circumstances, a person who sold stock to an ESOP was permitted to defer income tax on any resulting gain by reinvesting the sales proceeds in other corporate securities.[3] This change contributed to the substantial increase in the number of ESOPs sponsored by nontraded companies.
- Commercial lenders were permitted to exclude from taxable income 50 percent of the interest they earned on certain ESOP securities acquisition loans.[4] This change resulted in a reduced financing rate on such loans, as lenders frequently passed a portion of the savings on to their customers. Many new ESOP loans were made as a result of this change. (Although 1989 legislation significantly limited this benefit, all of the prior loans were allowed to retain their tax advantages.)
- The regulatory requirement that if ESOPs buy outstanding shares, the purchase must be tested under the corporate redemption rules was eliminated.[5] The significance of this development was that the IRC recognized the independence of ESOPs from their sponsors if certain controls are in place. Thus, it increased the usefulness of ESOPs in transfers of ownership of closely held companies.

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[1] IRC Sections 404(a)(9) and 415 (c)(6).

[2] IRC Section 404(k).

[3] IRC Section 1042.

[4] IRC Section 133.

[5] Rev. Proc. 87-22, which superseded Rev. Procs. 77-30, 78-18, and 78-23.

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Appendix D

Impact of SOP on Current ESOP Guidance

Current Guidance	*Impact of SOP*
FASB Statement No. 87, *Employers' Accounting for Pensions*	The SOP includes accounting guidance on nonleveraged ESOPs that is consistent with the guidance for defined contribution plans in Statement No. 87.
AICPA SOP 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans* [section 10,130]	The SOP supersedes SOP 76-3 [section 10,130]. However, under the transition provisions in the proposed SOP, employers may continue their current accounting practices for ESOP shares purchased before December 31, 1992.
EITF Issue No. 85-11, *Use of an Employee Stock Ownership Plan in a Leveraged Buyout*	No consensus was reached on this issue by the EITF. However, for ESOP shares accounted for under the SOP, the issue is moot, because compensation cost is measured based on the fair value of shares when committed to be released.
EITF Issue No. 86-4, *Income Statement Treatment of Income Tax Benefit for Employee Stock Ownership Plan Dividends*	FASB Statement No. 109, *Accounting for Income Statement Income Taxes* nullified this consensus. The SOP deals with issues related to accounting for income taxes.
EITF Issue No. 86-27, *Measurement of Excess Contributions to a Defined Contribution Plan or Employee Stock Ownership Plan*	The SOP supersedes this consensus. However, under the transition provisions in the SOP, employers may continue their current accounting for shares purchased in a pension reversion occurring before December 31, 1992.
EITF Issue No. 87-23, *Book Value Stock Purchase Plans*	This EITF topic includes three issues; only the third one relates to ESOPs. The SOP, which is consistent with the consensus, supersedes this consensus on the third issue. However, under the transition provisions in the SOP, employers may continue their current accounting for shares purchased before December 31, 1992. This consensus applies to employers making that election.

Current Guidance	*Impact of SOP*
EITF Issue No. 88-27, *Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations*	The SOP does not deal with this issue and accordingly does not supersede the consensus. The consensus is reprinted in this appendix.
EITF Issue No. 89-8, *Expense Recognition for Employee Stock Ownership Plans*	The SOP supersedes this consensus. However, under the transition provisions in the SOP, employers may continue their current accounting for shares purchased before December 31, 1992. This consensus applies to employers making that election.
EITF Issue No. 89-10, *Sponsor's Recognition of Employee Stock Ownership Plan Debt*	The SOP, which is consistent with this consensus, supersedes the consensus.
EITF Issue No. 89-11, *Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan*	The SOP does not deal with this issue and accordingly does not supersede the consensus. The consensus is reprinted in this appendix.
EITF Issue No. 89-12, *Earnings-per-Share Issues Related to Convertible Preferred Stock Held by an Employee Stock Ownership Plan*	The SOP supersedes these consensuses. However, under the transition provisions in the SOP, employers may continue their current accounting for shares purchased before December 31, 1992. This consensus applies to employers making that election.
EITF Issue No. 90-4, *Earnings-per-Share Treatment of Tax Benefits for Dividends of Stock Held by an Employee Stock Ownership Plan*	FASB Statement No. 109, *Accounting for Income Taxes*, nullified this consensus.
EITF Issue No. 92-3, *Earnings-per-Share Treatment of Tax Benefits for Dividends on Unallocated Stock Held by an Employee Stock Ownership Plan*	Under this SOP, dividends paid on unallocated shares are not charged to retained earnings. However, under the transition provisions in the SOP, employers may continue their current accounting for shares purchased before December 31, 1992. This consensus would apply to employers making that election.
EITF Issue No. 93-2, *Effect of Acquisition of Employer Shares for/by an Employee Benefit Trust on Accounting for Business Combinations*	The SOP does not deal with this issue and accordingly does not supersede this consensus. The consensus is reproduced in this appendix.

EITF Abstracts

Issue No. 88-27

Title: Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations

Date Discussed: January 12-13, 1989

References: APB Opinion No. 16, *Business Combinations*
AICPA Accounting Interpretation 20, *Treasury Stock Allowed with Pooling,* of APB Opinion No. 16
AICPA Statement of Position 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans*
SEC Accounting Series Release No. 146, *Effect of Treasury Stock Transactions on Accounting for Business Combinations*
SEC Accounting Series Release No. 146A, *Statement of Policy and Interpretations in Regard to Accounting Series Release No. 146*

ISSUE

Employee stock ownership plans (ESOPs) may hold shares of the sponsoring entity that are not allocated to the participants in the plan. Those unallocated shares may be allocated later or, under certain limited circumstances, may be sold or disposed of otherwise by the ESOP. Unlike allocated shares that must be reallocated to remaining plan participants if a participant leaves the plan before the shares become vested, the unallocated sponsoring entity shares held by the ESOP are not required to remain within the ESOP or with its participants. Further, to the extent the ESOP acquires unallocated shares as a result of a pension plan termination, Issue No. 86-27, "Measurement of Excess Contributions to a Defined Contribution Plan or Employee Stock Ownership Plan," requires unallocated shares held by the ESOP to be reported as treasury shares by the sponsoring entity.

The issue is under what circumstances, if any, unallocated sponsoring entity shares held by an ESOP should be considered tainted treasury shares for purposes of determining whether the pooling-of-interests method of accounting is appropriate for a business combination.

EITF DISCUSSION

The Task Force reached a consensus that unallocated shares held by an ESOP should not be considered tainted for purposes of determining whether the pooling-of-interests method of accounting is appropriate unless (1) there is more than a remote possibility that such shares could revert to the sponsoring entity, (2) there exists an agreement or intent, either written or implicit, whereby the sponsoring entity will repurchase or reacquire shares from the ESOP or from an employee that receives shares in a distribution (except if required by law to provide liquidity to the plan participant), or (3) the shares were acquired to circumvent the requirements of Opinion 16.

The Task Force considered comments by a tax partner of an accounting firm that generally, for unallocated shares in an ESOP, the possibility of those shares reverting to the sponsoring entity is remote. Some Task Force members noted that the relevant attributes of unallocated shares differ for purposes of determining whether the shares are treasury shares, as addressed in Issue 86-27, compared with whether those treasury shares are tainted, as addressed in this Issue.

STATUS

No further EITF discussion is planned.

5/18/89

EITF Abstracts

Issue No. 89-11

Title: Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan

Dates Discussed: September 21, 1989; December 14, 1989

References: APB Opinion No. 25, *Accounting for Stock Issued to Employees*
SEC Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"*

ISSUE

Under federal income tax regulations, employer securities (such as convertible preferred stock) that are held by participants in an employee stock ownership plan (ESOP) and that are not readily tradeable on an established market must include a put option. The put option is a right to demand that the sponsor redeem shares of employer stock held by the participant for which there is no market for an established cash price. The employer may have the option to issue marketable securities for all or a portion of that option rather than to pay cash. The provisions of the ESOP may permit the ESOP to substitute for the sponsor as buyer of the employer stock; however, in no case can the sponsor require the ESOP to assume the obligation for the put option.

The issue is, in a leveraged ESOP, if securities subject to a put option are classified outside of permanent equity, whether any of the debit in the equity section of the sponsor's balance sheet (sometimes described as *loan to ESOP* or *deferred compensation*) should be similarly classified.

EITF DISCUSSION

The Task Force reached a consensus that when ASR 268 (as presented in Section 211 of the "Codification of Financial Reporting Policies") requires some or all of the value of the securities to be classified outside of permanent equity, a proportional amount of the debit in the equity section of the sponsor's balance sheet (sometimes described as *loan to ESOP* or *deferred compensation*), if any, should be similarly classified.

The SEC Observer indicated that ASR 268 requires that to the extent that there are conditions (regardless of their probability of occurrence) whereby holders of equity securities may demand cash in exchange for their securities, the sponsor must reflect the maximum possible cash obligation related to those securities outside of permanent equity. Thus, securities held by an ESOP (whether or not allocated) must be reported outside of permanent equity if by their terms they can be put to the sponsor for cash. With respect to ESOP securities where the cash obligation relates only to market value guarantee features, the SEC staff would not object to registrants only classifying outside of permanent equity an amount that represents the maximum cash obligation of the sponsor based on market prices of the underlying security as of the reporting date; accordingly, reclassifications of equity amounts would be required based on the market values of the underlying security. Alternatively, the SEC staff would not object to classifying the entire guaranteed value amount outside of permanent equity due to the uncertainty of the ultimate cash obligation because of a possible market value decline in the underlying security.

STATUS

No further EITF discussion is planned.

12/14/89

EITF Abstracts

Issue No. 93-2

Title: Effect of Acquisition of Employer Shares for/by an Employee Benefit Trust on Accounting for Business Combinations

Date Discussed: January 21, 1993

References: APB Opinion No. 16, *Business Combinations*
AICPA Accounting Interpretation 20*, Treasury Stock Allowed with Pooling,* of APB Opinion No. 16
AICPA Statement of Position 76-3*, Accounting Practices for Certain Employee Stock Ownership Plans*
AICPA Proposed Statement of Position*, Employers' Accounting for Employee Stock Ownership Plans,* dated December 21, 1992
SEC Accounting Series Release No. 146, *Effect of Treasury Stock Transactions on Accounting for Business Combinations*
SEC Accounting Series Release No. 146A, *Statement of Policy and Interpretations in Regard to Accounting Series Release No. 146*

ISSUE

An employer (Company) establishes an irrevocable grantor trust (Trust) to prefund certain employee benefits. The Company sells shares of its stock to the Trust in return for a note payable and, at or about the same time, reacquires treasury shares. Alternatively, the Trust may acquire Company shares in the marketplace using funds borrowed from the Company. The shares will be released from the Trust in future periods as debt is repaid or forgiven and will be used to meet obligations of the Company to various employee benefit plans.

The issue is whether Company shares reacquired coincident with the establishment of the Trust, either by the Company or by the Trust, should be considered tainted shares for purposes of pooling-of-interests accounting under Opinion 16.

EITF DISCUSSION

The SEC Observer stated that it is the SEC staff's position that Issue No. 88-27, "Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations," and Topic No. D-19, "Impact on Pooling-of-Interests Accounting of Treasury Shares Acquired to Satisfy Conversions in a Leveraged Preferred Stock ESOP," in *EITF Abstracts* Appendix D, addressed ESOPs that are defined contribution employee benefit plans, as contemplated by SOP 76-3.[1] An ESOP that funds other employee benefit plans was not contemplated by either Issue 88-27 or Topic D-19.[2]

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[1] This type of ESOP arrangement has been characterized as a Type I ESOP in the proposed Statement of Position on employers' accounting for employee stock ownership plans:

Type I—shares are released to compensate employees directly. Such ESOPs are not used to fund other employee benefits and the fair value of the shares at the time of release is not a factor at the time of release. These ESOPs are the typical ESOPs that existed at the time SOP 76-3 was issued.

[2] This type of ESOP arrangement has been characterized as a Type II ESOP in the proposed Statement of Position:

Type II—shares are released to settle or fund liabilities for other specified or determinable employee benefits, such as an employer's match of a 401(k) plan. The fair value of shares released is used to determine how many shares are needed to satisfy an obligation that arose outside the ESOP.

The SEC staff believes that the application of the consensus in Issue 88-27 and the statements made in Topic D-19 should be limited to "Type I" ESOPs. However, the SEC staff will not object to the application of the consensus in Issue 88-27 and Topic D-19 for shares held by a "Type II" ESOP as of January 21, 1993, provided the respective criteria are satisfied. Shares purchased by a Type II ESOP subsequent to January 21, 1993 would be considered treasury stock directly acquired by the employer and presumed to be tainted shares for the purpose of applying the provisions of paragraph 47(d) of Opinion 16.

The SEC Observer also stated that the trust arrangement described in this Issue is neither a Type I nor a Type II ESOP. Therefore, the SEC staff's position is that shares acquired in the past or in the future and placed in trust to fund future corporate obligations, such as the trust vehicle described in this Issue, are treasury stock directly acquired by the employer and presumed to be tainted shares for the purpose of applying the provisions of paragraph 47(d) of Opinion 16.

Because of the SEC staff's position, the Task Force did not discuss this Issue.

STATUS

No further EITF discussion is planned.

5/20/93

.103

Glossary

This glossary contains definitions of certain terms used in employers' accounting for ESOP transactions.

Allocated shares. The shares in an ESOP trust that have been assigned to individual participant accounts based on a known formula. IRS rules require allocations to be nondiscriminatory generally based on compensation, length of service, or a combination of both. For any particular participant such shares may be vested, unvested, or partially vested.

Committed-to-be-released shares. The shares that, although not legally released, will be released by a future scheduled and committed debt service payment and will be allocated to employees for service rendered in the current accounting period. The period of employee service to which shares relate is generally defined in the ESOP documents. Shares are legally released from suspense and from serving as collateral for ESOP debt as a result of payment of debt service. Those shares are required to be allocated to participant accounts as of the end of the ESOP's fiscal year. Formulas used to determine the number of shares released can be based on either (*a*) the ratio of the current principal amount to the total original principal amount (in which case unearned ESOP shares and debt balance will move in tandem) or (*b*) the ratio of the current principal plus interest amount to the total original principal plus interest to be paid. Shares are released more rapidly under the second method than under the first. Tax law permits the first method only if the ESOP debt meets certain criteria.

Dividends on previously allocated shares used for debt service. The allocation of shares to participant accounts that replaces the cash dividends on allocated shares that were or will be used for debt service. Under the IRC, dividends on shares held by an ESOP that have been allocated to participant accounts cannot be used for debt service unless the employers allocate shares to those participants whose dollar value is no less than the dollar value of the dividends that were used for debt service. (The IRS has not issued guidance on what employers would be required to do to make up the difference between the value of any dividends withdrawn and the shares allocated. In practice, plan sponsors apply a wide variety of techniques to satisfy the Code requirements.)

Suspense shares. Shares that have not been released, committed to be released, or allocated to participant accounts. Suspense shares generally collateralize ESOP debt.

Top-up shares. The shares or cash that an employer contributes to an ESOP because the fair value of the shares released is less than the employer's liability for a particular benefit, such as a savings plan match.

Vested shares. Allocated shares for which a participant's right to receive the shares or redeem the shares for cash is no longer contingent on remaining in the service of the employer. Allocated shares that have not been vested may be forfeited if a participant terminates his or her employment and reallocated to other participants. Whether the shares in a participant's ESOP account are vested depends on the length of that employee's service and the vesting provisions of the ESOP. The Code specifies minimum vesting requirements for benefits attributable to employer contributions. Currently, the Code permits two minimum vesting approaches:

a. Graded vesting, under which employees vest 20 percent after three years of service and 20 percent for each additional year of service until they become 100 percent vested.

b. Cliff vesting, under which employees vest 100 percent after five years of service.

Accordingly, the shares allocated to participants at any date will include shares that are fully vested, shares that are not vested, and (if graded vesting is used) shares that are partially vested.

Accounting Standards Executive Committee (1992-1993)

ESOP Task Force

AICPA Staff

[The next page is 79,851.]

Section 10,590

Statement of Position 93-7
Reporting on Advertising Costs

December 29, 1993

NOTE

Statements of Position (SOPs) of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA SOPs as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this SOP should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

SOP 93-7 is amended by SOP 00-2, *Accounting by Producers or Distributors of Films*. SOP 00-2 is effective for financial statements for fiscal years beginning after December 15, 2000. Earlier application is encouraged. The cumulative effect of changes in accounting principles caused by adapting the provisions of this SOP should be included in the determination of net income in conformity with paragraph 20 of APB Opinion 20. Disclosure of pro forma effects of retroactive application (APB Opinion 20, paragraph 21) is not required. An entity should not restate previously issued annual financial statements.

Introduction

.01 The Accounting Standards Executive Committee (AcSEC) has on its agenda a project on reporting the costs of activities—such as advertising, preopening, start-up, training, customer acquisition, and similar activities—that are undertaken to create future economic benefits through the development of intangible assets. The project was undertaken to provide guidance that would aid in resolving issues concerning financial reporting for the costs of such activities.

.02 Because of the difficulty of developing sound financial reporting guidance that could be applied broadly to the costs of all activities, AcSEC decided that this statement of position (SOP) should be issued as a first step and be used to develop guidance for reporting costs of other kinds of activities undertaken to create such benefits although AcSEC has not begun deliberations to develop such guidance. The guidance in this SOP therefore is not intended to be used to account for the costs of other kinds of activities undertaken to create future economic benefits through the development of intangible assets.

.03 Some entities report the costs of all advertising as expenses when the costs are incurred. However, other entities report the costs of future economic benefits that they expect will result from some or all advertising as assets when the costs are incurred and amortize the costs to expense in the current and subsequent periods.

.04 The authoritative financial reporting literature provides no broad guidance on reporting the costs of advertising, although it does provide guidance for certain specific transactions and industries and on reporting the costs of activities similar to advertising. The lack of broad guidance and the inconsistency of existing guidance has led to diversity in practice.

.05 This SOP provides guidance for annual financial statements on the following:

- Reporting the costs of advertising, which should be expensed either as incurred or the first time the advertising takes place, except for direct-response advertising (*a*) whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and (*b*) that results in probable future economic benefits
- For direct-response advertising that may result in reported assets—
  - — How such assets should be measured initially
  - — How the amounts ascribed to such assets should be amortized
  - — How the realizability of such assets should be assessed
- The financial statement disclosures that should be made about advertising
- Amendments to other accounting literature affected by this SOP
- Transition rules for applying this SOP

Scope

.06 This SOP provides financial reporting guidance for the annual financial statements of all entities and all advertising other than that for which pronouncements included in category (a) in paragraph 10 of Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, provide such guidance.[1] This SOP does not apply to financial statements for interim periods. Paragraphs 15 and 16 of Accounting Principles Board (APB) Opinion No. 28, *Interim Financial Reporting*, which are discussed in the appendix of this SOP [paragraph .81], provide guidance for accounting for advertising in interim periods. This SOP amends the following AICPA SOPs[2]:

a. SOP 88-1, *Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications*, paragraph 22 [section 10,430.22]

b. SOP 89-5, *Financial Accounting and Reporting by Providers of Prepaid Health Care Services*, paragraph 54

c. SOP 90-8, *Financial Accounting and Reporting by Continuing Care Retirement Communities*, paragraph 15

.07 This SOP does not amend FASB Technical Bulletin 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*.

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[1] Category (a) in paragraph 10 of SAS No. 69 consists of Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards and Interpretations, Accounting Principles Board (APB) Opinions, and AICPA Accounting Research Bulletins. Advertising that is covered by pronouncements in category (a) of paragraph 10 of SAS No. 69 should be accounted for in conformity with that guidance regardless of the guidance in this SOP.

[2] The appendix [paragraph .81] discusses the guidance concerning advertising in these SOPs. Paragraphs .51 to .53 of this SOP discuss the amendments to these SOPs.

.08 This SOP applies to not-for-profit organizations.

.09 Reporting on the costs of advertising conducted for others under contractual arrangements is part of reporting on contracts in general and is not covered by this SOP. Indirect costs that are specifically reimbursable under the terms of a contract also are excluded from this SOP.

Background

.10 FASB Statement No. 2, *Accounting for Research and Development Costs*, issued in 1974, requires all research and development costs to be reported as expenses when incurred. Therefore, FASB Statement No. 2 in effect prohibits reporting the research and development costs incurred in anticipation of probable future benefits as assets. Although activities similar to research and development were included in the discussion memorandum that initiated the FASB's project, paragraph 22 of appendix A of Statement No. 2 states that the FASB concluded, following the public hearing on the Discussion Memorandum, that the "initial Statement of Financial Accounting Standards resulting from the project should address solely accounting for research and development costs."

.11 Since issuing the discussion memorandum, the FASB has developed its conceptual framework, which provides conceptual criteria for asset recognition, and there has been periodic interest in how the costs of activities similar to research and development are reported on. The Securities and Exchange Commission (SEC) has issued some accounting and auditing enforcement releases on activities similar to research and development, and the SEC staff has expressed concern about the accounting for these activities.

.12 Costs incurred in anticipation of the probable future economic benefits of advertising generally have been expensed for the following reasons:

- Financial statement preparers generally presumed that the benefit period is short.
- The periods during which the future economic benefits probably would be received and the amounts of such benefits could not be measured and determined easily and objectively.
- The advertising costs for some entities were not material.

.13 Advertising is undertaken to provide or increase future economic benefits. FASB Statement on Financial Accounting Concepts (Concepts Statement) No. 6, *Elements of Financial Statements*, paragraph 178, states, "An entity commonly incurs costs to obtain future economic benefits, either to acquire assets from other entities in exchange transactions or to add value through operations to assets it already has . . . ." New technology, sources of information, and measurement techniques have given some entities the ability to better estimate the future economic benefits that could result from certain kinds of advertising.

.14 If future economic benefits do result from advertising, they generally would be in the form of revenue.

Authoritative Pronouncements

.15 FASB Concepts Statement No. 6, paragraph 25, defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."[3] Footnote 18 to Concepts Statement No. 6 states that "*probable* is used with its usual general meaning, rather than in a specific accounting or technical sense, . . . and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved . . . ." Paragraph 26 states:

> An asset has three essential characteristics: (*a*) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (*b*) a particular entity can obtain the benefit and control others' access to it, and (*c*) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

.16 Appendix B of Concepts Statement No. 6 discusses in paragraphs 175 and 176 the characteristics of assets and the concept of probable future economic benefits, including those that may arise from activities such as advertising:

> Uncertainty about business and economic outcomes often clouds whether . . . particular items that might be assets have the capacity to provide future economic benefits to the entity, . . . sometimes precluding their recognition as assets. The kinds of items that may be recognized as expenses or losses rather than as assets because of uncertainty are some in which management's intent in taking certain steps or initiating certain transactions is clearly to acquire or enhance future economic benefits available to the entity. For example, business enterprises . . . advertise, develop markets . . . and spend significant funds to do so. The uncertainty is not about the intent to increase future economic benefits but about whether and, if so, to what extent they succeeded in doing so. Certain expenditures for . . . advertising . . . are examples of the kinds of items for which assessments of future economic benefits may be especially uncertain . . . .
>
> If . . . advertising results in an entity's acquiring or increasing future economic benefit, that future economic benefit qualifies as an asset as much as do the future benefits from prepaid insurance or prepaid rent. The practical problem is whether future economic benefit is actually present and, if so, how much—an assessment that is greatly complicated by the feature that the benefits may be realized far in the future, if at all.

.17 Paragraphs 247 to 250 discuss deferred costs and acknowledge that advertising may provide future economic benefits, but they note that such benefits may not be reported as assets for practical reasons stemming from considerations of uncertainty or measurement. Paragraph 248 states, in part:

> The question that needs to be answered to apply the definition of assets is whether the economic benefit received by incurring those costs was used up at the time the costs were incurred or shortly thereafter or future economic benefit remains at the time the definition is applied. Costs such as . . . advertising services do not *by themselves* qualify as assets under the definition in paragraph 25 any more than do spoiled units, dry holes, or legal costs. The reason for considering the possibility that they might be accounted for as if they were assets stems from their possible relationship to future economic benefits.

.18 FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* paragraph 63, sets forth the following criteria that should be met to report an item in the financial statements:

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[3] Because assets should be understood to represent current conditions, the term *probable future economic benefits* in this SOP means that current prospects indicate that the reporting entity probably will receive economic benefits in the future.

Definitions—The item meets the definition of an element of financial statements.

Measurability—It has a relevant attribute measurable with sufficient reliability.

Relevance—The information about it is capable of making a difference in user decisions.

Reliability—The information is representationally faithful, verifiable, and neutral.

.19 No authoritative pronouncement provides broad guidance on financial reporting on advertising. However, aspects of the following documents, discussed in the appendix [paragraph .81], provide guidance on reporting on advertising in connection with specific items or industries.

a. FASB Statement No. 13, *Accounting for Leases*, as amended by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*

b. FASB Statement No. 51, *Financial Reporting By Cable Television Companies*

c. FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*[*]

d. FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*

e. FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*

f. The AICPA Industry Audit Guide *Audits of Airlines*, as amended by SOP 88-1, *Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications* [section 10,430]

g. The AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*

h. SOP 89-5, *Financial Accounting and Reporting by Providers of Prepaid Health Care Services*

i. FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*

.20 Aspects of the following documents, also discussed in the appendix [paragraph .81], provide further guidance on reporting on activities similar to research and development:

a. APB Opinion 17, *Intangible Assets*[**]

b. APB Opinion 28, *Interim Financial Reporting*

c. FASB Statement No. 2, *Accounting for Research and Development Costs*

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[*] In 2000, the FASB rescinded FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*, and AcSEC issued SOP 00-2, *Accounting by Producers or Distributors of Films* [section 10,800]. The provisions of this SOP apply to entities within the scope of SOP 00-2 [section 10,800]. [Footnote added, June 2004, to reflect conforming changes necessary due to the rescission of FASB Statement No. 53 and the issuance of SOP 00-2.]

[**] FASB Statement No. 142, *Goodwill and Other Intangible Assets,* supersedes APB Opinion No. 17, *Intangible Assets*. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 142.]

d. FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*

e. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*

f. FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*

g. The AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*

h. SOP 90-8, *Financial Accounting and Reporting by Continuing Care Retirement Communities*

.21 The guidance in the pronouncements listed in the two preceding paragraphs is not consistent. Some believe that pronouncements permitting capitalization of advertising do so because a clearly demonstrable cause-and-effect relationship exists between the assets acquired and costs incurred. Also, some believe that pronouncements prohibiting capitalization of advertising do so because (*a*) no such demonstrable causal relationship exists, (*b*) the amounts capitalized would be immaterial, or (*c*) the costs of obtaining the information would not be justified by the benefits of reporting it. The conclusions reached in this SOP are based on the guidance in the FASB Concepts Statements.

Description of Advertising

.22 Advertising is the promotion of an industry, an entity, a brand, a product name, or specific products or services so as to create or stimulate a positive entity image or to create or stimulate a desire to buy the entity's products or services.[4]

.23 Advertising is one kind of customer acquisition activity. Financial reporting of other kinds of customer acquisition activities is outside the scope of this SOP.[5]

.24 Advertising generally uses a form of media—such as mail, television, radio, telephone, facsimile machine, newspaper, magazine, coupon, or billboard—to communicate with potential customers. Examples of kinds of advertising include the following:

- Directory and buyer's guide advertising
- Business and industrial publications
- Reprints of advertisements
- Television advertising
- Direct-mail advertising
- Consumer publications
- Radio advertisements
- Billboard advertisements
- Company and product catalogues
- Cooperative advertising

[4] Fund-raising by not-for-profit organizations is not considered advertising and is not within the scope of this SOP. However, this SOP does apply to advertising activities of not-for-profit organizations.

[5] The costs of premiums, contest prizes, gifts, and similar promotions, as well as discounts or rebates, including those resulting from the redemption of coupons, are not considered advertising costs for purposes of applying the guidance in this SOP. (Other costs of coupons and similar items, such as costs of newspaper advertising space, are considered advertising costs.)

- Booklets for sales promotion
- Newspaper advertising
- Point-of-sale material
- Sponsorship of public events

Conclusions

.25 The following conclusions should be read in conjunction with "Discussion of Conclusions and Implementation Guidance," beginning with paragraph .55 of this SOP, which explains the basis for the conclusions and provides guidance for implementing them.

Expensing or Capitalizing Advertising Costs

.26 The costs of advertising should be expensed either as incurred or the first time the advertising takes place (paragraphs .42 to .44 elaborate on component costs of advertising),[6] except for—

a. Direct-response advertising (1) whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and (2) that results in probable future economic benefits (future benefits). (Paragraph .37 discusses the conditions that must be met in order to conclude that direct-response advertising results in probable future benefits.) Examples of the first time advertising takes place include the first public showing of a television commercial for its intended purpose and the first appearance of a magazine advertisement for its intended purpose.

b. Expenditures for advertising costs that are made subsequent to recognizing revenues related to those costs, as discussed in paragraph .27.

.27 Expenditures for some advertising costs are made subsequent to recognizing revenues related to those costs. For example, some entities assume an obligation to reimburse their customers for some or all of the customers' advertising costs (cooperative advertising). Generally, revenues related to the transactions creating those obligations are earned and recognized before the expenditures are made. For purposes of applying this SOP, those obligations should be accrued and the advertising costs expensed when the related revenues are recognized.

.28 The costs of direct-response advertising (*a*) whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and (*b*) that results in probable future benefits should be reported as assets net of accumulated amortization. For purposes of calculating amortization and assessing realizability, which are discussed in paragraphs .46 to .48, each significant advertising effort establishes a separate stand-alone cost pool.

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[6] Deferring the costs of advertising until the advertising takes place assumes that the costs have been incurred for advertising that will occur. Such costs should be expensed immediately if such advertising is not expected to occur.

.29 The accounting policy selected from the two alternatives in the beginning of paragraph .26 (whether advertising costs are expensed as incurred or the first time the advertising takes place), should be applied consistently to similar kinds of advertising activities.

Tangible Assets

.30 Tangible assets, such as blimps or billboards, may be used for several advertising campaigns. The costs of such assets should be capitalized and depreciated or amortized using a systematic and rational method over their expected useful lives. That depreciation or amortization may be a cost of advertising if the tangible asset is used for advertising.

.31 For purposes of applying this SOP, costs incurred to produce film or audio and video tape to be used to communicate advertising do not create tangible assets.

.32 Sales materials, such as brochures and catalogues, may be accounted for as prepaid supplies until they no longer are owned or expected to be used, in which case their cost would be a cost of advertising and should be accounted for in conformity with the guidance in this SOP.

Direct-Response Advertising

.33 The costs of direct-response advertising should be capitalized if both of the following conditions are met:

a. The primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising. (Paragraph .34 discusses the conditions that must exist in order to conclude that the advertising's purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising.)

b. The direct-response advertising results in probable future benefits. (Paragraph .37 discusses the conditions that must exist in order to conclude that direct-response advertising results in probable future benefits.)

.34 In order to conclude that advertising elicits sales to customers who could be shown to have responded specifically to the advertising, there must be a means of documenting that response, including a record that can identify the name of the customer and the advertising that elicited the direct response. Examples of such documentation include the following:

- Files indicating the customer names and the related direct-response advertisement
- A coded order form, coupon, or response card, included with an advertisement, indicating the customer name
- A log of customers who have made phone calls to a number appearing in an advertisement, linking those calls to the advertisement

.35 Direct-response advertising activities exclude advertising that, though related to the direct-response advertising, is directed to an audience that could not be shown to have responded specifically to the direct-response advertising. For example, a television commercial announcing that order forms (that are direct-response advertising) soon will be distributed directly to some people in the viewing area would not be a direct-response advertising activity because the television commercial is directed to a broad audience, not all of which could be shown to have responded specifically to the direct-response advertising.

Probable Future Benefits of Direct-Response Advertising

.36 The probable future benefits of direct-response advertising activities are probable future revenues arising from that advertising in excess of future costs to be incurred in realizing those revenues.

.37 Demonstrating that direct-response advertising will result in future benefits requires persuasive evidence that its effects will be similar to the effects of responses to past direct-response advertising activities of the entity that resulted in future benefits. Such evidence should include verifiable historical patterns of results for the entity. Attributes to consider in determining whether the responses will be similar include (*a*) the demographics of the audience, (*b*) the method of advertising, (*c*) the product, and (*d*) economic conditions.

.38 Industry statistics would not be considered objective evidence that direct-response advertising will result in future benefits in the absence of the specific entity's operating history. If the entity does not have an operating history for a particular product or service but does have operating histories for other new products or services, statistics for the other products or services may be used if it can be demonstrated that the statistics for the other products or services are likely to be highly correlated to the statistics of the particular product or service being evaluated. For example, test market results for a new product or service may be used to support the view that the results of advertising for current new products or services are likely to be highly correlated with the results of advertising for new products or services previously sold by the entity. In the absence of the expectation of a high degree of correlation, a success rate based on historical ratios of successful products or services to total products or services introduced to the marketplace would not be a sufficient basis for reporting a portion of the costs of current-period advertising as resulting in assets.

.39 Direct-response advertising costs that are not capitalized because it cannot be demonstrated that the direct-response advertising will result in future benefits should not be retroactively capitalized in subsequent periods if historical evidence in those subsequent periods indicates that the advertising did in fact result in future benefits.

Basis of Measurement

.40 Based on the potential customers and the probable customer response rates, direct-response advertising that is expected to produce future revenues generally is undertaken before the customers' identity is known. Such advertising is undertaken with the expectation that not all targets of the direct-response advertising will provide benefits but that the benefits created by the customers who do respond to the advertising will justify the total advertising costs. Accordingly, the cost of the direct-response advertising directed to all prospective customers, not only the cost related to the portion of the potential customers that are expected to respond to the advertising, should be used to measure the amounts of such reported assets.

Costs of Direct-Response Advertising

.41 Costs of direct-response advertising that should be included in amounts reported as assets include only the following:

a. *Incremental direct costs of direct-response advertising incurred in transactions with independent third parties*—Examples of those costs may include, but are not limited to, costs of idea development, writing advertising copy, artwork, printing, magazine space, and mailing.

b. *Payroll and payroll-related costs for the direct-response advertising activities of employees who are directly associated with and devote time to the advertising reported as assets*—Examples of those activities may include, but are not limited to, idea development, writing advertising copy, artwork, printing, and mailing. The costs directly related to those advertising activities should include only that portion of employees' total compensation and payroll-related fringe benefits directly related to time spent performing such activities.

For purposes of this SOP, administrative costs, rent, depreciation other than depreciation of assets used directly for advertising activities (as discussed in paragraph .30), and other occupancy costs are not costs of direct-response advertising activities.

Components of Advertising Activities

.42 Advertising activities may have several component costs. Two primary components, which are made up of other components, are the costs of (*a*) producing advertisements, such as the costs of idea development, writing advertising copy, artwork, printing, audio and video crews, actors, and other costs, and (*b*) communicating advertisements that have been produced, such as the costs of magazine space, television airtime, billboard space, and distribution (postage stamps, for example).

Producing Advertising

.43 Costs of producing advertising are incurred during production rather than when the advertising takes place.

Communicating Advertising

.44 Costs of communicating advertising are not incurred until the item or service has been received and should not be reported as expenses before the item or service has been received, except as discussed in paragraph .27. For example—

- The costs of television airtime should not be reported as advertising expense before the airtime is used. Once it is used, the costs should be expensed, unless the airtime was used for direct-response advertising activities that meet the criteria for capitalization under this SOP.
- The costs of magazine, directory, or other print media advertising space should not be reported as advertising expense before the space is used. Once it is used, the costs should be expensed, unless the space was used for direct-response advertising activities that meet the criteria for capitalization under this SOP.

Executory Contracts

.45 Some activities, such as product endorsements and sponsorships of events, may be performed pursuant to executory contracts. Costs incurred under executory contracts generally are recognized as performance under the contract is received. Executory contracts should be evaluated to determine whether the costs recognized under such contracts are advertising costs. To the extent that those costs are advertising costs, such costs should be accounted for in conformity with the guidance in this SOP.

Amortization of Capitalized Advertising Costs

.46 The amounts at which direct-response advertising is reported as assets should be amortized on a cost-pool-by-cost-pool basis over the period during which the future benefits are expected to be received using the method described in paragraph .47.

.47 The amortization should be the amount computed using the ratio that current period revenues for the direct-response advertising cost pool bear to the total of current and estimated future period revenues for that direct-response-advertising cost pool. The amounts in this calculation should not be discounted to net present value. The estimated amounts of future revenues for that cost pool may increase or decrease over time, and the ratio should be recalculated at each reporting date.[7]

Assessment of Realizability and Subsequent Measurement

.48 The realizability of the amounts of direct-response advertising reported as assets should be evaluated at each balance-sheet date by comparing the carrying amounts of such assets on a cost-pool-by-cost-pool basis to the probable remaining future net revenues expected to result directly from such advertising. (For this evaluation, future net revenues are gross revenues less the probable future costs of all goods and activities necessary to earn those revenues, except amortization of direct-response advertising. Examples of such future costs are the costs of goods sold, sales commissions, and payroll and payroll-related costs associated with the future revenues.) If the carrying amounts of such advertising exceed the remaining future net revenues that probably will be realized from such advertising, the excess should be reported as advertising expense of the current period. The reduced carrying amounts should not be adjusted upward if estimates of future net revenues are subsequently increased.[8]

Disclosures

.49 The notes to the financial statements should disclose the following:

a. The accounting policy selected from the two alternatives in the beginning of paragraph .26 for reporting advertising, indicating whether such costs are expensed as incurred or the first time the advertising takes place

b. A description of the direct-response advertising reported as assets (if any), the accounting policy for it, and the amortization period

c. The total amount charged to advertising expense for each income statement presented, with separate disclosure of amounts, if any, representing a write-down to net realizable value

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[7] Changes in estimated future revenues for a direct-response-advertising cost pool should be reflected in the amortization calculation for current and future periods. Therefore, such changes in estimates would not result in reporting amounts expensed in prior periods as assets in the current or subsequent periods.

[8] [Footnote deleted.]

d. The total amount of advertising reported as assets in each balance sheet presented

.50 The following illustrates the disclosures discussed in paragraph .49:

Note X. Advertising

The Company expenses the production costs of advertising the first time the advertising takes place, except for direct-response advertising, which is capitalized and amortized over its expected period of future benefits.

Direct-response advertising consists primarily of magazine advertisements that include order coupons for the Company's products. The capitalized costs of the advertising are amortized over the three-month period following the publication of the magazine in which it appears.

At December 31, 19XX, $1,000,000 of advertising was reported as assets. Advertising expense was $10,000,000 in 19XX, including $500,000 for amounts written down to net realizable value.

Amendments to Other Guidance

.51 This SOP amends SOP 88-1 [section 10,430] by requiring advertising costs incurred in connection with route developmental costs related to the preparation of new route operations to be accounted for in conformity with the guidance in this SOP, rather than expensed as incurred. Paragraph 22 of SOP 88-1 [section 10,430.22] is amended as follows:

> Because of the current deregulated environment and the uncertainty regarding the recoverability of route developmental costs, the majority of the Accounting Standards Executive Committee (AcSEC) believes that developmental costs, other than advertising costs, related to preparation of operations of new routes should not be capitalized, as previously permitted under the guide. (Advertising costs should be accounted for in conformity with the guidance in SOP 93-7, *Reporting on Advertising Costs.*) Route expansion or alteration has become a recurring activity among the airlines, and any related cost is considered a normal and recurring cost of conducting business.

.52 This SOP amends SOP 89-5 by requiring advertising costs incurred as contract acquisition costs to be accounted for in conformity with the guidance in this SOP, rather than expensed as incurred. Paragraph 54 of SOP 89-5 is amended as follows:

> Although there is theoretical support for deferring certain acquisition costs, acquisition costs of providers of prepaid health care services, other than costs of advertising, should be expensed as incurred. (Advertising costs should be accounted for in conformity with the guidance in SOP 93-7, *Reporting on Advertising Costs*.)

.53 This SOP amends SOP 90-8 by clarifying that advertising costs incurred in connection with acquiring initial continuing care contracts should be accounted for in conformity with the guidance in this SOP. SOP 90-8 is amended by adding the following as a footnote after the word "advertising" in the second bullet in paragraph 15:

> Accounting for costs of advertising is not covered by this SOP. (Advertising costs should be accounted for in conformity with the guidance in SOP 93-7, *Reporting on Advertising Costs*.)

Effective Date and Transition

.54 This SOP is effective for financial statements for years beginning after June 15, 1994. Earlier application is encouraged in fiscal years for which financial statements previously have not been issued. Costs incurred, regardless of whether or not they are reported as assets, before the initial application of this SOP should not be adjusted to the amounts that would have been reported as assets had this SOP been in effect when those costs were incurred. However, the concepts included in the provisions of paragraphs .46 and .47 (amortization), paragraph .48 (assessment of realizability), and paragraph .49 (disclosures) of this SOP should be applied to any unamortized costs reported as assets before the initial application of this SOP that continue to be reported as assets after the effective date. In the year this SOP is first applied, the financial statements should disclose the nature of the accounting changes adopted to conform to the provisions of this SOP and their effect on income before extraordinary items, net income, and related per share amounts.

Discussion of Conclusions and Implementation Guidance

Expensing the Costs of Advertising Either as Incurred or the First Time the Advertising Takes Place, Unless the Advertising Is Direct-Response Advertising That Is Capitalized Under the SOP

.55 Practice for reporting the costs of advertising is diverse and includes the following:

- Some entities expense all such costs as the component services or items are performed or received. For example, the costs of hiring an actor to film a television commercial, which is one kind of component cost of television advertising, may be expensed when the actor has completed his or her acting assignment.
- Some entities expense such costs the first time the advertising takes place.
- Some entities expense such costs over the estimated life of the advertising.
- Some entities view the practices described in the three previous bulleted items as points on a continuum, and they expense those costs at some point on that continuum.
- Some entities expense such costs over the period that revenues are expected to result from the advertising.

.56 Some believe that all costs of advertising activities, other than direct-response advertising that results in probable future benefits and is capitalized in conformity with the guidance in paragraph .26, should be expensed as the component activities occur. They believe that if the costs of the component activities are not capitalized under the SOP because it cannot be demonstrated that there is an asset after the advertising occurs, it follows that there is no basis for concluding that there is an asset before the advertising occurs.

.57 FASB Concepts Statement No. 5, paragraph 86, states that—

> Consumption of economic benefits during a period may be recognized either directly or by relating it to revenues recognized during the period:
>
> . . . b. Many expenses, such as selling and administrative salaries, are recognized during the period in which cash is spent or liabilities are incurred for goods and services that are used up either simultaneously with acquisition or soon after. [*Footnote reference omitted.*]

Some believe that the component costs of advertising activities, other than direct-response advertising that results in probable future benefits and is capitalized in conformity with the guidance in paragraph .26, result in assets until at least the first time the advertising occurs. They believe that such costs are not capitalized under this SOP after the advertising occurs because they do not result in *demonstrable* probable future economic benefits, not because they do not result in any probable future economic benefits. However, they believe that the component costs of advertising have, at a minimum, benefits that are received simultaneously with the advertising. They note that there must be some economic benefit to advertising activities because entities continue to undertake them. They also note that there is no opportunity for an entity to benefit from advertising until it occurs. Therefore, they conclude that it is reasonable to defer such costs until the first time the advertising takes place.

.58 Some believe the component costs of advertising activities, other than direct-response advertising that results in probable future benefits and is capitalized in conformity with the guidance in paragraph .26, result in assets and should be amortized over the life of the advertising. They believe that the component costs of advertising have benefits that are received over the period the advertising is used. They note that there must be some economic benefit to advertising activities over the period they are used, because entities incur incremental costs to undertake them. Some believe that advertising should be expensed over the period in which revenues are expected to result from the advertising.

.59 AcSEC believes that the views discussed in paragraphs .55 through .58 have merit and acknowledges that choosing from among the accounting methods resulting from them is based to some extent on arbitrary judgments. AcSEC believes that the views discussed in paragraph .58 should not be adopted for advertising other than direct-response advertising, because probable future benefits beyond the first time the advertising takes place are too uncertain and are not demonstrable or measurable with the degree of reliability required to recognize an asset. Further, AcSEC believes the diversity in practice should be limited. AcSEC believes that the costs of advertising that otherwise would not be capitalized under the SOP should be expensed no later than the first time the advertising takes place. However, AcSEC is unable to reach a consensus on whether the costs of advertising that would otherwise not be capitalized under this SOP should be expensed (*a*) as incurred or (*b*) the first time the advertising takes place. Therefore, for practical reasons (including the likelihood that, for most entities, the financial statement effect of choosing the accounting described by (*a*) to the exclusion of (*b*), or vice versa, would be immaterial), AcSEC has concluded that entities should expense the costs of advertising that otherwise would not be capitalized under this SOP either as incurred or the first time the advertising takes place.

Capitalization of Direct-Response Advertising Costs Based on FASB Concepts Statements

.60 AcSEC based its conclusions for capitalizing direct-response advertising on FASB Concepts Statement Nos. 5 and 6. AcSEC also considered other authoritative financial reporting literature that could be relevant to financial reporting for advertising. Such other literature is excerpted in the appendix [paragraph .81].

.61 AcSEC believes that advertising that results in an entity's acquiring or increasing probable future economic benefits meets the definition of an asset. However, for most advertising, those benefits cannot be measured with the degree of reliability required to report an asset in the financial statements. AcSEC believes that direct-response advertising that meets certain criteria is the only advertising that may result in benefits that can be measured with the degree of reliability required to report an asset in the financial statements after the first time the advertising takes place.

Recognition Criteria

.62 FASB Concepts Statement No. 5, paragraph 63, sets forth the criteria of definition, measurability, relevance, and reliability that should be met to report an item in the financial statements.

Definition of an Asset

.63 Paragraph 25 of Concepts Statement No. 6 states that "assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." Advertising can create assets according to that definition, and the costs of such advertising may qualify to be capitalized.

.64 The probable future benefits are probable future revenues arising from direct-response advertising in excess of the future costs to be incurred in realizing those revenues. Those assets are deferrals, within the meaning of paragraph 141 of Concepts Statement No. 6, resulting from current cash payments or their equivalent. Recognition in income of the costs of such assets is deferred until the future economic benefits underlying the assets are partly or wholly realized or lost.

.65 Historical patterns of responses to the direct-response advertising or contracts that are enforced generally are evidence that the reporting entity obtains the benefits and can control others' access to them.

Measurability

.66 The probable future revenues that will result from direct-response advertising that meets the conditions for capitalization under this SOP can be measured with the degree of reliability necessary to report the costs to obtain them as an asset in financial statements. The list of attributes in paragraph 67 of Concepts Statement No. 5 includes historical cost, net realizable value, and present value of future cash flows.

Relevance

.67 FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, paragraphs 34 to 40, states that financial reporting should provide information that is useful in making rational economic decisions. That includes information helpful to users in assessing the amounts, timing, and uncertainties of prospective net cash inflows, information about the economic resources of an enterprise, and information about the effects of transactions and circumstances that change resources. Information about the future revenues that will result from direct-response advertising and the costs incurred are relevant because they provide such information.

Reliability

.68 Paragraph 75 of Concepts Statement No. 5 states that to be reliable, information must be "representationally faithful, verifiable, and neutral." Paragraph 77 amplifies that statement:

> Unavailability or unreliability of information may delay recognition of an item, but waiting for virtually complete reliability or minimum cost may make the

> information so untimely that it loses its relevance. At some intermediate point, uncertainty may be reduced at a justifiable cost to a level tolerable in view of the perceived relevance of the information. If other criteria are also met, that is the appropriate point for recognition. Thus, recognition may sometimes involve a trade-off between relevance and reliability.

.69 There is a broad spectrum of advertising activities and circumstances in which they are undertaken. AcSEC believes that many kinds of advertising activities may result in assets that meet the recognition criteria of definition, measurability, and relevance. However, AcSEC believes that only certain direct-response advertising can meet the recognition criteria of reliability after the first time the advertising takes place. AcSEC believes advertising other than direct-response advertising would not result in assets that are measurable with the degree of reliability required to report an asset in the financial statements after the first time the advertising takes place.

Specificity of Conditions That Must Be Met in Order to Report the Probable Future Benefits of Direct-Response Advertising as Assets

.70 The conditions in this SOP that must be met in order to report the costs of direct-response advertising as assets beyond the first time the advertising takes place require reliable information. Those conditions are narrow because it is generally difficult to determine the probable future benefits of advertising with the degree of reliability sufficient to report the results of the advertising as assets.

.71 AcSEC considered providing guidance that would require or prohibit capitalization based on the use of econometric models, scanner studies, or other forms of data gathering as evidence that advertising leads to a response resulting in future benefits. Such forms of data gathering generally are designed to isolate the effects of all factors affecting revenue, such as advertising, price, and season, to estimate the effects of advertising on sales. AcSEC concluded that the SOP should prohibit capitalization of advertising based on the use of such information as evidence, because the effects of factors other than advertising on the production of revenue probably would not be measurable with the degree of reliability required to rely on such models.

Period and Extent of Expected Future Benefits

.72 The response to advertising usually occurs shortly after the advertising takes place, but in mail-order catalogue advertising, for example, it can take place over a longer period.

.73 AcSEC considered providing guidance that would either permit or prohibit reporting the costs of direct-response advertising as assets based on the inclusion of future revenues from renewals or repeat sales. Reporting entities with an established operating history, such as certain entities in subscription businesses, may be able to measure such amounts with the required degree of reliability and, if so, should report assets based on renewal amounts. The reporting entity must exercise judgment about (*a*) the existence of the degree of reliability required to determine the probability of renewals and (*b*) whether those renewals result from the direct-response advertising being accounted for. In order to conclude that the renewals result from the direct-response advertising being accounted for, the renewals must not result from significant direct-response advertising that took place subsequent to the direct-response advertising being accounted for. (As discussed in paragraph .28, each significant advertising effort establishes a separate stand-alone cost pool.) Examples of situations in which that required degree of reliability may exist, without significant direct-response advertising subsequent to the direct-response advertising being accounted for, include the following:

- The sale of subscriptions may be offered only through direct-response advertising. The entity may have objective evidence that, historically, a quantifiable percentage of subscriptions is renewed at the end of each subscription period without a significant advertising effort. After the subscription is purchased, in what is deemed to be an insignificant advertising effort, renewal subscriptions are offered for sale by mailing a renewal card to those who have subscriptions that will lapse soon. The amount of direct-response advertising reported as assets and amortized in future periods ordinarily would be based on the expected total revenue to be realized over both the initial and the renewal subscription periods.
- A series of products, such as pieces in a chess set, may be offered for sale only through direct-response advertising. After the first piece is purchased, the remaining pieces are offered for sale by mailing a response card to those who purchased the first piece in what is deemed to be an insignificant advertising effort. The entity may have objective evidence that, historically, each customer who buys the first piece will buy a quantifiable percentage of the remaining pieces. If each of the pieces is bought separately, the amount of direct-response advertising reported as assets and amortized in future periods ordinarily would be based on total revenue from all sales, including estimated future sales.

If significant marketing efforts are required to generate subsequent revenues through renewal or repeat sales, those subsequent revenues would not qualify as revenues resulting from the direct-response advertising that resulted in the initial sale and initial stand-alone cost pool. For example, in the previous bulleted item, if a pamphlet describing the chess set, its monetary and aesthetic value, and the history of the game of chess is sent to those who purchased the first piece, the amount of direct-response advertising reported as assets and amortized in future periods would be based on sales of the first piece rather than on the total of all sales including estimated future sales. However, subsequent direct-response advertising may result in the capitalization of the costs of that subsequent advertising, with its costs accumulated in a stand-alone cost pool, if the conditions for capitalization in this SOP are met.

.74 AcSEC concluded that it should not arbitrarily limit the period over which the direct-response advertising should be amortized. However, AcSEC believes that the reliability of accounting estimates decreases as the length of the period for which such estimates are made increases. Therefore, the period over which the benefits of direct-response advertising are amortized often is no longer than the greater of one year or one operating cycle. However, under certain circumstances, such as those discussed in paragraph .72, an entity may be able to demonstrate that the duration of the probable future benefits is greater than the longer of one year or one operating cycle.

Assets Should Be Reported Based on the Costs of the Advertising Directed to All Prospective Customers

.75 Paragraph .40 of this SOP states, in part, that the ". . . cost of the direct-response advertising directed to all prospective customers, not only the cost related to the portion of the potential customers that is expected to respond to the advertising, should be used to measure the amounts of such reported assets." Some believe that guidance to be inconsistent with guidance in other pronouncements issued by the FASB (such as FASB Statement Nos. 19 and 91) that require costs to be capitalized based on the portion of the costs expected to result in successful efforts. Other FASB pronouncements, such as FASB Statement No. 53, permit capitalization of advertising based on the cost of advertising directed to all potential customers.

.76 AcSEC compared and contrasted the guidance in this SOP with the guidance in FASB Statement Nos. 19 and 91. AcSEC concluded that, in general, any comparison of the guidance in Statement Nos. 19 and 91 should consider the differences in the kinds of activities addressed by those Statements and this SOP. In the extractive industries, drilling an oil well in a location without proven reserves can be viewed as a discrete effort; in financial industries, making or acquiring a loan can be viewed as a discrete effort. However, few would view an individual unit of advertising, such as one piece of advertising mailed as part of a direct-response advertising campaign, as a discrete effort. The entire mailing, not merely an individual piece of mail, constitutes the effort, and the advertiser evaluates the success of the advertising based on the response to the entire advertising effort, not on the response to one component of that effort.

.77 AcSEC believes the arguments supporting successful-effort accounting for exploration activities in the oil and gas industry are based on the inability to demonstrate, on an individual company basis, a direct cause-and-effect relationship between unsuccessful acquisition and exploration costs and revenues derived from successful activities in unrelated geological areas. For the kinds of activities capitalized under the guidance in this SOP, there is a reliable and demonstrated relationship between total costs and future benefits that is a direct result of incurring those costs. For example, reporting entities capitalizing advertising in conformity with this SOP would have reliable evidence that they must, for example, send out 1 million pieces of direct-mail advertising in order to get 10 thousand responses. The cost of obtaining those 10 thousand responses is the cost of sending out the million pieces of mail. The effort is the million pieces mailed, and documented operating history enables those reporting entities to make reliable predictions about the relationship between the total number of pieces of advertising mailed and the total future revenues obtained.

Acquisition Cost of the Assets

.78 AcSEC used FASB Statement Nos. 19 and 91 as a basis for determining the kinds of costs of direct-response advertising that result in assets that should be included in the acquisition cost of the assets. AcSEC believes that some activities, such as allocated overhead, may result in assets, but it excluded such costs because measurements of the amounts that should be allocated to advertising are too imprecise. The costs of materials bought from a supplier in the production of advertising materials should be reported as costs of assets from direct-response advertising if those materials can be directly attributed to specific direct-response advertising. An example of such costs and activities is the cost of paper bought from a third party used to produce catalogues.

Amortization

.79 APB Opinion 17, paragraph 32, states that intangible assets should be amortized using the straight-line method, unless a company demonstrates that another systematic method is more appropriate. AcSEC used FASB Statement No. 86 as a basis for determining the amortization method because it believes the method used in that Statement generally is more appropriate. AcSEC does not require straight-line amortization, because the benefits of advertising sometimes are greater or less in future periods than in current periods. AcSEC believes amortization should match the costs of obtaining the future benefits with those benefits.

.80 In calculating the amortization of the amounts reported as assets resulting from direct-response advertising, the amounts in the calculation should not be discounted to net present value. The FASB currently is studying discounting. Under current generally accepted accounting principles (GAAP), assets resulting from direct-response advertising are nonmonetary assets, and nonmonetary assets generally are not discounted. Further, the effect of discounting generally would not be material, because the amortization period usually would be short.

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Appendix

Other Financial Reporting Literature

The following sets forth relevant portions of authoritative and other financial reporting literature that was considered by AcSEC in its deliberation of financial reporting on advertising activities.

As discussed in paragraph .06 of this SOP, the guidance in this SOP does not apply to transactions for which pronouncements in category (a) in paragraph 10 of SAS No. 69 provide guidance.

Guidance Included in Category (a) in Paragraph 10 of SAS No. 69

APB Opinion 17

APB Opinion 17, *Intangible Assets*, paragraph 24, states the following:

> . . . [A] company should record as assets the costs of intangible assets acquired from other enterprises or individuals. Costs of developing, maintaining, or restoring intangible assets which are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole—such as goodwill—should be deducted from income when incurred.

However, paragraph 28 states that "a reasonable estimate of the useful life may often be based on upper and lower limits even though a fixed existence is not determinable."

APB Opinion 28

APB Opinion 28, *Interim Financial Reporting*, paragraph 15(a), states the following:

> Costs and expenses other than product costs should be charged to income in interim periods as incurred, or be allocated among interim periods based on an estimate of time expired, benefit received or activity associated with the periods. Procedures adopted for assigning specific cost and expense items to an interim period should be consistent with the bases followed by the company in reporting results of operations at annual reporting dates. However, when a specific cost or expense item charged to expense for annual reporting purposes benefits more than one interim period, the cost or expense item may be allocated to those interim periods.

Paragraph 16(d) states the following:

> Advertising costs may be deferred within a fiscal year if the benefits of an expenditure made clearly extend beyond the interim period in which the expenditure is made. Advertising costs may be accrued and assigned to interim periods in relation to sales prior to the time the service is received if the advertising program is clearly implicit in the sales arrangement.

FASB Statement No. 2

FASB Statement No. 2, *Accounting for Research and Development Costs*, provides no specific guidance on the financial reporting treatment of advertising but does include a discussion from which parallels can be drawn. Appendix B, "Basis for Conclusions," includes uncertainty of probable future benefits, lack of causal relationship between expenditures and benefits, and measurability of probable future economic benefits as bases for the FASB's conclusion that the costs of research and development should be reported as expenses when incurred and, in effect, that the benefits of that activity should not be reported as assets. The FASB considered the concept of selective reporting of assets for those activities, which would involve establishing conditions that would have to be met before the benefits of research and development could be reported as assets. However, because the factors on which such conditions might be based could not be objectively and comparably applied by all enterprises, the FASB rejected this concept for research and development activities.

The Statement, in paragraph 11, includes both internal and external costs among the costs to be identified with research and development activities.

FASB Statement No. 13

FASB Statement No. 13, *Accounting for Leases*, as amended by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, paragraph 24, states that "*initial direct costs* shall not include costs related to activities performed by the lessor for advertising [and] soliciting potential lessees . . ." and therefore requires that the costs of advertising, as they pertain to leases, be reported as expenses when incurred.

FASB Statement No. 19

FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, is discussed in the "Discussion of Conclusions and Implementation Guidance" section of this SOP.

FASB Statement No. 51

FASB Statement No. 51, *Financial Reporting by Cable Television Companies*, appendix A, paragraph 17, states that "direct selling costs include . . . local advertising targeted for acquisition of new subscribers . . ." and requires that they be reported as expenses when incurred, but initial hookup revenue may be recognized to the extent such costs are incurred.

FASB Statement No. 53[9]

FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*, requires in paragraph 15 that the probable future economic benefits of exploitation activities, including prerelease and early-release advertising of films in both primary and secondary markets that probably will benefit the film in future markets, be reported as film inventory at cost and amortized based on the ratio that gross revenues from the film for the current period bear to total anticipated gross revenues from the film during its useful life. The costs of local advertising that is "not clearly expected to benefit the film in future markets . . . shall be charged to expense in the period incurred."

FASB Statement No. 60

FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, requires in paragraph 29 that the probable future economic benefits of policy acquisition activities be reported as assets at cost and amortized in proportion to premium revenue reported. Appendix A, paragraph 66, defines acquisition costs as—

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[9] In 2000, the FASB rescinded FASB Statement No. 53 and AcSEC issued SOP 00-2, *Accounting by Producers or Distributors of Films* [section 10,800]. The provisions of this SOP apply to entities within the scope of SOP 00-2 [section 10,800]. [Footnote added, effective for financial statements for fiscal years beginning after December 15, 2000, by Statement of Position 00-2.]

> Costs incurred in the acquisition of new and renewal insurance contracts. Acquisition costs include those costs that vary with and are primarily related to the acquisition of insurance contracts (for example, agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees).

The Statement does not discuss whether acquisition activities include advertising activities.

FASB Statement No. 67

FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, appendix A, paragraph 28, defines the following terms:

> *Costs Incurred to Rent Real Estate Projects*
>
> Examples of such costs include costs of model units and their furnishings, rental facilities, semipermanent signs, rental brochures, advertising, "grand openings," and rental overhead including rental salaries.
>
> *Costs Incurred to Sell Real Estate Projects*
>
> Examples of such costs include costs of model units and their furnishings, sales facilities, sales brochures, legal fees for preparation of prospectuses, semipermanent signs, advertising, "grand openings," and sales overhead including sales salaries.

The probable future economic benefits of activities undertaken to sell real estate projects are reported as assets at cost if their costs are realizable from the sale of the project and are incurred for tangible assets that are used throughout the selling period to help sell the project. Paragraph 19 states that "capitalized selling costs shall be charged to expense in the period in which the related revenue is recognized as earned."

Paragraphs 20 and 21 state:

> If costs incurred to rent real estate projects, other than initial direct costs, under operating leases are related to and their recovery is reasonably expected from future rental operations, they shall be capitalized. Examples of such costs are costs of model units and their furnishings, rental facilities, semipermanent signs, "grand openings," and unused rental brochures. Costs that do not meet the criteria for capitalization shall be expensed as incurred, for example, rental overhead.
>
> Capitalized rental costs directly related to revenue from a specific operating lease shall be amortized over the lease term. Capitalized rental costs not directly related to revenue from a specific operating lease shall be amortized over the period of expected benefit. The amortization period shall begin when the project is substantially completed and held available for occupancy. Estimated unrecoverable amounts of unamortized capitalized rental costs associated with a lease or group of leases shall be charged to expense when it becomes probable that the lease(s) will be terminated. [*Footnote reference omitted.*]

FASB Statement No. 86

FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, provides no specific guidance on reporting on advertising, but it does provide guidance from which parallels can be drawn. Under the Statement, all costs incurred internally to create computer software products are reported as expenses when incurred until technological feasibility has been established for the products. For certain production costs of specific activities whose probable future benefits are reported as assets, paragraph 8 states:

> The annual amortization shall be the greater of the amount computed using (*a*) the ratio that current gross revenues for a product bear to the total of current

> and anticipated future gross revenues for that product or (*b*) the straight-line method over the remaining estimated economic life of the product including the period being reported on.

The unamortized amount of assets reported is compared to their net realizable value at the reporting date and is written down to the extent that it exceeds the net realizable value.

FASB Statement No. 91

FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, requires the probable future economic benefits of direct loan origination activities to be reported as assets at cost, which should be amortized over the lives of the loans with the amortization reported as yield adjustments. Paragraph 6 states that "direct loan origination costs of a completed loan shall include only (*a*) incremental direct costs of loan origination incurred in transactions with independent third parties for that loan and (*b*) certain costs directly related to specified activities performed by the lender for that loan." Those specified activities do not include advertising or marketing. Paragraph 7 states that "all other lending-related costs, including costs related to activities performed by the lender for advertising [and] soliciting potential borrowers . . . shall be charged to expense as incurred."

Guidance That Is Not Included in Category (a) of Paragraph 10 of SAS No. 69 but That Is Not Affected by This SOP

Industry Audit Guide *Audits of Stock Life Insurance Companies*

Paragraphs 8.27 to 8.30 of the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies* state that acquisition expenses should be deferred only if the expense both varies with and is primarily related to the production of new business. Paragraph 8.30 of the guide states that advertising activities are acquisition activities.

Advertising activities that are policy acquisition activities should continue to be accounted for in conformity with the guidance in FASB Statement No. 60 and *Audits of Stock Life Insurance Companies.*

Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*

Paragraphs 3.34 and 8.13 of the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* state that acquisition costs that vary with and are primarily related to the acquisition of new and renewal business should be capitalized as deferred acquisition costs. The guide does not state whether advertising activities are acquisition activities.

Advertising activities that are policy acquisition activities should continue to be accounted for in conformity with the guidance in FASB Statement No. 60 and *Audits of Property and Liability Insurance Companies*.

FASB Technical Bulletin No. 90-1

FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, discusses advertising costs incurred in connection with acquiring extended warranty and product maintenance contracts. Paragraph 4 states the following:

> Costs that are directly related to the acquisition of a contract and that would have not been incurred but for the acquisition of that contract (incremental di-

> rect acquisition costs) should be deferred and charged to expense in proportion to the revenue recognized. All other costs, such as . . . advertising expenses . . . should be charged to expense as incurred.

Guidance That Is Not Included in Category (a) of Paragraph 10 of SAS No. 69 That Is Amended by This SOP

SOP 88-1

AICPA SOP 88-1, *Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications*, paragraphs 19 to 24 [section 10,430.19–.24], amends *Audits of Airlines* by recommending that the probable future economic benefits of developmental activities not be reported as assets, "because of the current deregulated environment and the uncertainty regarding the recoverability" of the costs of such activities. The SOP states that the basis for the conclusion in the guide was that the airline industry operated in a regulated environment and "the expected future benefit and recoverability of such costs was generally not in doubt . . . . Route expansion or alteration has become a recurring activity among the airlines, and any related cost is considered a normal and recurring cost of conducting business."

Paragraph 51 of this SOP discusses amendments to SOP 88-1 [section 10,430.51].

SOP 89-5

Paragraphs 50 to 54 of SOP 89-5, *Financial Accounting and Reporting by Providers of Prepaid Health Care Services*, discuss accounting for contract acquisition costs. Paragraph 51 lists advertising as one kind of contract acquisition cost. Paragraph 54 states that ". . . acquisition costs of providers of prepaid health care services should be expensed as incurred."

Paragraph 52 of this SOP discusses amendments to SOP 89-5.

SOP 90-8

Paragraph 65 of SOP 90-8, *Financial Accounting and Reporting by Continuing Care Retirement Communities*, states the following:

> Costs of acquiring initial continuing-care contracts that are expected to be recovered from future contract revenues should be capitalized. These costs should be amortized to expense on a straight-line basis over the average expected remaining lives of the residents under contract or the contract term, if shorter. Costs of acquiring continuing-care contracts after a CCRC [continuing-care retirement community] is substantially occupied or one year following completion should be expensed when incurred.

Paragraph 15 states that advertising is not a cost of acquiring an initial continuing-care contract.

Some believe that SOP 90-8 includes no guidance for reporting the costs of advertising activities. Others believe that the exclusion of advertising activities from the definition of the costs of acquiring an initial continuing-care contract is a prohibition against capitalizing advertising under the guidance in paragraph 63.

Paragraph 53 of this SOP discusses amendments to SOP 90-8.

Accounting Standards Executive Committee (1992-1993)

Task Force on Reporting on Advertising Activities and Certain Other Activities Undertaken to Create Intangible Assets

AICPA Staff

[The next page is 79,921.]

Section 10,610

Statement of Position 94-3 Reporting of Related Entities by Not-for-Profit Organizations

September 2, 1994

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

SIGNIFICANT MATTERS SINCE THE ISSUANCE OF THIS SOP

In August 1996, the AICPA issued an Audit and Accounting Guide *Not-for-Profit Organizations* (the New Guide) which superseded the following AICPA Audit and Accounting Guides:

- Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*
- Industry Audit Guide *Audits of Colleges and Universities*
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*

It also superseded the following AICPA Statements of Position (SOPs):

- SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*
- SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*
- SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*

The New Guide is effective for financial statements for fiscal years ending on or after December 31, 1996. Earlier application is permitted.

This SOP applies to entities following the New Guide.

Readers should note the following matters:

- In July 1996, the AICPA issued an Audit and Accounting Guide *Health Care Organizations* that superseded the Audit and Accounting Guide *Audits of Providers of Health Care Services*. This SOP does not apply to entities following *Health Care Organizations*, just as it did not apply to entities following *Audits of Providers of Health Care Services*.
- References to pronouncements and guidance that are superseded have been shaded.
- In applying the guidance in paragraph .07, readers should refer to Chapter 8, "Investments," of the New Guide. Not-for-profit organizations that choose to report investments at market value in conformity with the New Guide may do so instead of reporting those investments by the equity method, which otherwise would be required by this SOP.
  - Although the New Guide superseded SOP 78-10, it did not supersede the guidance in paragraph .13 of this SOP that "[e]ntities that otherwise would be prohibited from presenting consolidated financial statements under the provisions of this SOP, but that currently present consolidated financial statements in conformity with the guidance in SOP 78-10, may continue to do so." Organizations that presented consolidated financial statements in conformity with the guidance in SOP 78-10 may continue to do so.
- In applying the definition of "economic interest" in the Glossary, readers should refer also to paragraph 3.22 of the New Guide.
- Paragraph C2 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, amends the last sentence of paragraph 2 of ARB No. 51, *Consolidated Financial Statements*, by deleting the phrase "is likely to be temporary or if it" from that sentence. The amended sentence in paragraph 2 therefore reads as follows:

  "A majority-owned subsidiary shall not be consolidated if control ~~is likely to be temporary or if it~~ does not rest with the majority owner…"

This SOP has been conformed to FASB Statement No. 144 to eliminate the exception to consolidation for a temporarily controlled subsidiary in circumstances in which this SOP requires consolidation based on a controlling financial interest through direct or indirect ownership of a majority voting interest (paragraphs .05 and .10 of this SOP). No such conforming change to this SOP is appropriate in circumstances in which consolidation is required or permitted based on control through other than a controlling financial interest through direct or indirect ownership of a majority voting interest (Paragraphs .11 and .12 of this SOP). Accordingly, this SOP retains the exception to consolidation for a temporarily controlled subsidiary in circumstances in which consolidation is required or permitted based on control through other than a controlling financial interest through direct or indirect ownership of a majority voting interest.

- In July 2004, the FASB ratified conclusions reached by the Emerging Issues Task Force in EITF Issue No. 02-14, *Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock*. Accordingly, this SOP has been conformed to include the guidance in EITF Issue No. 02-14. The consensus opinion reached in EITF Issue No. 02-14 expands the use of the equity method of accounting described in APB Opinion No. 18 to certain investments that are deemed "in-substance common stock" (as defined in the consensus opinion).[†] It requires an investor that has the ability to exercise significant influence over the operating and financial policies of an investee to apply the equity method of accounting only when it has an investment(s) in common stock and/or an investment that is in-substance common stock. The consensus opinion does not apply to investments accounted for under FASB Statement No. 133, non-corporate entities accounted for under AICPA Statement of Position No. 78-9, *Accounting for Investments in Real Estate Ventures*, or to LLCs accounted for under EITF Issue No. 03-16.

Also, in accordance with paragraph .07 of this SOP, EITF Issue No. 02-14 does not apply to investments that are reported at current market value or fair value. (Paragraphs A.10–A.13 of Appendix A of Chapter 8 of this Guide discuss the circumstances in which an investment may be reported at current market value or fair value.) When applied by a not-for-profit organization, EITF Issue No. 02-14 requires that an organization with the ability to exercise significant influence over the operating and financial policies of a for-profit entity apply APB Opinion No. 18 if that investment is common stock or "in-substance common stock." [Revised, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159.]

In-substance common stock is an investment in a for-profit investee that has risk and reward characteristics that are substantially similar to that entity's common stock. It might be an investment in a different class of stock or in an in-the-money warrant or option. An organization should consider three characteristics when determining whether an investment in a for-profit entity is substantially similar to an investment in that entity's common stock: subordination, risks and rewards of ownership, and obligation to transfer value. All three of the characteristics must be substantially similar to an investment in the entity's common stock for the organization to conclude that the investment is in-substance common stock. EITF Issue No. 02-14 provides numerous factors that should be considered when determining whether the three characteristics are substantially similar. It also provides examples that illustrate the application of the characteristics to various investments. The initial determination of whether an investment is substantially similar to common stock should be made on the date on which the investor obtains the investment if the investor has the ability to exercise significant influence over the operating and financial policies of the investee. That determination should be reconsidered upon the occurrence of one or more of the triggers described in the consensus opinion.

The use of the equity method of accounting is effectively limited to investment(s) in common stock, in-substance common stock, non-corporate entities accounted for under AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures*, limited liability companies that maintain "specific ownership accounts" for each investor as discussed in EITF Issue No. 03-16, *Accounting for Investments in Limited Liability Companies* and investments by a general partner in a limited partnership or similar entity when the general partner(s) do not control the partnership, as discussed in EITF Issue No. 04-5, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights*. If a not-for-profit organization uses the equity method of accounting to account

† [Footnote deleted, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

for investments in for-profit entities that are not included in that list, the equity method of accounting should be discontinued.[‡] The organization should evaluate whether the investment should be prospectively accounted for under FASB Statement 124 or accounted for as described in Appendix A. The accounting for beneficial interests in trusts as required by FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, does not change as a result of EITF Issue No. 02-14. [Revised, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

- In June 2005, the FASB ratified conclusions reached by the Emerging Issues Task Force in EITF Issue No. 04-5, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights.* Accordingly, this SOP has been conformed to include the guidance in EITF Issue No. 04-5. The consensus opinion reached in EITF Issue No. 04-5 provides a framework to determine if a general partner, or the general partners as a group, controls a limited partnership or similar entity when the limited partners have certain rights. For not-for-profit organizations, the consensus opinion applies to limited partnerships or similar entities (such as limited liability companies that have governing provisions that are the functional equivalent of a limited partnership) unless, in conformity with GAAP, the interests in those entities are reported at fair value with changes in fair value reported in a statement of operations or financial performance. That is, if an organization is required to apply the consolidation guidance included in ARB 51 and FASB Statement No. 94 to its to its investment in a limited partnership, it is within the scope of EITF Issue No. 04-5. The consensus opinion need not be applied in circumstances in which no single general partner in a group of general partners controls the limited partnership. Guidance on determining which general partner in a group of general partners should consolidate the partnership is beyond the scope of this EITF Issue. [Added, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5. Revised, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159.]

The general partners in a limited partnership are presumed to control that limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership. The assessment of whether the rights of the limited partners should overcome the presumption of control by the general partners is a matter of judgment that depends on facts and circumstances. [Added, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

The general partners do not control the limited partnership if the limited partners have either (*a*) the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause (referred to as kick-out rights) or (*b*) substantive participating rights. Substantive participating rights provide the limited partners with the ability to effectively participate in significant decisions that would be expected to be made in the ordinary course of the limited partnership's business. Limited partners' rights that are only protective in nature (referred to as "protective rights") do not overcome the presumption that

[‡] Previously recognized equity method earnings and losses should not be reversed when the equity method of accounting is discontinued. [Footnote revised, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

the general partners control the limited partnership. Guidance on how to determine if the limited partners have these characteristics is provided by paragraphs 7 to 19 of EITF Issue No. 04-5 and examples in Exhibit 04-5A of the Issue abstract. [Added, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

If the limited partners possess substantive kick-out rights or if the limited partners have substantive participating rights, presumption of control by the general partners would be overcome, and each of the general partners should account for its investment in the limited partnership using the equity method of accounting. [Added, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

The assessment of limited partners' rights and their impact on the presumption of control of the limited partnership by the general partners should be made when an investor(s) first becomes a general partner(s) and should be reassessed at each reporting period thereafter for which financial statements of the general partner(s) are prepared. [Added, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

- In February 2007, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which creates an option under which an organization may irrevocably elect fair value as the initial and subsequent measure for many financial instruments and certain other items, with changes in fair value recognized in the statement of activities as those changes occur.[||] An election is made on a instrument-by-instrument basis (with certain exceptions), generally when an instrument is initially recognized in the financial statements. Not-for-profit organizations that choose to report investments at fair value in conformity with this Statement may do so instead of reporting those investments by the equity method, even if that method otherwise would be required by this SOP. [Added, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159.]
- In June 2007, the AICPA issued Statement of Position No. 07-1, *Clarification of the Scope of the Audit and Accounting Guide*, Audits of Investment Companies, *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*. SOP 07-1 amended paragraph .07 of SOP 94-3 and added to it footnotes 6 and 8. Subsequently, the FASB issued FSP SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1*, to delay indefinitely the effective date of the SOP and to prohibit adoption of the SOP by an entity that has not early adopted the SOP before issuance of the FSP. Therefore, the changes made by SOP 07-1 are not reflected in this Appendix. A not-for-profit organization that early adopts SOP 07-1 before issuance of the final FSP would be permitted but not required to continue to apply the provisions of the SOP; those organizations should refer to SOP 07-1 for the amendments. [Revised, March 2008, to reflect the issuance of SOP 07-1.]
- On September 27, 2007, the FASB issued an exposure draft, *Proposed FSP SOP 94-3-a and AAG-HCO-a, Omnibus Changes to Consolidation*

[||] FASB Statement No. 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Earlier adoption is permitted if certain conditions described in paragraph 30 of the Statement are met. [Footnote added, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159.]

and Equity Method Guidance for Not-for-Profit Organizations, which would make several changes to the guidance on consolidation and the equity method of accounting in SOP 94-3. It would amend paragraphs 3, 7, 10, 11, 12, and 20 and footnotes 4, 10, 11, and 13. It also would add a new paragraph (6A) about investments in for-profit partnerships, limited liability companies, and similar entities in which the not-for-profit organization has more than a minor interest. Readers should be alert to the issuance of a final standard. [Added, March 2008, to reflect the issuance of proposed exposure draft, *Proposed FSP SOP 94-3-a and AAG-HCO-a*.]

SUMMARY

This statement of position (SOP) amends and makes uniform the guidance concerning reporting related entities in the following AICPA publications:

- Industry Audit Guides *Audits of Voluntary Health and Welfare Organizations*[#] and *Audits of Colleges and Universities*[#]
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*[#]
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*[#]

The conclusions in this SOP are based on the premise that (1) whether the financial statements of a reporting not-for-profit organization and those of one or more other not-for-profit or for-profit entities should be consolidated and (2) the extent of disclosure that should be required, if any, if consolidated financial statements are not presented should be based on the nature of the relationship between the entities.

The guidance in this SOP focuses on (1) investments in for-profit entities and (2) financially interrelated not-for-profit organizations. That guidance includes the following:

Investments in For-Profit Entities

- A reporting not-for-profit organization should consolidate a for-profit entity in which it has a controlling financial interest through direct or indirect ownership of a majority voting interest if the guidance in Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, as amended by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards Nos. 94, *Consolidation of All Majority-Owned Subsidiaries* and 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, requires consolidation. The manner in which the for-profit entity's financial position, results of operations, and cash flows are presented in the reporting organization's financial statements depends on the nature of the activities of the for-profit entity.
- A reporting not-for-profit organization should use the equity method in conformity with Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, to report investments in common stock or "in substance common stock" of a for-profit entity if the guidance in that Opinion requires the use of the equity method.

[#] This publication has been superseded by the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. [Footnote renumbered, June 2007.]

- Not-for-profit organizations that choose to report at fair value their portfolio of other investments in conformity with paragraphs A.10–A.13 of Appendix A of Chapter 8 of the New Guide or that report investments in common stock or "in substance common stock" at fair value pursuant to FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*,[**] may do so instead of reporting those investments by the equity method, which otherwise would be required by this SOP. [Revised, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159.]

Financially Interrelated Not-for-Profit Organizations

- A not-for-profit organization should consolidate another not-for-profit organization in which it has a controlling financial interest through direct or indirect ownership of a majority voting interest, unless control does not rest with the majority owner, in which case consolidation is prohibited, as discussed in ARB No. 51, as amended by FASB Statement Nos. 94 and 144.
- A not-for-profit organization should consolidate another not-for-profit organization if the reporting not-for-profit organization has both control of the other not-for-profit organization, as evidenced by either majority ownership or a majority voting interest in the board of the other not-for-profit organization, and an economic interest in the other not-for-profit organization, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited.
- A not-for-profit organization may exercise control of another not-for-profit organization in which it has an economic interest by means other than majority ownership or a majority voting interest in the board of the other not-for-profit organization. In such circumstances, the not-for-profit organization is permitted, but not required, to consolidate the other not-for-profit organization, unless control is likely to be temporary, in which case consolidation is prohibited. If a not-for-profit organization controls another organization in which it has an economic interest by means other than majority ownership or a majority voting interest in the board of the other not-for-profit organization and consolidated financial statements are not presented, the not-for-profit organization should make the financial statement disclosures specified in paragraph .12.
- If either (but not both) control or an economic interest exists, the financial statement disclosures required by FASB Statement No. 57, *Related Party Disclosures*, should be made.

The conclusions in this SOP will be reconsidered when the FASB completes its project on consolidations and related matters, which may affect the definition of control and other related matters. In January 2004, after the issuance of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, the FASB moved its consolidations and related matters project from its technical agenda to its research project agenda. To date, no changes to the guidance in

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[**] FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157, *Fair Value Measurement*. [Footnote added, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159; Footnote renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

this SOP have resulted from the FASB's consolidations and related matters project.

This SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date shall be for fiscal years beginning after December 15, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117, Financial Statements of Not-for-Profit Organizations, before its effective date, earlier application of this SOP is encouraged. Comparative financial statements for earlier periods included with those for the period in which this SOP is adopted should be restated.

Changes Made to Reflect the Issuance of FASB Statement No. 144

There have been conforming changes made to this SOP due to the issuance of FASB Statement No. 144. Paragraph C2 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, amends the last sentence of paragraph 2 of ARB No. 51, *Consolidated Financial Statements*, by deleting the phrase "is likely to be temporary or if it" from that sentence. The following paragraphs of this SOP have changed and footnotes added: paragraph .05, footnote 4, paragraph .10, footnote 8, paragraph .11, footnote 11, and paragraph .12, footnote 12. Readers should be aware of the changes. [Revised, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

Changes Made to Reflect the Issuance of EITF Issue No. 02-14

There have been conforming changes made to this SOP due to the issuance of EITF Issue No. 02-14, *Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock*. Paragraph .06, footnote 5 was added. Readers should be aware of the change.

Changes Made to Reflect the Issuance of EITF Issue No. 04-5

There have been conforming changes made to this SOP due to the issuance of EITF Issue No. 04-5, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights*. Paragraph 5, footnote 5 was added and subsequent footnotes were renumbered. Readers should be aware of the change. [Added, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5].

Changes Made to Reflect the Issuance of FASB Statement No. 159

There have been conforming changes made to this SOP due to the issuance of FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. Paragraph 7 has been changed by removing reference to the superseded AICPA audit guides and replacing it with references to paragraphs A.10–A.13 of Chapter 8 of the AICPA Audit and Accounting Guide, *Not-for-Profit Organizations* and FASB Statement No. 159. Readers should be aware of the change. [Added, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159.]

Introduction

.01 The purpose of this statement of position (SOP) is to provide guidance to users and preparers of not-for-profit organizations' financial statements that will produce greater uniformity and comparability in the reporting of investments in majority-owned for-profit subsidiaries, investments in less than 50-percent-owned for-profit entities, and related but separate not-for-profit organizations. This SOP does not address how to prepare consolidated financial statements,[1] nor does it address all the conceptual issues underlying the reporting of relationships not evidenced by ownership.[2]

Scope

.02 This SOP—

- Amends and makes uniform the guidance concerning the reporting of related entities in the following AICPA publications:
  - Industry Audit Guides *Audits of Voluntary Health and Welfare Organizations*[#] and *Audits of Colleges and Universities* and *Audits of Colleges and Universities*[#]
  - Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*[#]
  - SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*[3]
- Does not apply to entities or activities that are covered by the AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*

Conclusions

.03 This SOP provides guidance for reporting (*a*) investments in for-profit majority-owned subsidiaries, (*b*) investments in common stock of for-profit entities wherein the not-for-profit organization has a 50 percent or less voting interest, and (*c*) financially interrelated not-for-profit organizations.

.04 Whether the financial statements of a reporting not-for-profit organization and those of one or more other entities should be consolidated, whether those other entities should be reported using the equity method, and the extent of the disclosure that should be required, if any, should be based on the nature of the relationships between the entities.

Investments in For-Profit Majority-Owned Subsidiaries

.05 Not-for-profit organizations with a controlling financial interest in a for-profit entity through direct or indirect ownership of a majority voting interest in that entity should follow the guidance in ARB No. 51, as amended by FASB Statement Nos. 94, *Consolidation of All Majority-Owned Subsidiaries*,

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[1] *Consolidation* of a parent and subsidiary organizations requires the presentation of a single set of amounts for the entire reporting entity. *Combination*, as discussed in paragraphs 22 and 23 of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, refers to financial statements prepared for organizations among which common control exists but for which the parent-subsidiary relationship does not exist. Both consolidation and combination require elimination of interorganization transactions and balances. This SOP provides no guidance concerning commonly controlled not-for-profit organizations.

[2] As discussed in Appendix C [paragraph .18], the Financial Accounting Standards Board (FASB) has on its agenda a project on consolidations and related matters.

[#] This publication has been superseded by the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. [Footnote renumbered, June 2007.]

[3] SOP 78-10 has no effective date. This SOP amends, but does not affect the status of, SOP 78-10.

and 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*,[4],[5] in determining whether the financial position, results of operations, and cash flows of the for-profit entity should be included in the not-for-profit organization's financial statements.[6]

Investments in Common Stock of For-Profit Entities Wherein the Not-for-Profit Organization Has a 50 Percent or Less Voting Interest

.06 Investments in common stock of for-profit entities wherein the not-for-profit organization has 50 percent or less of the voting stock in the investee should be reported under the equity method in conformity with Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for*

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[4] Paragraph C2 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, amends the last sentence of paragraph 2 of ARB No. 51, *Consolidated Financial Statements*, by deleting the phrase "is likely to be temporary or if it" from that sentence. The amended sentence in paragraph 2 therefore reads as follows:

> "A majority-owned subsidiary shall not be consolidated if control ~~is likely to be temporary or if it~~ does not rest with the majority owner..."

This SOP has been conformed to FASB Statement No. 144 to eliminate the exception to consolidation for a temporarily controlled subsidiary in circumstances in which this SOP requires consolidation based on a controlling financial interest (paragraphs .05 and .10 of this SOP). No such conforming change to this SOP is appropriate in circumstances in which consolidation is required or permitted based on control through other than a controlling financial interest (paragraphs .11 and .12 of this SOP). Accordingly, this SOP retains the exception to consolidation for a temporarily controlled subsidiary in circumstances in which consolidation is required or permitted based on control through other than a controlling financial interest.

[5] EITF Issue No. 04-5 requires consolidation by a general partner of limited partnerships or similar entities (such as limited liability companies that have governing provisions that are the functional equivalent of a limited partnership) unless the rights of the limited partners overcome a presumption that the general partner controls a limited partnership. Paragraphs 6–19 and the examples in Exhibit 04-5A of EITF Issue No. 04-5 provide a framework to determine if a general partner, or the general partners as a group, controls a limited partnership or similar entity when the limited partners have certain rights. If the presumption of control by the general partners is overcome, each of the general partners should account for its investment in the limited partnership using the equity method of accounting. The consensus does not apply to partnerships that are reported at fair value in conformity with paragraphs A.10–A.13 of this Guide. That is, if an organization is required to apply the consolidation guidance included in ARB No. 51 and FASB Statement No. 94 to its investment in a limited partnership, it is within the scope of EITF Issue No. 04-5. It also need not be applied in circumstances in which no single general partner in a group of general partners controls the limited partnership. The consensus opinion in this EITF Issue has been ratified by the FASB. EITF Consensus Opinions are category (c) GAAP as described in SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles. The accounting conclusions in this SOP are category (b) GAAP as described in SAS No. 69. Including the EITF Consensus Opinions within this SOP does not change their position in the GAAP hierarchy. However, the guidance in this consensus opinion may be relevant in applying the guidance in this SOP and should be considered in conjunction with it. A more detailed summary of this consensus opinion is provided in the "Summary" of "Significant Matters Since the Issuance of this SOP." [Footnote added, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5.]

[6] [Footnote removed, March 2008, due to indefinite deferral of effective date of SOP 07-1 by FSP SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1*.]

Investments in Common Stock, if the guidance in that Opinion requires use of the equity method, subject to the exception in paragraph .07 of this SOP.[7] ,[[8]] Also, not-for-profit organizations should make the financial statement disclosures required by APB Opinion No. 18 if the guidance in that Opinion requires them.

.07 Some AICPA audit guides applicable to some not-for-profit organizations (as discussed in paragraphs A.10–A.13 of the appendix A of chapter 8 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* permit investment portfolios to be reported at market value in certain circumstances. FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*,[**] permits common stock and "in-substance common stock" to be reported at fair value. Not-for-profit organizations that choose to report investment portfolios at market value in conformity with the AICPA audit guides or that make an election to report investments in common stock or "in-substance common stock" at fair value pursuant to FASB Statement No. 159 may do so instead of applying the equity method of accounting to investments covered by paragraph .06 of this SOP. [Revised, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159; Revised, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1; Revised, March 2008, to remove conforming changes made to reflect SOP 07-1 due to indefinite deferral of effective date of SOP 07-1 by FSP SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1*.]

Financially Interrelated Not-for-Profit Organizations

.08 Not-for-profit organizations may be related to one or more other not-for-profit organizations in numerous ways, including ownership, *control*,[9] and *economic interest*.

.09 As discussed in paragraphs .10–.13, the various kinds and combinations of control and economic interest result in various financial reporting. Certain kinds of control result in consolidation (paragraph .10). Other kinds of

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[7] EITF Issue No. 02-14, *Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock*, requires use of the equity method for investments that are deemed "in-substance common stock" (as defined in the consensus opinion). The consensus opinion in this EITF Issue has been ratified by the FASB. EITF Consensus Opinions are category (c) GAAP as described in AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles. The accounting conclusions in this SOP are category (b) GAAP as described in AU section 411. Including the EITF Consensus Opinions within this SOP does not change their position in the GAAP hierarchy. However, the guidance in this consensus opinion may be relevant in applying the guidance in this SOP and should be considered in conjunction with it. A summary of this consensus opinion is provided in the "Summary" of "Significant Matters Since the Issuance of this SOP." [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

[[8]] [Footnote removed, March 2008, due to indefinite deferral of effective date of SOP 07-1 by FSP SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1*.]

[**] FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157, *Fair Value Measurement*. [Footnote added, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159; Footnote renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

[9] Words or terms defined in the Glossary [paragraph .20] are in italicized type the first time they appear in this SOP. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

control result in consolidation only if coupled with an economic interest (paragraph .11). Still other kinds of control result in consolidation being permitted but not required if coupled with an economic interest (paragraph .12). The existence of control or an economic interest, but not both, is discussed in paragraph .13.

.10 Not-for-profit organizations with a controlling financial interest in another not-for-profit organization through direct or indirect ownership of a majority voting interest in that other not-for-profit organization should consolidate that other organization, unless control does not rest with the majority owner, in which case consolidation is prohibited, as discussed in ARB No. 51, as amended by FASB Statement Nos. 94 and 144.[10]

.11 In the case of (*a*) control through a majority ownership interest[11] by other than ownership of a majority voting interest, as discussed in paragraph .10, or control through a *majority voting interest in the board of the other entity* and (*b*) an economic interest in other such organizations, consolidation is required, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited.[12, 13]

.12 [10] Control of a separate not-for-profit organization in which the reporting organization has an economic interest may take forms other than majority ownership or voting interest; for example, control may be through contract or affiliation agreement. In circumstances such as these, consolidation is permitted but not required, unless control is likely to be temporary, in which case consolidation is prohibited. If the reporting organization controls a separate not-for-profit organization through a form other than majority ownership or voting interest and has an economic interest in that other organization, and consolidated financial statements are not presented, the notes to the financial statements should include the following disclosures:

- Identification of the other organization and the nature of its relationship with the reporting organization that results in control

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[10] Footnote 4 to paragraph .05 of this SOP discusses the effect of FASB Statement No. 144 on the guidance in this SOP. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

[11] Ownership of not-for-profit organizations may be evidenced in various ways because not-for-profit organizations may exist in various legal forms, such as corporations issuing stock, corporations issuing ownership certificates, membership corporations issuing membership certificates, joint ventures, and partnerships, among other forms. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

[12] Interests by not-for-profit organizations in other not-for-profit organizations may be less than complete interests. For example, a not-for-profit organization may appoint 80 percent of the board of the other not-for-profit organization. If the conditions for consolidation in this SOP are met, the basis of that consolidation would not reflect a minority interest for the portion of the board that the reporting not-for-profit organization does not control, because there is no ownership interest other than the interest of the reporting not-for-profit organization. However, some not-for-profit organizations may enter into agreements with other entities, such as sharing revenue from fund-raising campaigns, resulting in liabilities to those other entities. In such circumstances, those liabilities should be reported. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

[13] Footnote 4 to paragraph .05 of this SOP discusses the effect of FASB Statement No. 144 on the guidance in this SOP. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

- Summarized financial data of the other organization including—
  - Total assets, liabilities, net assets, revenue, and expenses
  - Resources that are held for the benefit of the reporting organization or that are under its control
- The disclosures set forth in FASB Statement No. 57, *Related Party Disclosures*

.13 In the case of control and an economic interest, the presentation of consolidated financial statements, as discussed in paragraph .11, or the disclosures, as discussed in paragraph .12, are required. The existence of control or an economic interest, but not both, precludes consolidation, except as stated in the next sentence, but requires the disclosures set forth in FASB Statement No. 57.[14] Entities that otherwise would be prohibited from presenting consolidated financial statements under the provisions of this SOP, but that currently present consolidated financial statements in conformity with the guidance in SOP 78-10, may continue to do so.

.14 If consolidated financial statements are presented, they should disclose any restrictions made by entities outside of the reporting entity on distributions from the controlled not-for-profit organization to the reporting organization and any resulting unavailability of the net assets of the controlled not-for-profit organization for use by the reporting organization.

Effective Date and Transition

.15 This SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date shall be for fiscal years beginning after December 15, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, prior to its effective date, earlier application of this SOP is encouraged. Comparative financial statements for earlier periods included with those for the period in which this SOP is adopted should be restated.

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[14] The existence of an economic interest does not necessarily cause the entities to be related parties, as defined in FASB Statement No. 57. However, the disclosures required by that Statement also are required under this SOP if an economic interest exists. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

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Appendix A

Background Information and Discussion of Conclusions

A-1. This Appendix discusses considerations that were deemed significant by members of AcSEC in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

Background

Characteristics and Objectives of Financial Reporting

A-2. FASB Statement of Financial Accounting Concepts No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, states, among other things, that financial reporting by not-for-profit organizations should provide information—

> . . . that is useful to . . . resource providers . . . in making rational decisions about the allocation of resources to those organizations. (paragraph 35)

and that is

> . . . about the economic resources, obligations, and net resources of an organization and the effects of transactions . . . that change resources and interests in those resources. (paragraph 43)

A-3. FFASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, as amended by FASB Concepts Statement No. 6, *Elements of Financial Statements*, examines the characteristics that make accounting information useful. The Statement sets forth a hierarchy of qualities, with usefulness for decision making being most important. The two primary characteristics that make accounting information useful are relevance and reliability. Comparability, which includes consistency, interacts with relevance and reliability to increase the usefulness of information.

A-4. Information about the nature of relationships and forms of control among not-for-profit organizations and between not-for-profit organizations and for-profit entities should contribute to the objectives set forth in FASB Concepts Statement No. 4, as well as meet the criteria for accounting information set forth in Concepts Statement No. 2. As indicated in paragraphs A-11 and A-12 of this SOP, the information currently presented in not-for-profit organizations' financial statements may not meet the objectives set forth in Concepts Statement No. 4.

A-5. Related but separate not-for-profit organizations and for-profit entities result from the following:

a. The decision of not-for-profit organizations to structure their operations in a manner that helps them achieve their mission

b. Investments by not-for-profit organizations in for-profit entities

Structure of Not-for-Profit Organizations

A-6. Not-for-profit organizations conduct their operations through a variety of organizational structures. *The Not-For-Profit Organization Reporting Entity* (the Holder Report), a 1986 research report by William W. Holder, identifies three basic kinds of organizational structure:

a. *Simple structures*, consisting of a single entity that conducts all operations and activities of the organization

b. *Separate entities*, conducting individual program activities

c. *Single entity and separate entities*, conducting, respectively, program activities and support and other noncentral activities, such as fund-raising

Relationship of Separate Entities to Each Other

A-7. The Holder Report, as well as other studies, identified a variety of relationships that could indicate that the resources and activities of an entity are controlled by another entity. Among the most widespread are the following:

- *Ownership*—One entity is the legal owner of another entity, either through stock ownership or some other means, such as membership in a membership corporation.
- *Board membership*—(*a*) One entity has the ability to appoint or elect a voting majority of the board of directors of another entity or (*b*) a voting majority of one entity's board, as a result of its charter or bylaws, is also a voting majority of the board of another entity.
- *Charter or bylaws*—The corporate charter or bylaws of an entity limits its activities to those that are beneficial to another entity.
- *Oversight relationship*—A national charter establishes conditions, such as financial relationships or an accreditation process, for a separate entity's use of a national name or participation in the activities of a national organization.
- *Contract*—The relationship between separate entities is spelled out in a written contract.

Factors Influencing Relationships of Separate Entities to Each Other

A-8. According to the Holder Report, the most common reasons for establishing separate entities are the following:

- *Taxes*—To ensure the income tax deductibility of contributions by donors and to avoid problems of unrelated business income for taxation purposes
- *Legal*—To limit legal liability; protect funding sources; and avoid laws, rules, and regulations perceived to be overly restrictive
- *Organization*—To establish clear-cut organizational limits of authority and autonomy for various activities
- *Public identity*—To create a separate, distinct public identity for the specific activity in question

Generally, entities that are established for these reasons are not-for-profit organizations; however, they also may be for-profit entities, principally for tax reasons.

Not-for-Profit Organization Investment Portfolio Relationships

A-9. Not-for-profit organizations' investment portfolios may include ownership interests in for-profit entities. Such investments generally are made to earn returns on assets rather than to conduct operating activities and frequently are held for long-term investment purposes. Some not-for-profit organizations holding such investments own more than 20 percent interests in these for-profit organizations; for example—

- A federated fund-raising organization may hold a majority interest in an oil company.
- A not-for-profit organization's endowment fund may include controlling interests in shopping malls, commercial buildings, and venture capital funds.

Current practice for reporting such investments is diverse, including cost, lower of cost or market, fair market value, and the equity method. Such investments generally are not reported by consolidating their financial statements with the financial statements of the reporting not-for-profit organizations.

Current Authoritative Literature

A-10. Current authoritative literature on reporting the resources and activities of related entities of which one or more is a not-for-profit organization is inconsistent. Two noteworthy instances are the following:

- Appendix B [paragraph .17] discusses the inconsistencies in the AICPA audit and accounting guides and the SOP listed in paragraph .02 of this SOP. Efforts to correct or address these inconsistencies will take a long time, and no immediate guidance is anticipated other than this SOP.
- There has been uncertainty in practice over whether and to what extent certain pronouncements of the FASB—for example, FASB Statement No. 94—apply to not-for-profit organizations. In September 1994, the AICPA Accounting Standards Executive Committee (AcSEC) issued SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*, which provides that not-for-profit organizations should follow the guidance in effective provisions or ARBs, APB Opinions, and FASB Statements and Interpretations except for specific pronouncements that explicitly exempt not-for-profit organizations.

Appendix C [paragraph .18] summarizes other projects related to this SOP and their current status.

Needs of Financial Statement Users

A-11. Because of the variety of organizational structures, the nature of the relationships among separate entities, and the inconsistency of the guidance in the current authoritative accounting literature, the needs of users of not-for-profit organizations' financial reports described in FASB Concepts Statement Nos. 2 and 4 may not be met.

A-12. Among the deficiencies noted by creditors, identified in the Holder Report, are the following:

- Relationships with and among affiliated entities and other related parties are not always clear and readily understandable in an organization's financial reports.
- Creditors sometimes are unable to understand the scope of activities and range of entities that make up the reporting entity simply by reading the financial reports.
- Substantially different reporting practices exist for similar economic circumstances.

Among the deficiencies noted by grantors and contributors, also identified in the Holder Report, are the following:

- Reporting for fund-raising and administrative activities sometimes is fragmented into more than one set of financial statements.
- The level of disclosure in financial statements about the kinds of activities conducted and the existence and inclusion of related entities is inadequate. Of specific concern is whether all the resources controlled and all the activities conducted by a not-for-profit organization are included in its financial statements.

Reporting and Disclosures

A-13. Relationships between not-for-profit organizations and other entities range from complete control of the other entities by a central organization to a loose association. These relationships have resulted in the following eight financial reporting alternatives:

a. Consolidation or combination under the guidelines in ARB 51, FASB Statement No. 94, and SOP 78-10[#]

b. Reporting the investment under the equity method of accounting for investments

c. Reporting the investment at cost

d. Reporting the investment at market

e. Reporting the investment at the lower of cost or market

f. Disclosures similar to those under the AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*

g. Related-party disclosures under the guidelines of FASB Statement No. 57

h. No reporting or disclosures

Consolidation and Combination

A-14. Drawing on ARB 51, FASB Statement No. 94, paragraph 1, states:

> The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions.

A-15. SOP 78-10,[#] which is included in the AICPA Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*[#] and which predates FASB Statement No. 94, states in paragraphs 42 and 43:

> For a reporting organization that controls another organization having a compatible purpose, it is presumed that combined or combining financial statements are more meaningful than separate statements and are usually necessary for a fair presentation in conformity with generally accepted accounting principles. *Control* means the direct or indirect ability to determine the direction of the management and policies through ownership, by contract, or otherwise.
>
> The accounting standards division has considered the foregoing definition in relation to the nonprofit organizations covered by this statement of

[#] This publication has been superseded by the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. [Footnote renumbered, June 2007.]

> position and has concluded that it may be construed by some to be so broad, considering the structure of some nonprofit organizations, that presentation of combined financial statements might have relatively little value to users of such combined statements, particularly in relation to the cost of their preparation.

SOP 78-10, paragraph 44, states, in part:

> . . . combined financial statements should be presented if (1) control exists as defined in paragraph 42 and (2) any of the following circumstances exists:
>
> *a.* Separate entities solicit funds in the name of and with the expressed or implied approval of the reporting organization, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or used at its discretion or direction.
>
> *b.* A reporting organization transfers some of its resources to another separate entity whose resources are held for the benefit of the reporting organization.
>
> *c.* A reporting organization assigns functions to a controlled entity whose funding is primarily derived from sources other than public contributions.

Equity Method

A-16. APB Opinion 18 states in paragraph 17:

> . . . the equity method of accounting for an investment in common stock should . . . be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency.

Disclosures

A-17. Paragraph 13.04 of *Audits of Providers of Health Care Services* suggests presenting "summarized information about the assets, liabilities, results of operations, and changes in fund balances of related organizations" that "describe the nature of the relationships between . . . the related organizations."

A-18. FASB Statement No. 57 requires the following disclosures for material related-party transactions:

- The existence and nature of the relationship
- A description of the transactions between the entities, summarized if appropriate, for the period reported on, including amounts, if any, and any other information deemed necessary to an understanding of the effects of those transactions on the reporting organization's financial statements
- The dollar volume of transactions between the entities and the effects of any changes in the method of establishing their terms from the preceding period
- Amounts due from or to the related entities, and, if not otherwise apparent, the terms and manner of settlement

Discussion of Conclusions

Scope

A-19. Consistent with the May 19, 1993, exposure draft of this SOP, this SOP does not apply to entities that are included in the scope of *Audits of Providers of Health Care Services*. AcSEC considered including those entities in the scope of this SOP but exempted them for practical purposes. The ways those entities are related to each other are evolving and may not be contemplated by this SOP. For example, many of those entities are affiliated based on participation in networks of health care providers, with complex contractual agreements that make it difficult to determine whether control and economic interest exist based on the definitions in this SOP. While AcSEC believes the basic principles in this SOP also may apply to those entities, further study and deliberation are necessary to determine whether this SOP would require clarification for it to be made operational for those entities. Further, AcSEC believes (*a*) there is a need for guidance now for entities included in the scope of this SOP and (*b*) including entities covered by *Audits of Providers of Health Care Services* in the scope of this SOP likely would delay its issuance. Accordingly, AcSEC concluded it should exclude entities that are required to follow *Audits of Providers of Health Care Services* from the scope of this SOP. Guidance for reporting related entities for entities covered by *Audits of Providers of Health Care Services* is expected to be included as part of the current project to revise that guide.

Underlying Principles

A-20. The conclusions in this SOP are based on the premise that (*a*) whether the financial statements of a reporting not-for-profit organization and those of one or more other entities (either a not-for-profit organization or a for-profit entity) should be consolidated and (*b*) the extent of disclosure that should be required, if any, if consolidated financial statements are not presented should be based on the nature of the relationship between the entities.

Control

A-21. This SOP does not develop new concepts concerning the definition of control. Because the FASB currently has on its agenda a project on consolidations and related matters that may result in a definition of control different from that contained in SOP 78-10, AcSEC concluded that it should not revise the definition of control at this time.[15]

Relation to Other Guidance

A-22. This SOP makes uniform the application of APB Opinion No. 18 and FASB Statement No. 94 for not-for-profit organizations with the following exception: This SOP permits not-for-profit organizations that otherwise would report their investment portfolios at market value in conformity with guidance in the not-for-profit audit guides to do so instead of adopting the equity method for unconsolidated subsidiaries and 50 percent or less owned entities. AcSEC permitted this exception because it believes uniform guidance will be issued by the FASB on reporting the overall investment activities of not-for-profit organizations as part of the FASB's project on not-for-profit organizations.

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[15] In January 2004, after the issuance of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, the FASB moved its consolidations and related matters project from its technical agenda to its research project agenda. To date, no changes to the guidance in this SOP have resulted from the FASB's consolidations and related matters project. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

A-23. The conclusions in this SOP evolve from and consider the conclusions of SOP 78-10 and *Audits of Providers of Health Care Services* to provide uniform criteria for consolidation. They provide for financial statement disclosures that can be applied objectively and that can curb potential abuses in not reporting (*a*) the results of separate but related entities established by a not-for-profit organization to raise funds on its own behalf and (*b*) assets controlled by another not-for-profit organization. (This SOP does not revise *Audits of Providers of Health Care Services*.)

A-24. This SOP requires consolidation if there is an economic interest and control by either a majority voting interest in the board of the other entity or the ability to appoint a majority of its board members. Some not-for-profit organizations are related to each other in ways that would meet the definition of control under this SOP. However, in the case of some of the organizations, no such economic interest exists. In circumstances of control other than a controlling financial interest in another not-for-profit organization through direct or indirect ownership of a majority voting interest, this SOP requires the existence of an economic interest for consolidation to be required or permitted. That provision is included in order to preclude the reporting of misleading information about the assets, liabilities, results of operations, and cash flows of the reporting organization.

Economic Interest

A-25. The Glossary [paragraph .20] of this SOP states that "[a]n *economic interest* in another entity exists if (*a*) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the not-for-profit organization, either directly or indirectly by producing income or providing services, or (*b*) the reporting organization is responsible for the liabilities of the other organization." The Glossary [paragraph .20] includes examples of circumstances that result in economic interests, including a reporting organization assigning certain of its functions to another entity. For example, an educational institution assigning its research functions to a research corporation that holds significant resources that must be used for the unrestricted or restricted purposes of the reporting organization, either directly or indirectly, results in an economic interest in that research corporation. Also, an organization may have an economic interest in a lobbying organization if that lobbying organization conducts any of the organization's lobbying functions and uses significant resources that must be used for the unrestricted or restricted purposes of the reporting organization, either directly or indirectly.

Circumstances Permitting but Not Requiring Consolidation

A-26. Paragraph .12 of this SOP permits but does not require consolidation if the reporting not-for-profit organization controls a separate not-for-profit organization in which it has an economic interest and that control is achieved other than control through—

a. A controlling financial interest in the other not-for-profit organization through direct or indirect ownership of a majority voting interest or

b. A majority voting interest in the board of the other entity.

AcSEC considered requiring consolidation in all circumstances in which the reporting not-for-profit organization controls and has an economic interest in another not-for-profit organization. However, AcSEC believes consolidation may not be meaningful in all situations in which there is control and an economic interest. For example, some national organizations may control local chapters through affiliation agreements and receive funds from those local chapters. In such circumstances, both control and an economic interest exist. However, consolidation may not be meaningful. AcSEC encourages consolidation if—

a. The reporting not-for-profit organization controls a separate not-for-profit organization in which it has an economic interest and that control is other than control through—

   i. A controlling financial interest in the other not-for-profit organization through direct or indirect ownership of a majority voting interest or

   ii. A majority voting interest in the board of the other entity and

b. Consolidation would be meaningful.

Disclosures

A-27. AcSEC believes the disclosures required by this SOP in circumstances in which control exists by contract, agreement, or otherwise provide financial statement users with information that is more meaningful than the information they now receive under the existing not-for-profit audit guides. The disclosure requirements in this SOP are an interim step until the FASB completes its consolidations and related matters project.[16]

Combined Financial Statements

A-28. This SOP provides guidance concerning consolidated financial statements. As discussed in footnote 1, ARB 51 provides guidance concerning combined financial statements. Paragraph 22 of ARB 51 states that "there are circumstances, however, where combined financial statements (as distinguished from consolidated statements) of commonly controlled companies are likely to be more meaningful than their separate statements." This SOP prohibits consolidated financial statements in certain circumstances. However, it provides no guidance concerning combined financial statements of commonly controlled not-for-profit organizations, which may be presented, in certain circumstances, in conformity with the guidance in ARB 51.

Parent or Subsidiary-Only Financial Statements

A-29. This SOP provides no guidance concerning parent-entity-only or subsidiary-entity-only financial statements. Paragraph 15 of FASB Statement No. 94 precludes the use of parent-company financial statements for use as the general-purpose financial statements of the primary reporting entity. However, that Statement is silent concerning parent-company financial statements as other than general-purpose financial statements for the primary reporting entity. Generally accepted accounting principles do not preclude the issuance of subsidiary-only financial statements. However, care should be taken to include all disclosures required by FASB Statement No. 57 and other relevant pronouncements.

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[16] See footnote 15. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote revised and further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

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Appendix B

Other Financial Reporting Literature

B-1. The following discusses the authoritative and other financial reporting literature that is relevant to AcSEC's consideration of consolidated financial statements involving not-for-profit organizations. All references and discussion pertain to literature as it exists prior to being revised by this SOP. As discussed in paragraph .02, this SOP revises certain AICPA literature.

SOP 78-10

B-2. SOP 78-10,[#] *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, is discussed in paragraph A-15 of this SOP. (As discussed in paragraph .02 of this SOP, this SOP amends SOP 78-10.)

Audits of Providers of Health Care Services

B-3. The AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*, paragraph 13.02, recommends consolidation or combination of organizations related to health care entities by direct or common ownership in accordance with the provisions of ARB 51. In cases in which related organizations are controlled through means other than direct or common ownership and ARB 51 does not require consolidation, *Audits of Providers of Health Care Services* does not recommend consolidation or combination.

B-4. In circumstances in which *Audits of Providers of Health Care Services* does not recommend consolidation or combination, paragraph 13.04 of that guide requires disclosure of certain summarized information concerning the related organizations if control and at least one of the following circumstances exist:

a. The organization has solicited funds in the name of the health care entity and with the expressed or implied approval of the health care entity, and substantially all the funds solicited by the organization were intended by the contributor, or were otherwise required, to be transferred to the health care entity or used at its discretion or direction.

b. The health care entity has transferred some of its resources to the organization, and substantially all of the organization's resources are held for the benefit of the health care entity.

c. The health care entity has assigned certain of its functions (such as the operation of a dormitory) to the organization, which is acting primarily for the benefit of the health care entity.

(As discussed in paragraph .02 of this SOP, this SOP does not amend *Audits of Providers of Health Care Services*.)

Audits of Colleges and Universities

B-5. *The AICPA Industry Audit Guide Audits of Colleges and Universities*,[#] paragraph 11.09, states:

[#] This publication has been superseded by the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. [Footnote renumbered, June 2007.]

> For adequate disclosure, all separately incorporated but related units for which the reporting institution is fiscally responsible, such as university presses, intercollegiate athletics, and research foundations, should be (1) included in the financial statements, (2) adequately disclosed by notes, or (3) presented in separate financial statements accompanied by and cross-referenced in the basic financial statements of the institution.

(As discussed in paragraph .02 of this SOP, this SOP amends *Audits of Colleges and Universities*.)[#]

Audits of Voluntary Health and Welfare Organizations

B-6. The AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* provides no guidance on whether consolidated financial statements should be presented. However, paragraphs 7.08 and 7.09 provide guidance for determining whether auditors should audit the financial statements of organizations associated with the reporting not-for-profit organization. (As discussed in paragraph .02 of this SOP, this SOP amends *Audits of Voluntary Health and Welfare Organizations.*)

[#] This publication has been superseded by the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. [Footnote renumbered, June 2007.]

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Appendix C
Other Projects Related to This SOP

FASB Project on Consolidations and Related Matters

C-1. This project is addressing various issues concerning the reporting entity, including those relating specifically to not-for-profit organizations. The FASB issued its September 10, 1991, Discussion Memorandum, *Consolidation Policies and Procedures*. The conclusions in this SOP will be reconsidered when the FASB completes its project on consolidations and related matters, which may affect the definition of control and other related matters. In January 2004, after the issuance of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, the FASB moved its consolidations and related matters project from its technical agenda to its research project agenda. To date, no changes to the guidance in this SOP have resulted from the FASB's consolidations and related matters project.

FASB Project on Investments

C-2. This project is addressing various issues concerning investments held by not-for-profit organizations. The project is in the preliminary stages. The conclusions in this SOP will be reconsidered when the FASB completes its project on investments, which may affect the conclusions concerning investments in common stock of for-profit entities wherein the not-for-profit organization has a 50 percent or less voting interest and other related matters. [*In November 1995, the FASB issued FASB Statement No. 124,* Accounting for Certain Investments Held by Not-for-Profit Organizations, *which does not effect the conclusions of this SOP*.]

AICPA Project on the Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations

C-3. In September 1994, AcSEC issued SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations* [section 10,600], which provides that not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations except for specific pronouncements that explicitly exempt not-for-profit organizations.

AICPA Accounting and Audit Guide Revisions

C-4. The AICPA will revise the existing audit and accounting guides for not-for-profit organizations and colleges and universities to reflect the accounting and reporting requirements of FASB Statement Nos. 116, *Accounting for Contributions Received and Contributions Made*, and 117, *Financial Statements of Not-for-Profit Organizations*, among other things.[17]

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[17] In 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*, to reflect the accounting and reporting requirements of FASB Statement Nos. 116 and 117, among other things. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

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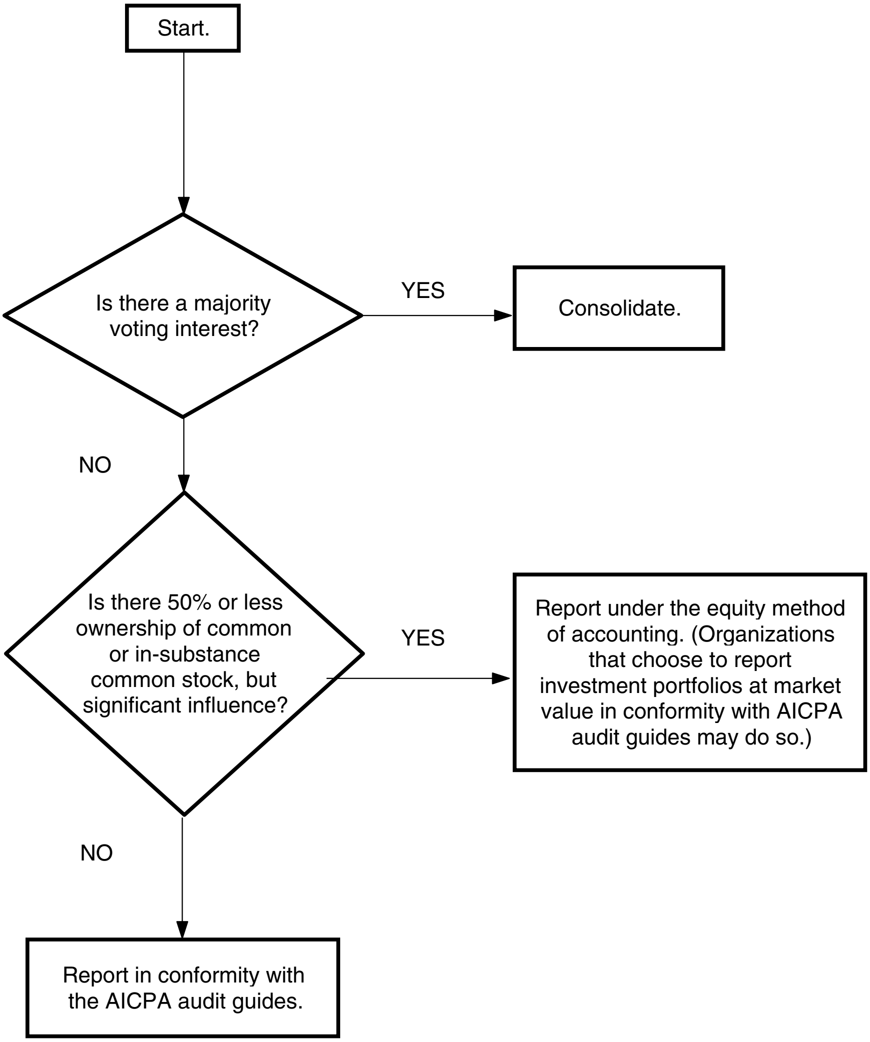
Appendix D

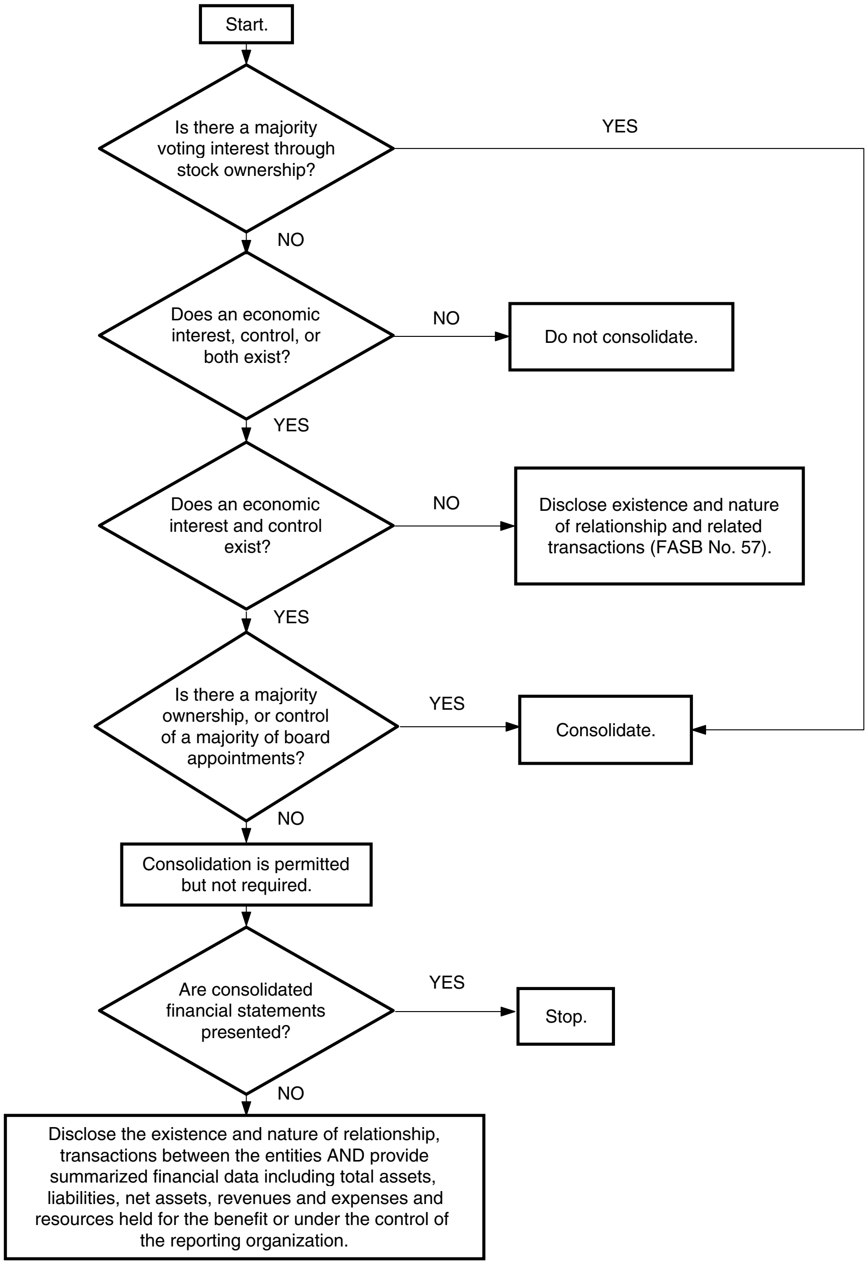
Flowcharts and Decision Trees[18]

Ownership of a For-Profit Entity



[18] The flowcharts and decision trees summarize certain guidance in this SOP and are not intended as substitutes for the SOP. [Footnote renumbered, May 2006, to reflect conforming changes necessary due to the issuance of EITF Issue No. 04-5; Footnote further renumbered, June 2007, to reflect conforming changes necessary due to the issuance of SOP 07-1.]

Relationship With Another Not-for-Profit Organization



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Glossary

Control. The direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.

Economic interest. An interest in another entity that exists if (*a*) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the not-for-profit organization, either directly or indirectly by producing income or providing services, or (*b*) the reporting organization is responsible for the liabilities of the other entity. The following are examples of economic interests:

- Other entities solicit funds in the name of and with the expressed or implied approval of the reporting organization, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or used at its discretion or direction.
- A reporting organization transfers significant resources to another entity whose resources are held for the benefit of the reporting organization.
- A reporting organization assigns certain significant functions to another entity.
- A reporting organization provides or is committed to provide funds for another entity or guarantees significant debt of another entity.

Majority voting interest in the board of another entity. For purposes of this SOP, a majority voting interest in the board of another entity is illustrated by the following example. Entity B has a five-member board, and a simple voting majority is required to approve board actions. Entity A will have a majority voting interest in the board of entity B if three or more entity A board members, officers, or employees serve on or may be appointed at entity A's discretion to the board of entity B. However, if three of entity A's board members serve on the board of entity B but entity A does not have the ability to require that those members serve on the entity B board, entity A does not have a majority voting interest in the board of entity B.

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The committees gratefully acknowledge the significant contributions of Mary F. Foster and Richard F. Larkin.

[The next page is 79,961.]

Section 10,620

Statement of Position 94-4
Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans

September 23, 1994

NOTE

Statements of Position (SOPs) of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA SOPs as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this SOP should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

SOP 94-4 is amended by SOP 99-3, *Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters*. SOP 99-3 is effective for financial statements for plan years ending after December 15, 1999. Earlier application is encouraged for fiscal years for which annual financial statements have not been issued. If the previously required "by fund" disclosures are eliminated, the reclassification of comparative amounts in financial statements for earlier periods is required.

SOP 94-4 is also amended by FASB Staff Position (FSP) AAG INV-1 and SOP 94-4-1, *Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans*. The financial statement presentation and disclosure guidance in paragraphs 8–11 of FSP AAG INV-1 and SOP 94-4-1 is effective for financial statements for plan years ending after December 15, 2006. The revised definition of fully benefit-responsive in paragraph 7 of the FSP shall be effective for all investment contracts as of the last day of the annual period ending after December 15, 2006. Earlier application is permitted for fiscal years in which annual financial statements have not been issued. If comparative financial statements are presented, the guidance in that FSP shall be applied retroactively to all prior periods presented. If an investment contract is considered fully benefit-responsive under the revised definition as of the last day of the annual period ending after December 15, 2006, that contract shall be considered fully benefit-responsive for all periods presented, provided that contract would have been considered fully benefit-responsive in accordance with the then existing provisions of this SOP.

Introduction

.01 The American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide) includes standards of financial accounting and reporting for the financial statements

statements of health and welfare benefit plans and defined-contribution pension plans. The Guide states that plan investments are generally to be presented at their fair value at the reporting date. Paragraph 3.15 of the Guide states that "contracts with insurance companies are to be included as plan assets in the manner required by [the Employee Retirement Income Security Act of 1974] ERISA annual reporting requirements and are to be reported in a manner consistent with the requirements of [Department of Labor] DOL Form 5500 or 5500-C/R." Paragraph 4.10 of the Guide and paragraph 26 of AICPA Statement of Position (SOP) 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans* [section 10,530.26], contain similar language. The instructions to DOL Forms 5500 and 5500-C/R permit unallocated insurance contracts to be reported at either fair value or amounts determined by the insurance company, that is, contract value. Currently, "contracts with insurance companies" include investment contracts that do not incorporate mortality or morbidity risk. The Guide specifically excludes contract value reporting for investments in similar contracts issued by banks, savings institutions, or other financial institutions. Contract value generally equals the principal balance plus accrued interest.

.02 The Financial Accounting Standards Board (FASB) has issued Statement of Financial Accounting Standards Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts,* which requires defined-benefit pension plans to report investment contracts issued by either an insurance enterprise or other entity at fair value. It amends FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* to permit defined-benefit pension plans to report only contracts that incorporate mortality or morbidity risk at contract value. The FASB decided not to address the measurement of plan assets held by health and welfare benefit plans or defined-contribution pension plans. Instead, the FASB asked the AICPA, in view of its experience with those plans, to address further the appropriate reporting of investments held by those plans.

Scope

.03 This SOP provides guidance on the reporting of investment and insurance contracts held by health and welfare benefit plans and defined-contribution pension plans. It applies to all health and welfare benefit plans and defined-contribution pension plans. The Appendix [paragraph .20] provides guidance for determining whether contract value accounting is appropriate for investment contracts held by defined-contribution plans, including both health and welfare, and pension plans. Certain examples may also be useful in determining the fair value of investment contracts held by other types of plans. [As amended, effective for financial statements for plan years ending after December 15, 2006, by FASB Staff Position AAG INV-1 and SOP 94-4-1.]

Conclusions

Reporting of Contracts

.04 Defined-benefit health and welfare benefit plans should report investment contracts at fair value. Defined-contribution plans, including both health and welfare and pension plans, should report all investments (including derivative contracts) at fair value. However, contract value is the relevant measurement attribute for that portion of the net assets available for benefits of a defined-contribution plan attributable to fully benefit-responsive investment contracts. [As amended, effective for financial statements for plan years ending after December 15, 2006, by FASB Staff Position AAG INV-1 and SOP 94-4-1.]

.05 Health and welfare benefit plans and defined-contribution pension plans should report insurance contracts in the same manner required by ERISA annual reporting requirements of DOL Form 5500 or 5500-C/R. For purposes of this SOP, the terms *insurance contract* and *investment contract* are used as those terms are described for accounting purposes in FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises,* and No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (see paragraphs .13 and .14).

Background

.06 Defined-benefit plans provide participants with a determinable benefit based on a formula provided for in the plans, whereas defined-contribution plans provide benefits based on amounts contributed to an employee's individual account plus or minus forfeitures, investment experience, and administrative expenses. The Internal Revenue Code (IRC) generally requires that all investment experience under defined-contribution plans be allocated to individual account balances.

.07 Consequently, information relevant to the primary users of defined-contribution plan financial statements—plan participants—is different from that which is relevant to users of defined-benefit plan financial statements. In defined-contribution plans, plan participants have a greater vested interest in monitoring the financial condition and operations of the plan since they bear investment risk under these plans and plan transactions can directly affect their benefits.

.08 The primary objective of a defined-contribution plan's financial statements is to provide information that is useful in assessing the plan's present and future ability to pay benefits when they are due. In a defined-contribution plan, the plan's net assets available to pay benefits equal the sum of participants' individual account balances. Accordingly, benefits that can be paid by the plan when they are due relate to the value of the assets that may currently be made available to the individual participants.

.09 Consistent with the objective of a defined-contribution plan's financial statements, net assets available for benefits of defined-contribution plans should be measured and reported at values that are meaningful to financial statement users. Information that is useful to plan participants includes the amount they would receive currently if they were to withdraw or borrow funds from or transfer funds within the plan. [As amended, effective for financial statements for plan years ending after December 15, 2006, by FASB Staff Position AAG INV-1 and SOP 94-4-1.]

[.10] [Paragraph deleted by the issuance of FASB Staff Position AAG INV-1 and SOP 94-4-1, December 2005.]

.11 An investment contract is considered fully benefit-responsive for purposes of this SOP, if *all* of the following criteria are met for that contract, analyzed on an individual basis:

a. The investment contract is effected directly between the plan and the issuer and prohibits the plan from assigning or selling the contract or its proceeds to another party without the consent of the issuer.

b. Either (1) the repayment of principal and interest credited to participants in the plan is a financial obligation of the issuer of the investment contract or (2) prospective interest crediting rate adjustments are provided to participants in the plan on a designated pool of investments held by the plan or the contract issuer, whereby a financially responsible third party, through a contract generally referred to as a wrapper, must provide assurance that the adjustments to the interest crediting rate will not result in a future interest crediting rate that is less than zero. If an event has occurred such that realization of full contract value for a particular investment contract is no longer probable (for example, a significant decline in credit-worthiness of the contract issuer or wrapper provider), the investment contract shall no longer be considered fully benefit-responsive.

c. The terms of the investment contract require all permitted participant-initiated transactions with the plan to occur at contract value with no conditions, limits, or restrictions. Permitted participant-initiated transactions are those transactions allowed by the plan, such as withdrawals for benefits, loans, or transfers to other funds within the plan.

d. An event that limits the ability of the plan to transact at contract value with the issuer (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives) and that also limits the ability of the plan to transact at contract value with the participants in the plan must be probable of not occurring.

e. The plan itself must allow participants reasonable access to their funds.

If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. For example, if plan participants are allowed access at contract value to all or a portion of their account balances only upon termination of their participation in the plan, it would not be considered reasonable access and, therefore, investment contracts held by that plan would generally not be deemed to be fully benefit-responsive. However, in plans with a single investment fund that allow reasonable access to assets by inactive participants, restrictions on access to assets by active participants consistent with the objective of the plan (for example, retirement or health and welfare benefits) will not affect the benefit responsiveness of the investment contracts held by those single-fund plans. Also, if a plan limits participants' access to their account balances to certain specified times during the plan year (for example, semiannually or quarterly) to control the administrative costs of the plan, that limitation generally would not affect the benefit responsiveness of the investment contracts held by that plan. In addition, administrative provisions that place short-term restrictions (for example, three or six months) on transfers to competing fixed-rate investment options to limit arbitrage among those investment options (*equity wash* provisions) would not affect a contract's benefit responsiveness. [As amended, effective for all investment contracts as of the last day of the annual period ending after December 15, 2006, by FASB Staff Position AAG INV-1 and SOP 94-4-1.]

.12 If a plan holds multiple contracts, each contract should be evaluated individually for benefit responsiveness. If a plan invests in pooled funds that hold investment contracts, each contract in the pooled fund should be evaluated individually for benefit responsiveness. However, if the pooled fund places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive. Contracts that provide for prospective interest adjustments may still be fully benefit-responsive provided that the terms of the contracts specify that the crediting interest rate cannot be less than zero. The Appendix [paragraph .20] to this SOP includes examples of the application of the definition of fully benefit-responsive for defined-contribution plan investments. [As amended, effective for financial statements for plan years ending after December 15, 2006, by FASB Staff Position AAG INV-1 and SOP 94-4-1.]

.13 As discussed in paragraph .05, for purposes of this SOP, the terms *insurance contract* and *investment contract* are described for accounting purposes in FASB Statements No. 60 and No. 97. Paragraph 1 of FASB Statement No. 60 describes insurance contracts:

> The primary purpose of insurance is to provide economic protection from identified risks occurring or discovered within a specified period. Some types of risks insured include death, disability, property damage, injury to others, and business interruptions. Insurance transactions may be characterized generally by the following:
>
> *a.* The purchaser of an insurance contract makes an initial payment or deposit to the insurance enterprise in advance of the possible occurrence or discovery of an insured event.
>
> *b.* When the insurance contract is made, the insurance enterprise ordinarily does not know if, how much, or when amounts will be paid under the contract.

.14 Paragraphs 7 and 8 of FASB Statement No. 97 describe insurance and investment contracts:

> Long-duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity are referred to in this Statement as investment contracts. A mortality or morbidity risk is present if, under the terms of the contract, the enterprise is required to make payments or forego required premiums contingent upon the death or disability (in the case of life insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals. A contract provision that allows the holder of a long-duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms.
>
> Annuity contracts may require the insurance enterprise to make a number of payments that are not contingent upon the survival of the beneficiary, followed by payments that are made if the beneficiary is alive when the payments are due (often referred to as life-contingent payments). Such contracts are considered insurance contracts under this Statement and Statement 60 unless (*a*) the probability that life-contingent payments will be made is remote or (*b*) the present value of the expected life-contingent payments relative to the present value of all expected payments under the contract is insignificant. [Footnote references omitted.]

Financial Statement Presentation and Disclosure Requirements

.15 The statement of net assets available for benefits of the plan shall present amounts for (1) total assets, (2) total liabilities, (3) net assets reflecting all investments at fair value, and (4) net assets available for benefits. The amount representing the difference between (3) and (4) shall be presented on the face of the statement of net assets available for benefits as a single amount, calculated as the sum of the amounts necessary to adjust the portion of net assets attributable to each fully benefit-responsive investment contract from fair value to contract value. The statement of changes in net assets available for benefits shall be prepared on a basis that reflects income credited to participants in the plan and net appreciation or depreciation in the fair value of only those investment contracts that are not deemed to be fully benefit responsive.

Defined-contribution plans, including both health and welfare, and pension plans, shall disclose the following in connection with fully benefit-responsive investment contracts, in the aggregate:

a. A description of the nature of those investment contracts, how they operate, and the methodology for calculating the interest crediting rate, including the key factors that could influence future average interest crediting rates, the basis for and frequency of determining interest crediting rate resets, and any minimum interest crediting rate under the terms of the contracts. This disclosure should explain the relationship between future interest crediting rates and the amount reported on the statement of net assets available for benefits representing the adjustment for the portion of net assets attributable to fully benefit-responsive investment contracts from fair value to contract value.

b. The average yield earned by the plan for all fully benefit-responsive investment contracts (which may differ from the interest rate credited to participants in the plan) for each period for which a statement of net assets available for benefits is presented. This average yield shall be calculated by dividing the annualized earnings of all fully benefit-responsive investment contracts in the plan (irrespective of the interest rate credited to participants in the plan) by the fair value of all fully benefit-responsive investment contracts in the plan.

c. The average yield earned by the plan for all fully benefit-responsive investment contracts with an adjustment to reflect the actual interest rate credited to participants in the plan for each period for which a statement of net assets available for benefits is presented. This average yield shall be calculated by dividing the annualized earnings credited to participants in the plan for all fully benefit-responsive investment contracts in the plan (irrespective of the actual earnings of those investments) by the fair value of all fully benefit-responsive investment contracts in the plan.

d. A description of the events that limit the ability of the plan to transact at contract value with the issuer (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives), including a statement as to whether the occurrence of those events that would limit the plan's ability to transact at contract value with participants in the plan is probable or not probable. [The term *probable* is used in this Statement consistent with its use in FASB Statement No. 5, *Accounting for Contingencies*.]

e. A description of the events and circumstances that would allow issuers to terminate fully benefit-responsive investment contracts with the plan and settle at an amount different from contract value.

[As amended, effective for financial statements for plan years ending after December 15, 1999, by Statement of Position 99-3. As amended, effective for financial statements for plan years ending after December 15, 2006, by FASB Staff Position AAG INV-1 and SOP 94-4-1.]

.16 For ERISA-covered plans, if a fully benefit-responsive investment contract does not qualify for contract-value reporting in the DOL Form 5500 but is reported in the financial statements at contract value, and the contract value does not approximate fair value, the DOL's rules and regulations require that a statement explaining the differences between amounts reported in the financial statements and DOL Form 5500 be added to the financial statements.

Amendments to the Guide

[.17] [Paragraph deleted, June 2006, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Amendment to SOP 92-6 [section 10,530]

[.18] [Paragraph deleted, June 2006, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Effective Date and Transition

.19 This SOP is effective for financial statements for plan years beginning after December 15, 1994, except that the application of this SOP to investment contracts entered into before December 31, 1993, is delayed to plan years beginning after December 15, 1995. Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this SOP should be made as of the beginning of the year in which the change is adopted. The effect of initially applying this SOP should be reported in a manner similar to the cumulative effect of a change in accounting principle (Accounting Principles Board [APB] Opinion No. 20, *Accounting Changes,* paragraph 20). Pro forma effects of retroactive application (APB Opinion 20, paragraph 21) are not required. Restatement of financial statements of prior years is not permitted.

.20

Appendix

Application of Fair Value and Contract Value Reporting for Defined-Contribution Plan Investments

A.1 Defined-contribution plans, including both health and welfare, and pension plans, shall report all investments (including derivative contracts) at fair value. However, contract value is the relevant measurement attribute for that portion of the net assets available for benefits of a defined-contribution plan attributable to fully benefit-responsive investment contracts. If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive.

A.2 Investment contracts may be valued by discounting the related cash flows based on current yields of similar investments with comparable durations. In determining the similarity of investments, appropriate consideration should be given to the credit quality of the contract issuer. Generally, contract termination (penalty) clauses need not be considered unless it is probable that the plan intends to terminate the contract.

A.3 In the following examples, value is determined within the context of the objectives of financial statements for a defined-contribution plan. The valuation must reflect the ability of the plan to pay benefits from the perspective of the participants. This value is then reflected on participants' statements to disclose the amount they can expect to receive when they exercise their rights to withdraw, borrow, or transfer funds under the terms of the plan.

EXAMPLE 1

A Five-Year Public Bond (or Portfolio of Bonds) Which Is Guaranteed by a Third Party to Have a Fixed Value at the End of Three Years

A.4 The guarantee applies only to the extent that the bond (or portfolio) is not liquidated prior to the end of three years. Liquidation within three years is at market value.

A.5 Because guaranteed proceeds from the bond are not available for benefit withdrawals or transfers prior to maturity, the contract is not fully benefit-responsive and, therefore, net assets available for benefits shall reflect the fair value for this investment contract. Fair value may be determined as the amount at which the bond could be exchanged in a current transaction between parties, other than in a forced or liquidation sale, considering the guaranteed fixed value of the bond at the end of three years.

EXAMPLE 2

A Benefit-Responsive Investment Contract

A.6 This contract provides a fixed crediting interest rate, and a financially responsible entity guarantees liquidity at contract value prior to maturity for any and all participant-initiated benefit withdrawals, loans, or transfers arising under the terms of the plan, which allows access for all participants on a quarterly basis.

A.7 The net assets available for benefits shall reflect the contract value for this investment contract, because the plan will receive such value and only such value if the contract is accessed to pay participant benefits or transfers.

A.8 The contract described in the preceding paragraph would be viewed as fully benefit-responsive. Examples of some variations on this contract, and their impact on the valuation, follow.

a. *Liquidity at contract value is not guaranteed for benefits that are attributable to termination of the plan, a plan spin-off to a new employer plan, or amendments to plan provisions.* Net assets available for benefits shall reflect the contract value for this investment contract, unless it is probable that the plan will be terminated, spun off, or amended.

b. *Liquidity at contract value is not guaranteed for benefits that are attributable to the layoff of a large group of workers or an early retirement program.* Net assets available for benefits should reflect the contract value for this investment contract, unless it is probable that termination of the employment of a significant number of employees will occur.

c. *The contract will pay for benefits of up to 30 percent of the contract at contract value, and any excess benefits will be at some adjusted value.* Net assets available for benefits shall reflect the fair value for this investment contract because they are not fully benefit-responsive. Fair value may be determined as the guaranteed amount plus the estimated discounted cash flows related to the amount in excess of 30 percent of the contract value.

d. *The contract will pay benefits at contract value, but only if the issuer of the contract determines that there is sufficient liquidity in the portfolio of assets that backs the contract.* Because the third party has not guaranteed liquidity for participant-initiated withdrawals, net assets available for benefits shall reflect the fair value for this investment contract because they are not fully benefit-responsive.

e. *The contract will not pay benefits at contract value if benefits are due to participant transfers to another fixed income investment option, unless the funds are invested in an equity option for at least three months (*equity wash *provisions).* Net assets available for benefits shall reflect the contract value for this investment contract because the contract would be considered fully benefit-responsive.

EXAMPLE 3

A Five-Year, Nonbenefit-Responsive Investment Contract That Has No Liquid Market for Trading

A.9 Net assets available for benefits shall reflect the fair value for this investment contract because there is no guarantee of liquidity at contract value. Fair value would be determined in the same manner as for an illiquid bond. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments,* includes a discussion of methods used to determine the fair values of illiquid instruments.

EXAMPLE 4

A Benefit-Responsive, Participating, Separate Account Investment Contract

A.10 A financially responsible issuer pays contract value for participant withdrawals, regardless of the value of the assets in the separate account. The credited interest rate is a function of the relationship between the contract value and the value of the assets in the separate account. The rate is reset periodically, daily, monthly, quarterly, and so on, by the issuer and cannot be less than zero. There may or may not be a specified maturity date on the contract. The contractholder may terminate the contract at any time, and receive the value of the assets in the separate account.

A.11 Net assets available for benefits shall reflect the contract value for this investment contract because participants are guaranteed return of principal and accrued interest.

EXAMPLE 5

A Synthetic Investment Contract—"Managed" Type

A.12 This contract operates similarly to a separate account guaranteed investment contract (GIC), except that the assets are placed in a trust (with ownership by the plan) rather than a separate account of the issuer and a financially responsible third party issues a *wrapper* contract that provides that participants can, and must, execute plan transactions at contract value.

A.13 Net assets available for benefits shall reflect the contract value for this investment contract because participants are guaranteed return of principal and accrued interest.

EXAMPLE 6

A Synthetic Investment Contract—"Repurchase" Type

A.14 Under this contract, the plan purchases a bond and places it in trust. The plan then contracts with a financially responsible third party to provide benefit responsiveness. Under the contract, should the bond need to be sold to meet a participant-initiated withdrawal benefit, loan, or transfer, the plan is obligated to sell the bond to the contract issuer, and the issuer is obligated to buy the bond. The transaction price is defined under the contract (for example, amortized cost).

A.15 Net assets available for benefits shall reflect the contract value for this investment contract because return of principal and accrued interest has been guaranteed to participants.

A.16 If the contract provided only an *option* for the sponsor to sell the bond to the issuer, rather than an obligation to do so, reflecting net assets available for benefits at contract value for this investment contract would also apply.

[As amended, effective for financial statements for plan years ending after December 15, 2006; the revised definition of fully benefit-responsive is effective for all investment contracts as of the last day of the annual period ending after December 15, 2006, by FASB Staff Position AAG INV-1 and SOP 94-4-1.]

Accounting Standards Executive Committee (1993-1994)

Employee Benefit Plans Committee (1992-1993)

AICPA Staff

The Employee Benefit Plans Committee gratefully acknowledges the contributions of Mary Ann Arlt, George Cowles, Victor Gallo, Timothy P. Moran, and Randi L. Starr, ad hoc task force members.

[The next page is 79,991.]

Section 10,630

Statement of Position 94-5 Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises

December 15, 1994

NOTE

Statements of Position (SOPs) of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA SOPs as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this SOP should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

SOP 94-5 is amended by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*. SOP 01-5 is effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date.

Introduction

[.01] [Paragraph deleted by the issuance of Statement of Position 01-5, December 2001.]

Scope

.02 This Statement of Position (SOP) applies to annual and complete sets of interim financial statements prepared in conformity with generally accepted accounting principles (GAAP) of life and health insurance enterprises (including mutual life insurance enterprises), property and casualty insurance enterprises, reinsurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, financial guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies. [As amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date, by Statement of Position 01-5.]

Applicability to Statutory Financial Statements

.03 AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of Statement on Auditing Standards No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60–.81), requires auditors to apply the same disclosure evaluation criteria for statutory financial statements and for financial statements prepared in conformity with GAAP. [Paragraph added, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date, by Statement of Position 01-5.]

Relationship to Other Pronouncements

.04 In some circumstances, the disclosure requirements in this SOP may be similar to, or overlap, the disclosure requirements in certain other authoritative accounting pronouncements issued by the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), or the Securities and Exchange Commission (SEC). For example—

- FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, requires certain disclosures related to loss contingencies, including catastrophe losses of property and casualty insurance companies.
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, requires certain disclosures about liabilities for unpaid claims and claim adjustment expenses and statutory capital.
- FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, requires certain disclosures about reinsurance transactions.
- AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties* [section 10,640], requires disclosures about certain significant estimates.
- The SEC Securities Act Guide 6, *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters*, requires disclosures of information about liabilities for unpaid claims and claim adjustment expenses.

The disclosure requirements in this SOP supplement the disclosure requirements in other authoritative pronouncements. This SOP does not alter the requirements of any FASB or SEC pronouncement. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

Conclusions

.05 The disclosure requirements in this section should be read in conjunction with appendix A, "Illustrative Disclosures" item A-2 [paragraph .15], and appendix B, "Discussion of Conclusions" item B-1 [paragraph .16]. [Paragraph renumbered and amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date, by Statement of Position 01-5.]

Statutory Accounting Practices

.06 The insurance laws and regulations of most states require insurance enterprises domiciled in those states to comply with the guidance provided in the National Association of Insurance Commissioners (NAIC) *Accounting Practices and Procedures Manual*, except as prescribed or permitted by state law. In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual. Auditors of insurance enterprises should monitor the status of the adoption of the revised Manual by the various state regulatory authorities. [Paragraph renumbered and amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date, by Statement of Position 01-5.]

.07 Prescribed statutory accounting practices are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. A state may adopt the revised Manual in whole, or in part, as an element of prescribed statutory accounting practices. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state. [Paragraph renumbered and amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date, by Statement of Position 01-5.]

.08 Permitted statutory accounting practices include practices not prescribed by the domiciliary state as described in paragraph .07 above, but allowed by the domiciliary state regulatory authority. An insurance enterprise may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (*a*) if it wishes to depart from the prescribed statutory accounting practices, or (*b*) if prescribed statutory accounting practices do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future. [Paragraph renumbered and amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date, by Statement of Position 01-5.]

.09 The disclosures in this paragraph should be made if (*a*) state prescribed statutory accounting practices differ from NAIC statutory accounting practices or (*b*) permitted state statutory accounting practices differ from either state prescribed statutory accounting practices or NAIC statutory accounting practices. The disclosures should be made if the use of prescribed or permitted statutory accounting practices (individually or in the aggregate) results in reported statutory surplus or risk-based capital that is significantly different from the statutory surplus or risk-based capital that would have been reported had NAIC statutory accounting practices been followed. If an insurance enterprise's risk-based capital would have triggered a regulatory event had it not used a permitted practice, that fact should be disclosed in the financial statements. Insurance enterprises should disclose, at the date each financial statement is presented, a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed statutory accounting practices or NAIC statutory accounting practices.[1] [Paragraph renumbered and amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date, by Statement of Position 01-5.]

Liability for Unpaid Claims and Claim Adjustment Expenses

.10 The liability for unpaid claims and claim adjustment expenses represents the amounts needed to provide for the estimated ultimate cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the statement of financial position date). The estimated liability includes the amount of money that will be required for future payments of (*a*) claims that have been reported to the insurer, (*b*) claims related to insured events that have occurred but that have not been reported to the insurer as of the date the liability is estimated, and (*c*) claim adjustment expenses. Claim adjustment expenses include costs incurred in the claim settlement process such as legal fees; outside adjuster fees; and costs to record, process, and adjust claims. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.11 Financial statements should disclose for each fiscal year for which an income statement is presented the following information about the liability for unpaid claims and claim adjustment expenses:

a. The balance in the liability for unpaid claims and claim adjustment expenses at the beginning and end of each fiscal year presented, and the related amount of reinsurance recoverable

b. Incurred claims and claim adjustment expenses with separate disclosure of the provision for insured events of the current fiscal year and of increases or decreases in the provision for insured events of prior fiscal years

c. Payments of claims and claim adjustment expenses with separate disclosure of payments of claims and claim adjustment expenses attributable to insured events of the current fiscal year and to insured events of prior fiscal years

Also, insurance enterprises should discuss the reasons for the change in incurred claims and claim adjustment expenses recognized in the income statement attributable to insured events of prior fiscal years and should indicate whether additional premiums or return premiums have been accrued

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[1] Disclosures in this paragraph should be applied by a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, if the enterprise prepares U.S. generally accepted accounting principles (GAAP) financial statements. If a foreign insurance enterprise that does not have a U.S. insurance subsidiary prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, the notes to the financial statements should disclose permitted regulatory accounting practices that significantly differ from the prescribed regulatory accounting practices of its respective regulatory authority and their monetary effects. [Footnote added, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date, by Statement of Position 01-5.]

as a result of the prior-year effects. [Paragraph renumbered and amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date, by Statement of Position 01-5.]

.12 In addition to the disclosures required by FASB Statement No. 5 and other accounting pronouncements, insurance enterprises should disclose management's policies and methodologies for estimating the liability for unpaid claims and claim adjustment expenses for difficult-to-estimate liabilities, such as for claims for toxic waste cleanup, asbestos-related illnesses, or other environmental remediation exposures. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

Effective Dates and Transition

.13 The provisions of this SOP as originally issued in 1994 are effective for annual and complete sets of interim financial statements for periods ending after December 15, 1994. Disclosures of information required by paragraph .11 should be included for each fiscal year for which an income statement is presented. [Paragraph renumbered and amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date, by Statement of Position 01-5.]

.14 The provisions of this SOP as amended by AICPA SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification* [section 10,840], are effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date. Disclosures of information required by amended paragraph .09 and item A-2 in appendix A [paragraph .15] should be included for each fiscal year for which a balance sheet is presented. In the initial year of implementation of those disclosures, prior year amounts for the effect of permitted practices and prescribed practices should be disclosed as required by the SOP prior to those amendments. Retroactive application of the amendments is not permitted. [Paragraph added, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date, by Statement of Position 01-5.]

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Appendix A

Illustrative Disclosures

A-1. The illustrations included in this appendix are guides to implementation of the disclosures required by this SOP. Insurance enterprises are not required to display the information contained herein in the specific manner or in the degree of detail illustrated. Alternative disclosure presentations are permissible if they satisfy the disclosure requirements of this Statement of Position (SOP).

Prescribed or Permitted Statutory Accounting Practices

A-2. Following are two examples of illustrative disclosures that an insurance enterprise could make to meet the requirements of paragraph .09, item 8, of this SOP.

Note X. Statutory Accounting Practices

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department. [*State of domicile*] has adopted the National Association of Insurance Commissioners' statutory accounting practices (NAIC SAP) as the basis of its statutory accounting practices, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of [*state of domicile*] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP. This accounting practice increased statutory capital and surplus by $2.5 million and $2.3 million at December 31, 20X2 and 20X1, respectively, over what it would have been had the permitted practice not been allowed. The Company's statutory capital and surplus, including the effects of the permitted practice, was $30.0 million and $27.9 million at December 31, 20X2 and 20X1, respectively.

Had the Company amortized its goodwill over ten years and recorded its home office property at depreciated cost, in accordance with NAIC SAP, the Company's capital and surplus would have been $29.9 million and $27.7 million at December 31, 20X2 and 20X1, respectively.[1]

Note X. Statutory Accounting Practices

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department. [*State of domicile*] has adopted the National Association of Insurance Commissioners' statutory accounting practices (NAIC SAP) as the basis of its statutory accounting practices, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of the [*state of domicile*] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP.

[1] [Footnote deleted by the issuance of Statement of Position 01-5, December 2001.]

The monetary effect on statutory capital and surplus of using accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department is as follows:

	December 31	
	20X2	*20X1*
	$m	$m
Statutory capital and surplus per statutory financial statements	$30.0	$27.9
Effect of permitted practice of recording home office property at estimated fair value	(2.5)	(2.3)
Effect of [state of domicile's] prescribed practice of immediate write-off of goodwill[2]	2.4	2.1
Statutory capital and surplus in accordance with the NAIC statutory accounting practices[3]	$29.9	$27.7

Liability for Unpaid Claims and Claim Adjustment Expenses

A-3. The following is an illustration of information an insurance enterprise would disclose to meet the requirements of paragraph .11 of this SOP. (This illustration presents amounts incurred and paid net of reinsurance. The information may also be presented before the effects of reinsurance with separate analysis of reinsurance recoveries and recoverables related to the incurred and paid amounts.)

Note X. Liability for Unpaid Claims and Claim Adjustment Expenses

Activity in the liability for unpaid claims and claim adjustment expenses is summarized as follows.

	20X2	*20X1*
Balance at January 1	$7,030	$6,687
Less reinsurance recoverables	1,234	987
Net Balance at January 1	5,796	5,700
Incurred related to:		
Current year	2,700	2,600
Prior years	(171)	96
Total incurred	2,529	2,696
Paid related to:		
Current year	781	800
Prior years	2,000	1,800
Total paid	2,781	2,600
Net Balance at December 31	5,544	5,796
Plus reinsurance recoverables	1,255	1,234
Balance at December 31	$6,799	$7,030

[2] This amount compared to the prior year reflects the net impact of an additional year's amortization and the fact that admitted goodwill is based on the level of statutory capital and surplus and thus can fluctuate. [Footnote added, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date, by Statement of Position 01-5.]

[3] In the initial year of implementation of this disclosure, prior year amounts for the effect of permitted practices and prescribed practices should be disclosed as required under the original SOP. [Footnote added, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date, by Statement of Position 01-5.]

As a result of changes in estimates of insured events in prior years, the claims and claim adjustment expenses (net of reinsurance recoveries of $X and $X in 20X2 and 20X1, respectively) decreased by $171 million in 20X2 reflecting lower-than-anticipated losses on Hurricane Howard, and increased by $96 million in 20X1 reflecting higher-than-anticipated losses and related expenses for claims for asbestos-related illnesses, toxic waste cleanup, and workers' compensation.

A-4. The following is an illustration of an insurance enterprise disclosure designed to meet the requirements of paragraph .12 of this SOP. (Additional disclosures about the liabilities for unpaid claims and claim adjustment expenses may be required under FASB Statement No. 5, FASB Interpretation 14, *Reasonable Estimation of the Amount of a Loss*, AICPA SOP 94-6 [section 10,640], and SEC requirements.)

Note X. Environmental-Related Claims

In establishing the liability for unpaid claims and claim adjustment expenses related to asbestos-related illnesses and toxic waste cleanup, management considers facts currently known and the current state of the law and coverage litigation. Liabilities are recognized for known claims (including the cost of related litigation) when sufficient information has been developed to indicate the involvement of a specific insurance policy, and management can reasonably estimate its liability. In addition, liabilities have been established to cover additional exposures on both known and unasserted claims. Estimates of the liabilities are reviewed and updated continually. Developed case law and adequate claim history do not exist for such claims, especially because significant uncertainty exists about the outcome of coverage litigation and whether past claim experience will be representative of future claim experience.

[Paragraph renumbered and amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date, by Statement of Position 01-5.]

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Appendix B

Discussion of Conclusions

B-1. In 1999, the National Association of Insurance Commissioners (NAIC) completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. This SOP was updated in 2001 to conform to the revised Manual. This section discusses factors that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this SOP when it was originally issued in 1994. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

B-2. The business and regulatory environment of insurance enterprises has become more complex and volatile, and therefore riskier. Accordingly, AcSEC believed the need existed to reconsider the disclosures made in the financial statements of insurance enterprises.

B-3. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises*, states financial reporting should "provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions" (paragraph 34). Further, the Concepts Statement says that to support that decision-making process, financial reports should help such users "assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprises" (paragraph 37) by providing "information about the economic resources of an enterprise, the claims to those resources . . . and the effects of transactions, events, and circumstances that change resources and claims to those resources" (paragraph 40).

B-4. AcSEC considered a wide variety of potential disclosures, and tried to identify the areas of importance to insurance enterprises for which the current disclosures were lacking. AcSEC concluded that additional disclosures in the financial statements of insurance enterprises about regulatory risk-based capital, the liability for unpaid claims, and certain accounting methods permitted by state regulatory authorities would help insurance enterprises better meet the objectives of financial reporting in their financial statements. After the completion of the NAIC codification, AcSEC concluded that additional disclosures reconciling statutory surplus between statutory financial statements (including permitted practices), state prescribed basis, and in accordance with NAIC statutory accounting practices would be useful to the reader of generally accepted accounting principles (GAAP) financial statements. AcSEC is aware that certain insurance enterprises domiciled in Bermuda, the Cayman Islands, and other foreign jurisdictions may prepare financial statements in accordance with accounting principles generally accepted in the United States even though such enterprises do not conduct business in the United States. Additionally, a U.S.-based enterprise may have a foreign-domiciled insurance subsidiary and a foreign-based enterprise may have a U.S.-domiciled insurance subsidiary. Because the foreign insurance operations of such enterprises (whether they are in a foreign subsidiary of a U.S.-based enterprise, the foreign insurance operations of a foreign-based enterprise that has U.S.-domiciled operations or the foreign insurance operations of a foreign-based enterprise that does not have U.S.-domiciled insurance operations) are not subject to the United States regulatory framework, AcSEC does not believe it is appropriate for those enterprises to determine how the NAIC codification would affect foreign insurance operations. With respect to their foreign insurance operations, those enterprises should disclose a description of and related monetary effect of any permitted regulatory accounting practices granted by their respective regulatory authority. The disclosure requirements need not apply to a foreign parent that files financial statements in accordance with home country GAAP that are reconciled to accounting principles generally accepted in the United States.

Risk-Based Capital

B-5. Insurance enterprises operate in a highly regulated environment directed primarily toward safeguarding policyholders' interests and maintaining public confidence in the safety and soundness of the insurance system. Historically, regulation of insurance enterprises has monitored solvency by focusing on their capital. One of the primary tools used by state regulatory authorities for ensuring that their objectives are being met is risk-based capital (RBC).

B-6. The NAIC has developed an RBC program that is used by state regulatory authorities to enable them to take appropriate and timely regulatory actions relating to insurers that show signs of weak or deteriorating financial conditions. This program is encompassed in the RBC Model Acts for life and property and casualty insurers, which have been or are intended to be adopted by most of the states. RBC is a series of dynamic surplus-related formulas set forth in the NAIC's RBC instructions for life and health and for property and casualty insurance enterprises. The formulas contain a variety of weighing factors that are applied to financial balances or to levels of activity based on the perceived degree of certain risks, such as asset risk, credit risk, interest rate risk (life insurance enterprises only), underwriting risk, and other business risks, such as risks related to management, regulatory action, and contingencies. The amount determined under such formulas, the authorized control level risk-based capital, is required to be disclosed in life insurance enterprises' statutory filings starting for the year ended December 31, 1993, and in property and casualty insurance enterprises' statutory filings starting for the year ended December 31, 1994.

B-7. The exposure draft of the SOP that was originally issued in 1994 contained a requirement that insurance enterprises that are required to calculate RBC should disclose in their financial statements the ratio of total adjusted capital to authorized control level RBC and the amount of total adjusted capital for each fiscal year for which a statement of financial position is presented.

B-8. However, the NAIC's RBC Model Acts for both life and property and casualty insurers have a confidentiality provision, which states:

> [E]xcept as otherwise required under the provisions of this Act [that is, in the annual financial reports filed with state insurance departments], the making, publishing, disseminating, circulation, or placing before the public, or causing, directly or indirectly to be made, placed before the public, in a newspaper, magazine or other publication . . . with regard to the RBC levels of any insurer . . . would be misleading and is therefore prohibited.

B-9. Prior to issuing the exposure draft, based on discussions with the drafters of the RBC Model Acts and some state insurance regulators, and based on the fact that the information is already in the public domain, AcSEC believed that the confidentiality provisions were not intended to apply to disclosures in financial statements. However, a number of respondents to the exposure draft stated that they believe disclosing RBC levels in financial statements would be illegal in states that have enacted the RBC Model Acts. They point out that words in the RBC Model Acts appear to be intended to restrict *all* other disclosure of RBC levels, including in insurers' financial statements.

B-10. AcSEC continues to believe, because of the importance of RBC in the regulatory oversight of insurance enterprises, that its disclosure would improve the relevance and usefulness of insurance enterprises' financial statements, and, therefore, it should be disclosed in the financial statements. Nevertheless, AcSEC concluded the legal issues require further consideration.

B-11. AcSEC decided that this SOP should not be delayed while the legal issues regarding RBC disclosures are considered. A separate SOP on RBC disclosures will be considered at a later date.

B-12. Nevertheless, AcSEC encourages insurance enterprises to disclose RBC levels if they are domiciled in states that have not adopted the RBC Model Acts, or if they have otherwise determined that it is legal to make such disclosures in their financial statements.

B-13. The exposure draft also required insurance enterprises whose level of RBC has triggered a regulatory event[1] to disclose certain information in their financial statements. Delaying the issuance of the RBC guidance does not change the fact that under Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, auditors must consider the need for disclosures about the principal conditions and events that triggered the regulatory event and the possible effects of such conditions and events, as well as management's plans.

Permitted Statutory Accounting Practices

B-14. Permitted statutory accounting practices historically have not been disclosed in the notes to the financial statements, except to the extent that they have been disclosed in the accounting practices and procedures note to the statutory financial statements. With increasing frequency, insurance enterprises have transactions that are not explicitly addressed by prescribed accounting practices, or for which no analogous prescribed accounting practices exist. Furthermore, insurance enterprises often request exceptions from certain prescribed accounting practices. Permitted statutory accounting practices may differ from state to state, and from company to company within a state, and may change in the future. Moreover, permitted statutory accounting practices have been used to enhance insurance enterprises' surplus positions. For example, some state regulatory authorities have permitted certain insurance enterprises to adjust home office facilities to appraised values even though the states' prescribed statutory accounting practices require that such assets be carried at depreciated historical cost.

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[1] Under the NAIC's RBC Model Acts, when the ratio of total adjusted capital to authorized control level RBC is less than or equal to 2 or less than or equal to 2.5 with negative trends for life insurance enterprises, a regulatory event exists—that is, the insurance enterprise would fail to meet the minimum RBC requirements. There are four types of regulatory events, ranging from least to most serious: company action level event, regulatory action level event, authorized control level event, and mandatory control level event. [Footnote renumbered by the issuance of Statement of Position 01-5, December 2001.]

B-15. AcSEC believes the required disclosure of permitted statutory accounting practices will enhance the relevance of the financial statements and fulfill the financial reporting objective of providing current and potential investors, creditors, policyholders, and other users of an insurance enterprise's financial statements with useful information. Not only will such disclosures identify situations in which permitted statutory accounting practices enhance an insurance enterprise's statutory capital and RBC position, but they also will improve the comparability of insurance enterprises' financial statements.

Liability for Unpaid Claims and Claim Adjustment Expenses

B-16. Insurance enterprises estimate their liability for unpaid claims and claim adjustment expenses for reported and unreported claims incurred as of the end of the accounting period in accordance with FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. The liability is estimated based on past loss experience, adjusted for current trends and other factors that will modify past experience. The liability may be calculated using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models.

B-17. FASB Concepts Statement No. 1, paragraph 21, states:

> The information provided by financial reporting largely reflects the financial effects of transactions and events that have already happened. Management may communicate information about its plans or projections, but financial statements and most other financial reporting are historical . . . . Estimates resting on expectations of the future are often needed in financial reporting, but their major use, especially of those formally incorporated in financial statements, is to measure financial effects of past transactions or events or the present status of an asset or liability . . . . To provide information about the past past as an aid in assessing the future is not to imply that the future can be predicted merely by extrapolating past trends or relationships. Users of the information need to assess the possible or probable impact of factors that may cause change and form their own expectations about the future and its relation to the past.

B-18. AcSEC believes that disclosures about an insurance enterprise's liabilities for unpaid claims and claim adjustment expenses development are useful in understanding insurance enterprises' liabilities and results of operations. Furthermore, AcSEC notes the disclosures are the same as some of the loss reserve development disclosures that the SEC requires registrants to file with the commission under Securities Act Guide 6.

B-19. Paragraph 60(a) of FASB Statement No. 60, requires all insurance enterprises to disclose the basis for estimating the liabilities for unpaid claims and claim adjustment expenses. Furthermore, FASB Statement No. 5, *Accounting for Contingencies*, requires disclosure of loss contingencies not accrued, for which it is at least reasonably possible that a loss has been incurred. Because of the relatively high degree of coverage litigation and the lack of historical information regarding the amount and nature of both known and unasserted claims relating to difficult-to-estimate liabilities (such as those related to environmental related illness claims and toxic-waste cleanup claims), traditional loss reserving techniques may not be used in estimating such liabilities. Therefore, a high degree of judgment is needed in estimating the amount of losses, and practice is developing in the area. Accordingly, AcSEC believes financial statement users will benefit from disclosure of the policies and methods management has used for estimating these amounts.

Discussion of Comments Received on Exposure Draft

B-20. An exposure draft of a Statement of Position (SOP), *Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises*, was issued on April 20, 1994, and distributed to a variety of interested parties to encourage comment by those that would be affected by the proposal. Forty comment letters were received on the exposure draft.

Risk-Based Capital

B-21. A number of comments were received on the risk-based capital disclosures. As discussed in paragraphs B-5 through B-13, AcSEC decided to consider a separate SOP at a later date on risk-based capital disclosures. The comments will be addressed at that time.

Permitted Statutory Accounting Practices

B-22. A number of respondents to the exposure draft of the SOP requested that the disclosure requirements for permitted statutory accounting practices be postponed until after the codification is complete. AcSEC believes that the disclosures are especially important before codification to improve understanding of the factors that affect comparability among the statutory capital of insurance enterprises.

B-23. Respondents asked for clarification of how disclosure of the monetary effect of statutory surplus would be calculated, particularly when there is no prescribed accounting practice to compare with the permitted practice. AcSEC agreed and revised the exposure draft to state that for permitted statutory accounting practices used when prescribed accounting practice is silent, a description of the transaction is sufficient. Respondents also asked for clarification about whether there should be disclosure of GAAP-permitted practices when there is no prescribed statutory accounting. If an insurance company uses a GAAP practice in its statutory financial statements when there is no prescribed practice, that is still considered a permitted statutory accounting practice. However, AcSEC agreed that no disclosures should be made for GAAP practices that are used when prescribed statutory practices do not specify the accounting for the transaction.

B-24. Respondents suggested that the requirement in the exposure draft to make a statement about the codification be eliminated. AcSEC agreed the disclosure might be confusing to users of financial statements, and eliminated the requirement.

Liability for Unpaid Claims and Claim Adjustment Expenses

B-25. The exposure draft would have required disclosure of information about actuarial adjustments made for nonrecurring or abnormal experience. A number of respondents suggested that that disclosure requirement be eliminated. AcSEC was persuaded that such actuarial adjustments are a normal part of making estimates that should not be disclosed in the financial statements, and eliminated the requirement.

[Paragraph renumbered and amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date, by Statement of Position 01-5.]

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[The next page is 80,031.]

Section 10,640

Statement of Position 94-6 Disclosure of Certain Significant Risks and Uncertainties

December 30, 1994

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Introduction

.01 The volatile business and economic environment underscores a need for improved disclosure about the significant risks and uncertainties that face reporting entities. In 1987, the AICPA issued the *Report of the Task Force on Risks and Uncertainties* (the Report), which was intended to help standards-setting bodies and others identify practical methods of improving the information communicated to users of financial statements to help them assess those risks and uncertainties. This statement of position (SOP) is largely based on the Report. The central feature of this SOP's disclosure requirements is selectivity: specified criteria serve to screen the host of risks and uncertainties that affect every entity so that required disclosures are limited to matters significant to a particular entity.

.02 The disclosures focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity. The risks and uncertainties this SOP deals with can stem from the nature of the entity's operations, from the necessary use of estimates in the preparation of the entity's financial statements, and from significant concentrations in certain aspects of the entity's operations.

Scope

.03 This SOP applies to financial statements prepared in conformity with generally accepted accounting principles (GAAP) applicable to nongovernmental entities. It applies to all entities that issue such statements. While this SOP applies to complete interim financial statements, it does not apply to condensed or summarized interim financial statements.[1] If comparative financial statements are presented, the disclosure requirements apply only to the financial statements for the most recent fiscal period presented.

.04 The disclosure requirements do not encompass risks and uncertainties that might be associated with management or key personnel, proposed changes in government regulations, proposed changes in accounting principles,[2] or deficiencies in the internal control structure. Nor do they encompass the possible effects of acts of God, war, or sudden catastrophes.

Relationship to Other Pronouncements

.05 The disclosure requirements of this SOP in many circumstances are similar to or overlap the disclosure requirements in certain pronouncements of the Financial Accounting Standards Board (FASB), such as FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and, for public business enterprises, FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*.[*] The disclosure requirements of this SOP in many circumstances also are similar to or overlap the disclosure requirements in certain pronouncements of the Securities and Exchange Commission (SEC). This SOP does not alter the requirements of any FASB or SEC pronouncement.

.06 Certain disclosure requirements in this SOP supplement the requirements of other authoritative pronouncements. In many cases, however, the disclosure requirements in this SOP, particularly those relating to certain significant estimates, will be met or partly met by compliance with such other pronouncements.

Definitions

.07 This SOP uses the following terms with the definitions indicated:

Near term. A period of time not to exceed one year from the date of the financial statements.

Severe impact. (Used in reference to current vulnerability due to certain concentrations. See paragraph .21.) A significant financially disruptive effect on the normal functioning of the entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material,[3] yet they may not be so significant as to dis-

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[1] However, see Accounting Principles Board (APB) Opinion No. 28, *Interim Financial Reporting*, paragraph 30, for guidance on disclosure of contingencies in summarized interim financial information of publicly traded companies.

[2] SEC Staff Accounting Bulletin No. 74 requires disclosure, both in Management's Discussion and Analysis (MD&A) and in the notes to the financial statements, concerning accounting standards that have been issued but that have not yet been adopted. Also, Auditing Interpretation No. 3 of SAS No. 1, section 410, "The Impact on an Auditor's Report of an FASB Statement Prior to the Statement Effective Date" (AICPA, *Professional Standards*, vol. 1, AU sec. 9410.13–.18), addresses reporting considerations when financial statements will have to be restated in the future because an authoritative accounting pronouncement that is not yet effective will require retroactive application of its provisions by prior-period adjustment.

[*] FASB Statement No. 131, *Disclosures About Segments of an Enterprise and Related Information*, supersedes FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 131.]

[3] FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, defines *materiality* as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

rupt the normal functioning of the entity. Some events are material to an investor because they might affect the price of an entity's capital stock or its debt securities, but they would not necessarily have a severe impact on (disrupt) the enterprise itself. The concept of severe impact, however, includes matters that are less than catastrophic.[4]

Conclusions

.08 The Accounting Standards Executive Committee (AcSEC) of the AICPA has concluded that reporting entities should make disclosures in their financial statements beyond those now required or generally made in financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

a. Nature of operations

b. Use of estimates in the preparation of financial statements

c. Certain significant estimates

d. Current vulnerability due to certain concentrations

These four areas of disclosure are not mutually exclusive. The information required by some may overlap. Accordingly, the disclosures required by this SOP may be combined in various ways, grouped together, or placed in diverse parts of the financial statements, or included as part of the disclosures made pursuant to the requirements of other authoritative pronouncements.

.09 The following detailed discussion of the four areas of disclosure enumerated in paragraph .08 should be read in conjunction with the "Illustrative Disclosures" in appendix A [paragraph .27] of this SOP, which provide guidance for implementing them.

Nature of Operations

.10 Financial statements should include a description of the major products or services the reporting entity sells or provides and its principal markets, including the locations of those markets. If the entity operates in more than one business, the disclosure should also indicate the relative importance of its operations in each business and the basis for the determination—for example, assets, revenues, or earnings. Not-for-profit organizations' disclosures should briefly describe the principal services performed by the entity and the revenue sources for the entity's services. Disclosures about the nature of operations need not be quantified; relative importance could be conveyed by use of terms such as *predominately*, *about equally*, or *major and other*.[5]

Use of Estimates in the Preparation of Financial Statements

.11 Financial statements should include an explanation that the preparation of financial statements in conformity with GAAP requires the use of management's estimates.

Certain Significant Estimates

.12 Various accounting pronouncements require disclosures about uncertainties addressed by those pronouncements. In particular, paragraphs 9 through

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[4] Matters that are catastrophic include, for example, those that would result in bankruptcy.

[5] See paragraph B-17 in appendix B [paragraph .28] for a comparison of this SOP's disclosure requirements concerning nature of operations with the disclosure requirements for public companies in FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*.[†]

† FASB Statement No. 131, *Disclosures About Segments of an Enterprise and Related Information*, supersedes FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 131.]

12, and 17b, and footnote 6 of FASB Statement No. 5 specify disclosures to be made about contingencies[6] that exist at the date of the financial statements. The disclosure requirements of paragraphs 9 through 12 of Statement No. 5 are further clarified in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss.* In addition to disclosures required by FASB Statement No. 5 and other accounting pronouncements, this SOP requires disclosures regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies, as described below.

.13 Disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that *both* of the following criteria are met:

a. It is at least reasonably possible[7] that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.

b. The effect of the change would be material to the financial statements.

.14 The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible[8] that a change in the estimate will occur in the near term.[9] If the estimate involves a loss contingency covered by FASB Statement No. 5, the disclosure also should include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required.

.15 Many entities use risk-reduction techniques to mitigate losses or the uncertainty that may result from future events. If the entity determines that the criteria in paragraph .13 are not met as a result of risk-reduction techniques, the disclosures described in paragraph .14 and disclosure of the risk-reduction techniques are encouraged but not required.

.16 This SOP's disclosure requirements are separate from and do not change in any way the disclosure requirements or criteria of FASB Statement No. 5; rather, the disclosures required under this SOP supplement the disclosures required under Statement No. 5 as follows:

- If an estimate (including estimates that involve contingencies covered by FASB Statement No. 5) meets the criteria for disclosure under paragraph .13 of this SOP, this SOP requires disclosure of an indication that it is at least reasonably possible that a change in the estimate will occur in the near term; FASB Statement No. 5 does not distinguish between near-term and long-term contingencies.
- An estimate that does not involve a contingency covered by Statement No. 5, such as estimates associated with long-term operating assets

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[6] FASB Statement No. 5 defines a *contingency* as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a 'gain contingency') or loss (hereinafter a 'loss contingency') to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability."

[7] The term *reasonably possible* is used in this SOP consistent with its use in FASB Statement No. 5 to mean that the chance of a future transaction or event occurring is more than remote but less than likely.

[8] The words *reasonably possible* need not be used in the disclosures required by this SOP.

[9] FASB Statement No. 5 states in paragraph 17b that "adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization."

and amounts reported under profitable long-term contracts, may meet the criteria in paragraph .13. This SOP requires disclosure of the nature of the estimate and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.

.17 Whether an estimate meets the criteria for disclosure under this SOP does not depend on the amount that has been reported in the financial statements, but rather on the materiality of the effect that using a different estimate would have had on the financial statements. Simply because an estimate resulted in the recognition of a small financial statement amount, or no amount, does not mean that disclosure is not required under this SOP.

.18 The following are examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term:

- Inventory subject to rapid technological obsolescence
- Specialized equipment subject to technological obsolescence
- Valuation allowances for deferred tax assets based on future taxable income
- Capitalized motion picture film production costs
- Capitalized computer software costs
- Deferred policy acquisition costs of insurance enterprises
- Valuation allowances for commercial and real estate loans
- Environmental remediation-related obligations
- Litigation-related obligations
- Contingent liabilities for obligations of other entities
- Amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits
- Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on disposition of a business or assets
- Amounts reported for long-term contracts

The above list is not intended to be all-inclusive.

.19 Paragraph 5 of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*,[‡] provides examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of an asset should be assessed.[10] [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Current Vulnerability Due to Certain Concentrations

.20 Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through

[‡] FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, supersedes FASB Statement No. 121. [Footnote added, October 2002, to reflect conforming changes necessary due to the issuance of FASB Statement No. 144.]

[10] [Footnote deleted, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

diversification. Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance.

.21 Financial statements should disclose the concentrations described in paragraph .22 if, based on information known to management prior to issuance of the financial statements, *all* of the following criteria are met:

a. The concentration exists at the date of the financial statements.

b. The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.

c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

.22 Concentrations, including known group concentrations, described below require disclosure if they meet the criteria of paragraph .21. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one category.

a. *Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor*. The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For purposes of this SOP, it is always considered at least reasonably possible that any customer, grantor, or contributor will be lost in the near term.

b. *Concentrations in revenue from particular products, services, or fund-raising events*. The potential for the severe impact can result, for example, from volume or price changes or the loss of patent protection for the particular source of revenue.

c. *Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations*. The potential for the severe impact can result, for example, from changes in the availability to the entity of a resource or a right.

d. *Concentrations in the market or geographic area*[11] *in which an entity conducts its operations*. The potential for the severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For purposes of this SOP, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term.

.23 Concentrations of financial instruments, and other concentrations not described in paragraph .22, are not addressed in this SOP. However, these other concentrations may be required to be disclosed pursuant to other authoritative pronouncements, such as FASB Statement No. 107, *Disclosures About Fair Value of Financial Instruments*,[||] as amended by FASB Statement No. 126,

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[11] [Footnote deleted, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 131.]

[||] FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by FASB Statements No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*, No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities,* and No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities,* supersedes FASB Statement No. 105, *Disclosure of Information About Financial Instruments With Off-Balance-Sheet Risk and Financial Instruments With Concentrations of Credit Risk*. FASB Statement No. 133 amends FASB Statement No. 107, *Disclosures About Fair Value of Financial Instruments*, to include in FASB Statement No. 107 the disclosure provisions about concentrations of credit risk from FASB Statement No. 105, with modifications. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 133, as amended by FASB Statements No. 137, No. 138, and No. 149.]

Exemption From Certain Required Disclosures About Financial Instruments for Certain Nonpublic Entities. [Revised, June 2004, to reflect conforming changes necessary to reflect the issuance of FASB Statement No.133, as amended by FASB Statements No. 137, No. 138, and No. 149.]

.24 Disclosure of concentrations meeting the criteria of paragraph .21 should include information that is adequate to inform users of the general nature of the risk associated with the concentration. For those concentrations of labor (paragraph .22*c*) subject to collective bargaining agreements and concentrations of operations located outside of the entity's home country (paragraph .22*d*) that meet the criteria of paragraph .21, the following specific disclosures are required:

- For labor subject to collective bargaining agreements, disclosure should include both the percentage of the labor force covered by a collective bargaining agreement and the percentage of the labor force covered by a collective bargaining agreement that will expire within one year.
- For operations located outside the entity's home country, disclosure should include the carrying amounts of net assets and the geographic areas in which they are located.

Adequate information about some concentrations may already be presented in diverse parts of the financial statements. For example, adequate information about assets or operations located outside the entity's home country may be included in disclosures made to comply with FASB Statement No. 131. In accordance with paragraph .08 of this SOP, such information need not be repeated. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 131.[#]]

Application of Disclosure Criteria

.25 An assessment of whether a disclosure is required should not be found to be in error simply as a result of future events. For example, reporting a concentration not followed by a severe impact does not imply that the disclosure should not have been made, because something that has only a reasonably possible chance of occurring obviously might not occur. Similarly, the occurrence of a severe impact related to a concentration not disclosed in the prior-year financial statements would not suggest noncompliance with this SOP's requirements if an appropriate judgment had been made that a near-term severe impact was not at least reasonably possible at the prior reporting date. In addition, a severe impact may arise from a concentration of which management did not have knowledge at the time the financial statements were issued.

Effective Date

.26 This SOP is effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which this SOP is to be first applied. Early application is encouraged but not required.

[#] FASB Statement No. 131, *Disclosures About Segments of an Enterprise and Related Information*, supersedes FASB Statement No. 14.

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Appendix A

Illustrative Disclosures

Contents	Paragraph Numbers

A-1. The kinds of disclosures required by this SOP are illustrated below. Each illustrative disclosure is accompanied by a scenario in which the disclosure would likely be made or not made and by a discussion of how and why the illustrative disclosure complies with the requirements of this SOP or why no disclosure is required by this SOP.

Nature of Operations

Illustrative Disclosure A—Nature of Operations

A-2. *Scenario*. Conglomerate, Inc. is a United States-based multinational corporation. Conglomerate's principal lines of business are automotive products, aerospace products and technologies, textiles, and nonprescription health-care products. The principal markets for the company's automotive and aerospace products and technologies are European- and Far East-based industrial concerns. Textiles are sold primarily to U.S. clothing manufacturers, while nonprescription health-care products are sold to wholesale and retail distributors worldwide. The operations of the company in any one country are not significant in relation to the company's overall operations. The following illustrates disclosure of the nature of operations required by this SOP.

A-3. *Disclosure*. **Conglomerate, Inc. is a multinational manufacturer and engineering concern. The company's principal lines of business are automotive products, aerospace products and technologies, textiles, and nonprescription health-care products, all of which are about equal in size based on sales. The principal markets for the automotive and aerospace products and technologies are European- and Far East—based industrial concerns. Textiles are sold primarily to domestic clothing manufacturers, while nonprescription health-care products are sold primarily to wholesale and retail distributors worldwide.**

A-4. *Discussion*. This disclosure provides—

a. Information necessary for users not familiar with the operations of the company to identify and consider the broad risks and uncertainties associated with the businesses and markets in which the company operates and competes. From the disclosures provided, financial statement users having a general knowledge of business matters should be able to assess that the company's product lines are subject to different and varied risks. Those financial statement users familiar with the businesses recognize the general risks associated with each of these businesses and their related markets.

b. Information that facilitates the overall understanding of the financial information presented. This kind of disclosure could provide users with a basis for comparing an enterprise's financial information with that of competitors or with applicable industry statistics.

c. Insight into the location of the company's principal markets, although on a broad scale. Because the company's markets are so diverse, it likely would not be useful to enumerate the specific locations of the company's markets. For this reason, the manner in which the information is disclosed in the illustrative disclosure is sufficient to meet the broad objectives of paragraph .10 of this SOP.

Illustrative Disclosure B—Combined Disclosure: Nature of Operations and Customer Concentration

A-5. *Scenario.* Smith Corporation, formerly Smith Munitions Corporation, was founded in 1940. At that time, Smith's principal business was the design and manufacture of artillery ammunition and other explosives. In 1959, commensurate with the evolution of its principal business to the design, engineering, and manufacture of military aircraft for sale to the U.S. government, Smith changed its name to Smith Corporation. Smith has one factory, located in New York. The following illustrates disclosure of the nature of operations required by this SOP.

A-6. *Disclosure.* **Smith Corporation is engaged principally in the design, engineering, and manufacturing of military aircraft and related peripheral equipment for sale primarily to the U.S. government.**

A-7. *Discussion.* This disclosure provides—

a. Information needed by users who are not familiar with the operations of the enterprise to identify and consider the broad risks and uncertainties faced by all or most enterprises operating in a specific business or market, which in this case is the defense contracting business. From this disclosure, financial statement users having a general knowledge of business matters should know that the enterprise's business may be heavily affected by future changes in U.S. defense and foreign policies.

b. Information that aids in the overall understanding of the other financial information presented. Certain accounting procedures involving estimation may apply only to particular industries or may be relevant in comparing a business enterprise's financial reports with those of business enterprises in other industries.

c. Insight into the location of the company's principal product markets and information about its current vulnerability due to concentrations. In the illustration, users would be able to recognize and assess the company's dependency on sales to the U.S. government (assuming the loss of the government as a customer would result in a near-term severe impact to the company).

Use of Estimates in the Preparation of Financial Statements

Illustrative Disclosure—Pervasiveness of Estimates

A-8. *Scenario.* The following illustrates disclosure of the pervasiveness of estimates in the financial statements of all reporting entities.

A-9. *Disclosure.* **The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.**

A-10. *Discussion.* This disclosure is intended to inform users of the inherent uncertainties in measuring assets and liabilities and related revenues and expenses and contingent assets and liabilities, and that subsequent resolution of some matters could differ significantly from the resolution that is currently expected. Such disclosure alerts users that uncertainties are present in the financial statements of all reporting entities.

Certain Significant Estimates

Note: Some of the following disclosures contain certain information that is already required to be disclosed under FASB Statement No. 5; in those cases, the FASB Statement No. 5 requirements are supplemented by an indication that it is at least reasonably possible that a change in an estimate will occur in the near term. Others may not be covered by FASB Statement No. 5.

Illustrative Disclosure A—Inventories

A-11. *Scenario*. XYZ Corporation manufactures high technology stereo equipment. In June 19X7, one of XYZ's competitors introduced a new model stereo system with the same features as XYZ's Model A. The competitor's version sells for significantly less than XYZ's suggested retail price for Model A. The introduction of this product resulted in a sharp decrease in the sales volume of Model A. At December 31, 19X7, XYZ has accumulated significant inventory quantities beyond its normal short-term needs of its Model A system. Inventory for Model A ($6 million) represents approximately 20 percent of XYZ's inventory at that date. The remaining 80 percent of XYZ's inventory consists of products experiencing only normal competitive pressures. XYZ has established provisions for obsolescence for this latter group of products in the normal course of business.

A-12. Management has developed a program to provide substantial dealer incentives on purchases of the Model A, which it expects will result in the sale of this inventory in the near term. Because of the existing high profit margin on its stereo systems, XYZ would continue to earn a marginal profit on sales of the Model A under the new program. It is also reasonably possible, however, that the program will not be wholly successful, and, accordingly, a material loss could ultimately result on the disposal of the inventory.

A-13. *Disclosure*. **At December 31, 19X7, some portion of $6 million of inventory of one of the company's products is in excess of XYZ's current requirements based on the recent level of sales. Management has developed a program to reduce this inventory to desired levels over the near term and believes no loss will be incurred on its disposition. No estimate can be made of a range of amounts of loss that are reasonably possible should the program not be successful.**

A-14. *Discussion*. This situation meets the criteria for disclosure under paragraph .13 of this SOP because circumstances that existed at the date of the financial statements, including the decreasing sales volume and excessive quantities of inventory of Model A, make it at least reasonably possible that management's plan to liquidate its excess inventory without a loss will be less than fully successful and that such an outcome would have a near-term material effect on the enterprise's financial statements.

A-15. In this illustration, XYZ discloses the existence of potentially excess quantities of inventory at the date of the financial statements and indicates that the uncertainty is expected to be resolved in the near term. The disclosure is intended to provide users with insight into management's assessment of recoverability of the cost of inventories existing at the date of the financial statements. Although disclosure of the $6 million carrying amount of the inventory of Model A is not required because, based on the facts presented, $6 million does not constitute a reasonable estimate of loss on the disposal of the inventory or the maximum amount in an estimated range of loss, disclosure of this amount is not misleading and may provide useful information.

A-16. Discussion of XYZ's provision for obsolescence for the remaining 80 percent of its inventory is not required because it is not considered reasonably possible that additional material losses on this inventory will occur.

Illustrative Disclosure B—Discontinued Operations: Assets Held for Sale

A-17. *Scenario*. Axel Industries, a manufacturer of automotive parts and heavy trucks, currently has facilities in Michigan, Tennessee, and Ontario, Canada. Axel's automotive parts segment constitutes a component of the entity because the operations of and cash flows of the automotive parts segment can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. As a result of weak demand in the automobile industry, Axel's management decided during the current year to exit the automotive parts segment, which is located entirely at the company's Michigan facility, and commits to a plan to sell the automotive parts segment. Axel's automotive parts segment is classified as held for sale at that date and measured at the lower of its carrying amount or fair value less cost to sell. The operations and cash flows of the automotive parts segment will be eliminated from ongoing operations as a result of the sale transaction, and Axel will have no continuing involvement in the operations of the product group after it is sold. The scenario meets the requirements of FASB Statement No. 144. Therefore Axel will report the results of operations of the component, including any gain or loss, in discontinued operations. The following illustrates disclosure of significant estimates and would likely appear as part of the disclosure of the disposition of a component of an entity made pursuant to APB Opinion No. 30, *Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, as amended by FASB Statements No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment to FASB Statement No. 13, and Technical Corrections*. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statements No. 144 and No. 145.]

A-18. *Disclosure*. Included in discontinued operations was a write down associated with our automotive components parts business. The write down was based on management's best estimates of the fair value of the assets less costs to sell. The amount included in discontinued operations could be adjusted in the near term if experience differs from current estimates.[12] [Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statements No. 144 and No. 145.]

A-19. *Discussion*. Determining a provision for discontinued operations required the use of assumptions and estimates. In this case, the disclosure is required because circumstances that existed at the date of the financial statements indicated it was at least reasonably possible that estimates of the loss on the disposal of discontinued operations could differ in the near term from the current estimates used as a basis for recognizing the charge to income by an amount that would be material to the entity's financial statements. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statements No. 144 and No. 145.]

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[12] [Footnote deleted, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statements No. 144 and No. 145.]

Illustrative Disclosure C—Specialized Manufacturing Equipment

A-20. *Scenario*. Offshore Industries is a manufacturer of offshore drilling rigs and platforms. The company's manufacturing process requires significant specialized equipment, which it currently owns. As a result of a decline in the price of oil, the demand for its products and services has fallen dramatically in the past two years, resulting in a significant underutilization of its manufacturing capacity.

A-21. The company depreciates its investments in specialized equipment based on its original estimate of the remaining useful lives of the equipment using the units-of-production method, since it believes that the exhaustion of usefulness of these specialized assets relates more to their use than to the passage of time. The company reevaluates these estimates in light of current conditions in accordance with generally accepted accounting principles. The company also monitors the policies of its major competitors and is aware that several have reported large write-downs of similar assets. Nevertheless, while the company believes that it is at least reasonably possible that its estimate that it will recover the carrying amount of those assets from future operations will change during the next year, it believes it is more likely that conditions in the industry will improve and that no write-down for impairment will be necessary.

A-22. *Disclosure*. **Offshore's policy is to depreciate specialized manufacturing equipment (with a net book value of $25 million at December 31, 19X7) over its remaining useful life using the units-of-production method and to evaluate the remaining life and recoverability of such equipment in light of current conditions.[13] [Given the excess capacity in the industry,[14]] it is reasonably possible that the company's estimate that it will recover the carrying amount of this equipment from future operations will change in the near term.**

A-23. *Discussion*. In this illustration, the company acknowledges that the carrying amount of the specialized assets is subject to significant uncertainty based on current conditions. The uncertainty relates to the measurement of the specialized assets at the date of the financial statements, and the company's disclosure makes clear that it is at least reasonably possible that the carrying amount will change in the near term.

Illustrative Disclosure D—Capitalized Software Costs

A-24. *Scenario*. Software, Inc. develops and markets computer programs. In 20X3, it acquired a software company. A significant portion of the purchase price was allocated to (capitalized) Product A (present net book value of $5 million), the most significant and profitable software program currently being marketed by the acquired company. Only nominal amounts of other software costs have been capitalized. Software, Inc. expects Product A and its derivatives to be among its most significant products over the next several years. However, a competitor has recently released a new product designed to compete directly with Product A. Software, Inc. amortizes the capitalized software costs of Product A by the greater of (*a*) the ratio that current gross revenues for a product bear to the total of current and anticipated future gross revenues for that product or (*b*) the straight-line method over the remaining estimated economic life of the product including the period being reported on, pursuant to FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*. The amount of the amortization computed for year 20X4

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[13] If this information is already disclosed elsewhere in the notes, it need not be repeated.

[14] This is an example of voluntary disclosure that is encouraged by paragraph .14

was equal to 20 percent of the beginning-of-the-year capitalized amount and was a significant component of cost of sales. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 141.]

A-25. The segment of the computer software industry in which Software, Inc. operates is characterized by sales of products occurring primarily on the basis of customers' perceptions of the relative technical merits of competing products. Those perceptions are greatly influenced by product reviews in technical journals and advertising, and they can change rapidly. Innovative products have been introduced in recent years that have reduced quickly and significantly the volume of sales of pre-existing products in the same market niche. While management of Software, Inc. believes its estimates of future gross revenues and the estimated economic life of Product A used in the determination of the amortization of capitalized software costs are reasonable, new products introduced by its competitors, such as the one discussed in paragraph A-24, could have a significant near-term negative effect on such estimates. As a result, the amount of periodic amortization could increase in the near term in amounts that could be material to the enterprise's financial statements.

A-26. *Disclosure*. **Software, Inc.'s policy is to amortize capitalized software costs by the greater of (*a*) the ratio that current gross revenues for a product bear to the total of current and anticipated future gross revenues for that product or (*b*) the straight-line method over the remaining estimated economic life of the product including the period being reported on.[15] It is reasonably possible that those estimates of anticipated future gross revenues, the remaining estimated economic life of the product, or both will be reduced significantly in the near term [due to competitive pressures].[16] As a result, the carrying amount of the capitalized software costs for Product A ($5 million) may be reduced materially in the near term.**

A-27. *Discussion*. In this illustration, the company acknowledges that the carrying amount of its capitalized software costs is subject to significant uncertainty. The uncertainty relates to estimates of future years' revenues and useful lives that are made at the date of the financial statements, and the company is aware that circumstances exist that could cause such estimates to change in the near term. The company's disclosure makes clear that it is at least reasonably possible that the carrying amount could be reduced in the near term.

Illustrative Disclosure E—Environmental Remediation Liability

A-28. *Scenario*. Ace Oil Company is a distributor of heating oil with four storage and distribution facilities located in Anystate. Federal, state, and local laws and regulations govern the operation of the company's facilities. The company has determined that, beginning in the coming year, a significant number of its storage tanks and a significant amount of its other equipment will need to be removed, replaced, or modified to satisfy regulations that go into effect in varying stages over the next seven years. In addition, the company has a present obligation to decontaminate the soil in the near term at its largest facility.

A-29. The company hired a consultant to evaluate the technological, regulatory, and legal factors involved. Based on the consultant's findings, the company estimated that total environmental expenditures over the next seven years related to the tanks and equipment will aggregate approximately $5 million. Of this amount, approximately $4.75 million represents capital

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[15] If this information is already disclosed elsewhere in the notes, it need not be repeated.

[16] This is an example of voluntary disclosure that is encouraged by paragraph .14

expenditures, which are expected to be recoverable through operations. The existing tanks have a net book value of $500,000, and the equipment has a net bookvalue of $475,000. The cost of soil decontamination is estimated to be at least $1 million, which is material to the company's operations, and may be as high as $3 million. Exposure to legal liability to third parties is considered remote.

A-30. The consultant has demonstrated substantial experience with similar sites, and the technical aspects of upgrading storage facilities and decontaminating soil appear to be fairly straightforward.

A-31. *Disclosure*. **The company will begin a project to decontaminate the soil at its Anytown, Anystate facility in the coming year. The company estimates the cost of decontamination to total at least $1 million and has accrued that amount as an operating expense in the current year.[17] The ultimate cost [, however, will depend on the extent of contamination found as the project progresses and[18]] may be as much as $3 million. The company expects decontamination to be substantially completed within one year.**

A-32. *Discussion*. This disclosure informs financial statement users of the existence of the soil contamination problem at the financial statement date and indicates that the liability is susceptible to change in the near term. This SOP does not require disclosure of the capital commitment because it is not a present obligation for which an estimate is reflected in the company's financial statements.

A-33. Although, in this case, the near-term nature of the possible change is indicated by a statement that the company expects decontamination to be substantially completed within one year, an expectation that decontamination will take more than one year to complete would not preclude the estimate from being susceptible to near-term change. In such cases, the disclosure could be worded to specifically refer to the near term.

Illustrative Disclosure F—Guarantee of Debt

A-34. *Scenario*. Shipping Company operates a shipping center in Local City. In 19X0, Shipping decided to raise money for modernization of facilities through a debt offering. In order for the offering to take place, Smokestack Company, a local manufacturer, agreed to guarantee the bonds if Shipping's revenues were insufficient to pay debt service. In May 19X4 (four years later when the bonds had an outstanding balance of $55 million), Shipping lost two of its major shipping customers, constituting 35 percent of its prior-year revenues, to a company in a neighboring port. At Smokestack's June 30, 19X4, year end, Shipping was directing substantial efforts toward finding new customers. It is reasonably possible, however, that Shipping will not replace the lost revenue in time to pay debt service installments at December 30, 19X4, and June 30, 19X5, totaling $6 million.

A-35. *Disclosure*. **In 19X0, Smokestack guaranteed the Series AA debt of Shipping Company, which operates a shipping center within Local City. Smokestack continues as guarantor of such debt totaling $55 million. In May 19X4, Shipping Company lost two of its major customers. Although Shipping Company is directing substantial efforts toward obtaining new customers, it is at least reasonably possible that**

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[17] FASB Statement No. 5 states that "disclosure of the nature of an accrual [footnote omitted] made pursuant to the provisions of paragraph 8, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading."

[18] This is an example of voluntary disclosure that is encouraged by paragraph .14.

Shipping Company will not replace lost revenues sufficient to make its December 19X4 and June 19X5 debt service payments totaling $6 million. If so, the company will become responsible for repayment of at least a portion of that amount and possibly additional amounts over the debt term. No amount has been reported in the company's financial statements pending the outcome of Shipping Company's efforts during the next fiscal year.

A-36. *Discussion*. This example illustrates the potential near-term effect of a change in estimate of a contingent liability resulting from the guarantee of the debt of another entity. Shipping's loss of customers causes the potential for a near-term material change in that estimate within the next fiscal year. Although disclosure of Shipping's ongoing efforts to replace those customers is not required, this additional information may be presented.

Illustrative Disclosure G—Long-Term Construction Contract

A-37. *Scenario*. Rivet Construction Company is a nonpublic general contractor specializing in the construction of commercial buildings. Rivet has three long-term projects underway that are in various stages of completion. Rivet has a substantial history of making reasonably dependable estimates of the extent of progress towards completion, contract revenues, and contract costs, and it uses the percentage-of-completion method of accounting for all of its long-term contracts.

A-38. Shortly after December 31, 19X2, but before the 19X2 financial statements were issued, subsoil conditions were discovered at the site of Project A that will require Rivet to incur substantial additional, unbudgeted costs in completing the project. The nature of the subsoil problem is unusual in the region in which Rivet operates. The additional estimated costs are not considered to be a normal, recurring contract-accounting adjustment. Engineers have estimated the additional construction cost to be 10 to 40 percent of the original estimated construction cost, with 15 percent ($1.5 million) being their best estimate, and delays in construction are expected to add an additional 3 to 7 percent to the cost of construction, depending on the time involved, with 5 percent ($500,000) being the best estimate. Accordingly, Rivet has revised upward its estimate of costs to complete the project by $2 million. Project A, which was begun in 19X1 under a fixed-price contract, is still expected to be completed in the coming year (19X3), and it is still expected to be profitable.

A-39. The following is a summary of financial data at December 31, 19X2, for Project A.

	Before Discovery of Condition	*After Discovery of Condition*
Contract price	$15,000,000	$15,000,000
Estimated total cost	10,000,000	12,000,000
Estimated gross profit	5,000,000	3,000,000
Costs incurred to date	6,400,000	6,400,000
Percentage of completion	64%	53%

Rivet's other two projects are proceeding as planned.

A-40. *Disclosure*. **As a result of the discovery of unusual subsoil conditions at the site of Project A, estimated contract completion costs have been revised upward by $2 million. [Due to uncertainties inherent**

in the estimation process,[19]] it is at least reasonably possible that completion costs for Project A will be further revised in the near-term [by up to an additional $2.7 million].[20]

A-41. *Discussion*. In addition to any disclosures regarding the change in estimates that might be required by APB Opinion 20,[21] the disclosure requirements of this SOP focus on the effects of possible near-term changes in estimates. Disclosure is required under this SOP because it is at least reasonably possible that the estimated cost of completing Project A will change in the near term and that the change will be material to the financial statements.

A-42. Disclosure of the potential for changes in other estimates used in determining amounts reported for Rivet's long-term contracts is not required because, given Rivet's history of making similar estimates, it is not considered at least reasonably possible that they will change in the near term by amounts that would be material to the financial statements.

Illustrative Disclosure H—Realizability of a Deferred Tax Asset

A-43. *Scenario*. XYZ Corporation develops, manufactures, and markets limited-use vaccines. The company has a dominant share of the narrow market it serves. As of December 31, 19X4, the company has no temporary differences and has aggregate loss carryforwards of $12 million that originated in prior years and that expire in varying amounts between 19X5 and 19X7. As of December 31, 19X4, the company has a deferred tax asset of $4.8 million that represents the benefit of the remaining $12 million in loss carryforwards, and it has concluded at that date that a valuation allowance is unnecessary. The loss carryforwards arose during the company's development stage when it incurred high levels of research and development expenses prior to commencing sales. While the company has earned, on average, $6 million income before tax (taxable income before carryforwards) in each of the last five years, future profitability in this competitive industry depends on continually developing new products. The company has a number of promising new vaccines under development, but it is aware that other companies recently began testing vaccines that would compete with the vaccines being developed by the company as well as products that will compete with the vaccines that are currently generating the company's profits. Rapid introduction of competing products or failure of the company's development efforts could reduce estimates of future profitability in the near term, which could affect the company's ability to fully utilize its loss carryforward.

A-44. *Disclosure*.[22] **The company has recorded a deferred tax asset of $4.8 million reflecting the benefit of $12 million in loss carryforwards, which expire in varying amounts between 19X5 and 19X7. Realization is dependent on generating sufficient taxable income prior to expiration of the loss carryforwards. Although realization is not assured, management believes it is more likely than not that all of**

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[19] This is an example of voluntary disclosure that is encouraged by paragraph .14.

[20] As this contract is still expected to be profitable, the estimate does not involve a loss contingency covered by FASB Statement No. 5. Accordingly, disclosure of an estimate of the range of the possible change in estimate is not required.

[21] APB Opinion 20, *Accounting Changes*, paragraph 33, requires or recommends, depending on the estimates involved, disclosure of the effect of significant revisions of estimates if the effect is material.

[22] In addition to other disclosures, information as to the amount of loss carryforwards and their expiration dates and the amount of any valuation allowance with respect to the recorded deferred tax asset is required under FASB Statement No. 109, *Accounting for Income Taxes*.

the deferred tax asset will be realized. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.

A-45. *Discussion.* This disclosure informs users that (*a*) realization of the deferred tax asset depends on achieving a certain minimum level of future taxable income within the next three years and (*b*) although management currently believes that achievement of the required future taxable income is more likely than not, it is at least reasonably possible that this belief could change in the near term, resulting in establishment of a valuation allowance.

Illustrative Disclosure I—Litigation

A-46. *Scenario.* ABC Company is the defendant in litigation involving a major competitor claiming patent infringement. The suit claims damages of $200 million. Discovery has been completed, and ABC is engaged in settlement discussions with the plaintiff. ABC has made an offer of $5 million to settle the case, which offer was rejected by the plaintiff; the plaintiff has made an offer of $35 million to settle the case, which offer was rejected by ABC. Based on the expressed willingness of the plaintiff to settle the case along with information revealed during discovery and the likely cost and risk to both sides of litigating, the company believes that it is probable the case will not come to trial. Accordingly, the company has determined that it is probable that it has some liability. The company's reasonable estimate of this liability is a range between $10 million and $35 million, with no amount within that range a better estimate than any other amount; accordingly, $10 million was accrued.

A-47. *Disclosure.* **On March 15, 19X1, the DEF Company filed a suit against the company claiming patent infringement. While the company believes it has meritorious defenses against the suit, the ultimate resolution of the matter, which is expected to occur within one year, could result in a loss of up to $25 million in excess of the amount accrued.**[23]

A-48. *Discussion.* FASB Statement No. 5 requires accrual of a loss contingency and disclosure of the nature of the contingency, the exposure to loss in excess of the amount accrued, and, depending on the circumstances, the amount accrued. This SOP requires disclosure of an indication that it is at least reasonably possible that a change in the company's estimate of its probable liability could occur in the near term.

Current Vulnerability Due to Certain Concentrations

Note: The following are illustrations of the disclosures required by paragraph .21 of this SOP. Some of the concentrations described may fall into more than one of the categories of concentrations given in paragraph .22, a *through* d.

Illustrative Disclosure A—Supplier/Sources of Supply

A-49. *Scenario.* Hi-Tech Corp. is a manufacturer of electronic equipment in which integrated circuits are an important component. Substantially all of Hi-Tech's customers require that only those vendors that meet quality criteria be used as sources for integrated circuits. Hi-Tech currently buys all of its integrated circuits from one manufacturer in the Far East, and no long-term sup-

[23] See footnote 17 of this Appendix.

ply contract exists. There are only a limited number of manufacturers of these particular integrated circuits, and a change of supplier could significantly disrupt the business due to the time it would take to locate and qualify a new vendor.

A-50. *Disclosure*. **The company currently buys all of its integrated circuits, an important component of its products, from one supplier. Although there are a limited number of manufacturers of the particular integrated circuits, management believes that other suppliers could provide similar integrated circuits on comparable terms. A change in suppliers, however, could cause a delay in manufacturing and a possible loss of sales, which would affect operating results adversely.**

A-51. *Discussion*. Although other sources of supply of this particular kind of integrated circuit are currently available, the limited number of such sources and the time it takes to qualify new vendors makes Hi-Tech currently vulnerable to the risk of a near-term severe impact.

A-52. Disclosure is required because it is considered at least reasonably possible, based on information known to management prior to issuance of the financial statements, that the events that could cause the severe impact will occur.

Illustrative Disclosure B—Supplier/Sources of Supply

A-53. *Scenario*. Minnesota Company manufactures various products in which wheat is an important raw material. It currently buys 80 percent of its wheat from one supplier, but numerous alternate sources of supply are readily available on comparable terms.

A-54. *Disclosure*. **(No disclosure is required.)**

A-55. *Discussion*. The concentration exists at the date of the financial statements, and an inability to obtain wheat could result in a near-term severe impact. No disclosure is required, however, because numerous alternative suppliers are available and, therefore, it is not considered at least reasonably possible that events that could cause a near-term severe impact will occur.

Illustrative Disclosure C—Patent

A-56. *Scenario*. Felt Pharmaceutical Company is a national pharmaceutical manufacturer headquartered in Atlanta, Georgia. The company markets a wide range of pharmaceutical products. One of its better-known name-brand products, a significant source of profits and cash flow, is an antibiotic on which there is a patent that will expire in six months. Competitors are preparing to enter the market with generic alternatives when Felt's patent expires, and the concentration therefore has the potential for a severe impact.

A-57. *Disclosure*. **Felt Pharmaceutical Company is a national pharmaceutical manufacturer with sales throughout the United States. The patent on one of its major products expires next year. This product accounts for approximately one-third [or "a significant portion"] of the company's revenues and a higher percentage of its gross profit.**

A-58. *Discussion*. The disclosure focuses on the nature of the business and on Felt's current vulnerability due to a concentration of its patented products. Disclosure is required because the concentration exists at the date of the financial statements, because the effect on the company's cash flows and profitability of competitors entering the market when the patent expires could be a severe impact, and because it is considered at least reasonably possible that the events that could cause the severe impact will occur in the near term.

A-59. Because the risk is evident from the description of the concentration, no further explanation of the risk is necessary.

Illustrative Disclosure D—Source of Supply of Labor

A-60. *Scenario*. Team Company is a manufacturer of industrial hardware. The contract with the union representing Team's labor force is due to expire in the coming year. Over the past thirty years, Team has, in rare instances, been affected by work stoppages in the course of contract negotiations; they have always been of short duration, and none has had a significant effect on Team's financial statements. Although management expects that there will initially be some differences between its offer to the union and union demands, based on preliminary discussions with union leaders, management believes it is very unlikely that those differences will result in a protracted conflict.

A-61. *Disclosure*. **(No disclosure is required.)**

A-62. *Discussion*. Although the concentration of labor exists at the date of the financial statements and it could result in a severe impact in the near term due to the potential of a protracted work stoppage, no disclosure is required because it is not considered at least reasonably possible in the light of past experience and current conditions that a protracted work stoppage will take place.

Illustrative Disclosure E—Contributor

A-63. *Scenario*. Zebra Zoo, a not-for-profit organization, is supported by contributions from the public. In the current year, two contributors provided 35 percent of the organization's combined revenues.

A-64. *Disclosure*. **Approximately 35 percent of the organization's combined revenues were provided by two contributors.**

A-65. *Discussion*. Disclosure is required because the two contributors provided a significant portion of the organization's revenues. As noted in paragraph .22, it is always considered reasonably possible that a customer, grantor, or contributor will be lost in the near term.

Illustrative Disclosure F—Geographic Area of Operations

A-66. *Scenario*. Offshore Productions, Inc. (Offshore), a Delaware corporation, designs and manufactures optical lenses, which it markets throughout the United States. Substantially all of its manufacturing operations are carried out in a single facility, which is located in Switzerland and which is owned by Offshore's subsidiary. Offshore does not carry insurance for risks of loss. Offshore's consolidated balance sheet includes $20 million representing the net assets of those operations.

A-67. *Disclosure*. **Included in the company's consolidated balance sheet at December 31, 19X4, are the net assets of the company's manufacturing operations, all of which are located in a single facility in Switzerland and which total approximately $20 million.**[24]

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[24] [Footnote deleted, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 131.]

A-68. *Discussion*. All of Offshore's specialized manufacturing capacity is concentrated in a single facility. As noted in paragraph .22, it is always considered at least reasonably possible that the use of a facility located outside of an entity's home country could be disrupted in the near term. Due to the specialized nature of the assets, it would not be possible to find replacement capacity quickly. Accordingly, loss of the facility could produce a near-term severe impact to Offshore. This disclosure informs financial statement users of that concentration of operations in a particular geographic area and informs them of the risks and uncertainties associated with the concentration. Because the concentration is one of operations located outside of Offshore's home country, the disclosure also sets forth the carrying amount of the net assets, as required by paragraph .24 of this SOP.

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Appendix B

Background Information and Basis for Conclusions

B-1. FASB Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises*, states that financial reporting should "provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions" (paragraph 34). To support that decision-making process, financial reports should help such users "assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise" (paragraph 37) by providing "information about the economic resources of an enterprise, the claims to those resources...and the effects of transactions, events, and circumstances that change resources and claims to those resources" (paragraph 40). Without additional disclosure in financial reports about significant risks and uncertainties, these objectives may not be fully met in today's environment.

B-2. Recognizing that a riskier business and economic climate equates to a riskier investment and lending climate, users increasingly are asking that financial statements include more information to help them assess the risks and uncertainties concerning a reporting entity's future cash flows and results of operations. These requests are underscored in calls for an "early warning system" expressed in the financial press and in congressional hearings.

B-3. No system of reporting can provide early warnings of all future detrimental events. Indeed, management may be unaware, and reasonably so, of some significant risks and uncertainties. And, clearly, financial statements should not be burdened in an attempt to describe every possible risk and uncertainty facing the reporting entity.

B-4. But such limitations should not prevent users from receiving improved disclosures concerning significant risks and uncertainties. Their existence merely means that any new disclosure requirements must focus on what is important. New disclosure requirements should effectively separate the significant matters that warrant reporting from the host of lesser risks and uncertainties that do not.[25] AcSEC believes that the requirements in this SOP meet those objectives.

B-5. In reaching the conclusions in this SOP, AcSEC considered and evaluated users' reliance on financial information, sources of financial information, current accounting and disclosure requirements, current SEC requirements, and users' perceptions of the kinds of information that should be presented in financial statements.

Users' Reliance on Financial Information

B-6. Information in financial statements, shaped by generally accepted accounting principles (GAAP) and, for SEC registrants, by the additional regulatory requirements of the Commission, is considered important to users in making investment and lending decisions. Financial statements provide information about certain current conditions and trends that help users in pre-

[25] This SOP does not prohibit disclosure of matters it does not require to be disclosed either because they do not meet the specified screening criteria or because they relate to risks and uncertainties that are outside the scope of this SOP.

dicting reporting entities' future cash flows and results of operations. The quality of users' predictions depends to a significant degree on their assessment of the risks and uncertainties inherent in entities' operations and of the information about those operations that financial reporting provides.

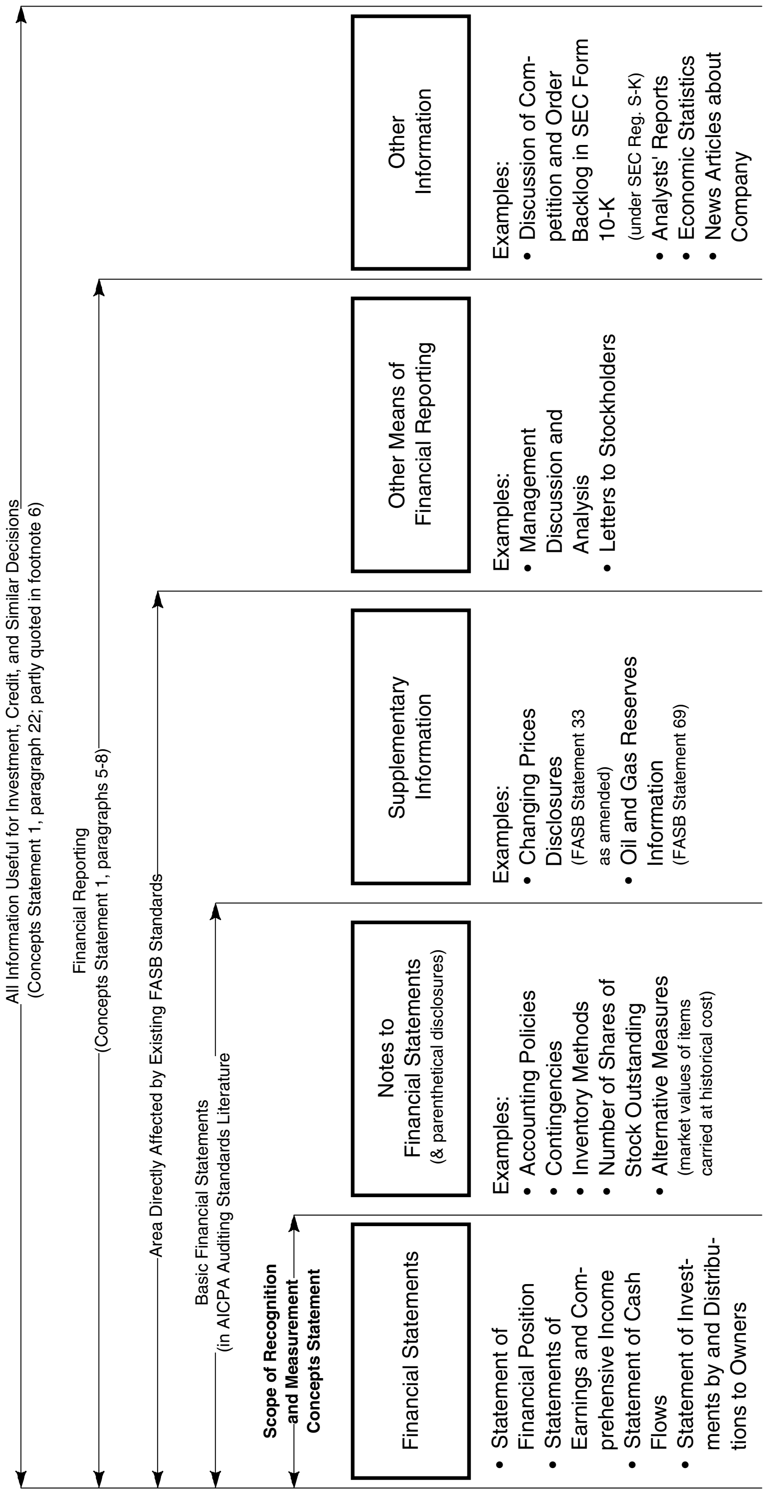
B-7. Financial reporting largely reflects the effects of past transactions and other events that have already affected a reporting entity. Such information can help users in assessing the future. But that does not mean the future can be predicted merely by extrapolating past trends or relationships. Indeed, volatility in the economic environment almost always means that simply extrapolating past trends and relationships will lead to inaccurate predictions. Users need to assess all currently available information to form their own expectations about the future and its relation to the past. Forming expectations—making predictions—is a vital part of the decision process. But it is a function of financial analysis, not of financial reporting. Furthermore, financial reporting is only one source of information required for making investment and credit decisions.

B-8. Reporting entities and those who have economic interests in them are affected by many factors that interact in complex ways. Those who use financial information for business and economic decisions need to combine information provided by financial reports with pertinent information from other sources, including additional information provided by issuers, financial analysts' reports, business and trade publications, and reports of macroeconomic and other local, national, and international events.

Sources of Financial Information

B-9. Financial reporting encompasses the financial statements and notes, required information supplementary to the financial statements, and other information, such as that included in Management's Discussion and Analysis (MD&A), which the SEC requires publicly held business enterprises to provide in their annual and quarterly reports. Additional sources of information include company releases, current information filings of publicly held business enterprises, investment advisory services, analysts' reports, the financial press, general economic statistics, and general news reports.

B-10. The major sources of financial information and their relationships for business and not-for-profit entities are illustrated in the following diagram, taken from FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.



[Source: FASB Concepts Statement No. 5, p. 5]

Current Accounting Requirements

B-11. Disclosing information to help users assess major risks and uncertainties is consistent with the established objectives of financial reporting, and some such information is already presented in financial statements. Such information includes, for example, information about financial instruments with off-balance-sheet risk and financial instruments with concentrations of credit risk, related party disclosures and information about receivables, leases, pensions, postretirement benefits, and commitments and contingencies. In addition, publicly held business enterprises are required to disclose in their financial statements segment information and information about foreign operations, export sales, and major customers, which, among other things, helps users to assess risks and uncertainties. This SOP, however, is intended to extend disclosures beyond those currently required and to help users discern those risks that are of particular importance.

Nature of Operations

B-12. Current GAAP (FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*) requires a public business enterprise to disclose the major types of products and services that generate revenues, that is, the nature of its businesses, as part of segment information in its financial statements, even if the business enterprise operates in only one industry.[26] Information presented includes a description of the types of goods or services provided, operating revenues, operating income or loss, net income or loss, net working capital, and total assets for each segment. But other reporting entities are not required to disclose such information.[27] Thus, financial statement users now sometimes cannot discern the nature of the operations of such other entities from information presented in their financial statements.

B-13. Information about the nature of operations is helpful because the various kinds of businesses in which reporting entities operate have diverse degrees and kinds of risks. Certain of these risks are inherent to the business in which an entity is engaged. Simply by knowing the nature of an entity's business and the principal markets for its products or services, a financial statement user is alerted, indirectly, about the risks common to that business.

B-14. Some have expressed concerns about whether this SOP conflicts with FASB Statement No. 21, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises*. AcSEC believes that, while the information that this SOP requires to be disclosed concerning the nature of a reporting entity's operations overlaps in certain respects the information public business enterprises are required to report under FASB Statement No. 14, it is significantly different in other respects. Accordingly, AcSEC does not believe this SOP conflicts with Statement No. 21.

B-15. Further, AcSEC notes that, for public business enterprises that already disclose information about the nature of their operations pursuant to FASB Statement No. 14, this SOP requires disclosure of additional information about the nature of their operations.

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[26] The FASB currently has on its agenda a project on disaggregated disclosures, which is reconsidering issues related to FASB Statement No. 14.

[27] FASB Statement No. 21, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises*, suspended the segment information reporting requirements of FASB Statement No. 14 for nonpublic enterprises.

B-16. The disclosure required by paragraph .10 of this SOP focuses on the entity's principal markets, including their locations. Current segment information for business enterprises, in contrast, focuses on the nature of the segments' operations and their identifiable assets and the geographic location of assets outside the enterprise's home location. Disclosure of the locations of a business or not-for-profit entity's principal markets provides information useful in assessing risks and uncertainties related to the environments in which the entity operates. The risks and the uncertainties associated with selling products and services in various regions in the United States may differ significantly. And they do differ significantly from the risks and the uncertainties in selling products and services outside the United States. Knowing those environments in which an entity sells its products or provides services helps users of financial reports to assess certain risks based on day-to-day national and world events.

B-17. The following table compares and contrasts the information required of public companies by FASB Statement No. 14 with paragraph .10.

Comparison of Disclosure Requirements:
FASB Statement No. 14 (Segment Reporting) Versus
Paragraph .10 of this SOP

Disclosure	*FASB Statement No. 14*	*Paragraph .10*
Description of the types of products or services sold	X	X
Revenue, profitability, identifiable assets, and other related disclosures for each reportable segment	X	**
Revenue, profitability, identifiable assets for foreign operations, by geographic area	X	††
Export sales by domestic operations, by geographic area	X	
Significant sales to single customer, foreign government, or domestic governmental agency	X	‡‡
Identification of principal markets		X
Description of location of principal markets		X

** Paragraph .10 requires an indication of the relative importance of operations in each business.

†† This SOP requires disclosure of current vulnerability due to concentrations in the market or geographic area in which an entity conducts its operations if the criteria in paragraph .21 are met.

‡‡ This SOP requires disclosure of current vulnerability due to concentrations of customers if the criteria in paragraph .21 are met.

B-18. AcSEC considered whether disclosure of an entity's principal operating locations would be informative to financial statement users and should, therefore, be included in paragraph .10. AcSEC concluded that, although in certain circumstances such information would be relevant, generally it would not be. In addition, disclosure of an entity's principal operating locations would be required under paragraph .21 (current vulnerability due to certain concentrations) in circumstances where operating in that particular environment created substantive near-term risk to the entity. Knowing, however, that a manufacturing plant is located in Dallas, Texas, for example, was not considered particularly relevant information. In contrast, knowing where a residential housing construction contractor's principal market is located was considered to be highly relevant. As a result, disclosure of the location of principal markets was chosen by AcSEC for inclusion in paragraph .10, while disclosure of the location of principal operating units was considered unnecessary.

Use of Estimates in the Preparation of Financial Statements

B-19. Auditors are required under generally accepted auditing standards (GAAS)[28] to acknowledge in their standard reports the use of estimates in the preparation of financial statements. AcSEC has concluded, however, that an explanation that the preparation of financial information requires the use of estimates and assumptions should be included in the financial statements by the reporting entity to inform users of the nature and limitations of those financial statements. AcSEC acknowledges that the disclosure would usually be standardized. AcSEC nevertheless believes it would help users make sounder use of financial statements.

B-20. There is a need to communicate explicitly to users of financial reports that the inescapable use of estimates in the preparation of financial information, including the estimation of fair and, in some cases, market values for assets carried at such bases, results in the presentation of a number of approximate rather than exact amounts. If users understand better the inherent limitations on precision in financial statements, they will be better able to make decisions.

B-21. Estimates inherent in the current financial reporting process inevitably involve assumptions about future events. For example, accruing income for the current period under a long-term contract requires an estimate of the total profit to be earned on the contract. For another example, carrying inventories at the lower of cost or market is based on an assumption that there will be sufficient demand for that product in the future to be able to sell the quantity on hand without incurring losses on the sales or, if market is used, that it can be estimated. Making reliable estimates for such matters is often difficult even in periods of economic stability; it is more so in periods of economic volatility. Although many users of financial reports are aware of that aspect of financial reporting, others often assume an unwarranted degree of reliability in financial statements. The disclosure required by this SOP should help dispel any such erroneous assumptions.

B-22. A number of publicly held business enterprises now include management reports in annual reports to stockholders. Many such reports and letters state that estimates and assumptions are required to prepare financial statements in conformity with GAAP. AcSEC acknowledges that development, but it believes the disclosure should be mandated and included in the notes to financial statements.

Certain Significant Estimates

B-23. FASB Statement No. 5 requires reporting entities to disclose certain loss contingencies, as follows:

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[28] SAS No. 58, *Reports on Audited Financial Statements*, requires auditors to include in their standard reports a statement that an audit includes "assessing . . . significant estimates made by management."

> If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or *if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.*[6] The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. [Emphasis added.] [FASB Statement No. 5, paragraph 10]

Footnote 6 to Statement No. 5 states:

> For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 8(a) but that is not accrued because the amount of loss cannot be reasonably estimated (paragraph 8(b)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8(a)—namely, those contingencies for which there is a *reasonable possibility* that a loss may have been incurred even though information may not indicate that it is *probable* that an asset has been impaired or a liability had been incurred at the date of the financial statements. [Emphasis in original.]

FASB Statement No. 5 defines loss contingencies as:

> an existing condition, situation, or set of circumstances involving uncertainty as to possible . . . loss . . . to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability. [paragraph 1]

The recognition and disclosure requirements of Statement No. 5 are further clarified in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*. This SOP does not change the requirements of FASB Statement No. 5 or FASB Interpretation No. 14; the requirements of this SOP supplement those requirements. For example, if a loss contingency meets the criteria for disclosure under both Statement No. 5 and paragraph .13 of this SOP, this SOP requires disclosure that it is at least reasonably possible that future events confirming the fact of the loss or the change in the estimated amount of the loss will occur in the near term.

B-24. This SOP also requires disclosure of matters that may not be deemed to be contingencies requiring disclosure under current GAAP. FASB Statement No. 5 distinguishes loss contingencies from other uncertainties inherent in making accounting estimates, as follows:

> Not all uncertainties inherent in the accounting process give rise to contingencies as that term is used in this Statement. Estimates are required in financial statements for many on-going and recurring activities of an enterprise. The mere fact that an estimate is involved does not of itself constitute the type of uncertainty referred to in the definition [of a contingency] in paragraph 1. For example, the fact that estimates are used to allocate the known cost of a depreciable asset over the period of use by an enterprise does not make depreciation a contingency; the eventual expiration of the utility of the asset is not uncertain. Thus, depreciation of assets is not a contingency as defined in paragraph 1, nor are such matters as recurring repairs, maintenance, and overhauls, which interrelate with depreciation. Also, amounts owed for services received, such as advertising and utilities, are not contingencies even though the accrued amounts may have been estimated; there is nothing uncertain about the fact that those obligations have been incurred. [paragraph 2]

FASB Statement No. 5 acknowledges, however, that the distinction between uncertainties inherent in making accounting estimates and uncertainties that give rise to a contingency is not always clear:

> A question has been raised whether uncollectibility of receivables and product warranties constitute contingencies within the scope of this Statement. The Board recognizes that uncertainties associated with uncollectibility of some receivables and some product warranties are likely to be, in part, inherent in making accounting estimates (described in paragraph 2) as well as, in part, the type of uncertainties that give rise to a contingency (described in paragraph 1). The Board believes that no useful purpose would be served by attempting to distinguish between those two types of uncertainties for purposes of establishing conditions for accrual of uncollectible receivables and product warranties. Consequently, those matters are deemed to be contingencies within the definition of paragraph 1 and should be accounted for pursuant to the provisions of this Statement. [paragraph 58]

B-25. AcSEC believes that requiring disclosure of certain estimates not deemed to be covered by current GAAP, for example, some amounts reported for long-term contracts, would enhance the usefulness of financial statements in assessing risks and uncertainties.

B-26. Among the matters specifically excluded from the scope of FASB Statement No. 5 is the write-down of operating assets. Paragraph 31 of Statement No. 5 states:

> In some cases, the carrying amount of an operating asset not intended for disposal may exceed the amount expected to be recoverable through future use of that asset even though there has been no physical loss or damage of the asset or threat of such loss or damage. For example, changed economic conditions may have made recovery of the carrying amount of a productive facility doubtful. The question of whether, in those cases, it is appropriate to write down the carrying amount of the asset to an amount expected to be recoverable through future operations is not covered by this Statement.

The requirements of paragraph .13 of this SOP are applicable to long-lived assets whose value may become impaired in the near term.

B-27. On November 29, 1993, the FASB issued an exposure draft of a Proposed Statement of Financial Accounting Standards, *Accounting for the Impairment of Long-Lived Assets*. That exposure draft is expected to result ultimately in the promulgation of authoritative guidance on recognition, measurement, and disclosure requirements for long-lived assets whose carrying amounts may not be recoverable. Paragraphs 102 and 103 of the exposure draft state:

> In 1985, the AICPA established a task force to consider the need for improved disclosures about risks and uncertainties that affect companies and the manner in which they do business. In July 1987, the task force published *Report of the Task Force on Risks and Uncertainties*, which concluded that companies should be making early warning disclosures as part of their financial statements. In March 1993, AcSEC issued an exposure draft of a proposed Statement of Position, *Disclosure of Certain Significant Risks and Uncertainties and Financial Flexibility*. That proposed SOP would require entities to include in their financial statements disclosures about (*a*) the nature of their operations, (*b*) the use of estimates in the preparation of their financial statements, (*c*) certain significant estimates, (*d*) current vulnerability due to concentrations, and (*e*) financial flexibility.

> Board members observed that for some impairments early warning disclosures would be useful. However, they were in general agreement, based on comment letters and testimony, that it would not be possible to adequately describe those situations and develop adequate disclosure requirements. Some Board members also believed that the proposed SOP is a much broader disclosure requirement that could have implications in several other Board projects. Board members therefore concluded not to require early warning disclosures in this Statement.

AcSEC notes that, while the exposure draft would not require early warning disclosures concerning impairment of long-lived assets, it acknowledges the usefulness of such disclosures and recognizes that the disclosure requirement of this SOP is a much broader requirement than the FASB considered.

Current Vulnerability Due to Certain Concentrations

B-28. Current GAAP requires disclosure of certain concentrations (for example, credit concentrations under FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and information about major customers under FASB Statement No. 14 for public enterprises) but does not specifically address disclosures of concentrations on a comprehensive basis. This SOP addresses known concentrations more comprehensively but stops short of requiring disclosure of all concentrations.

B-29. Some believe that disclosure of economic dependency is required under current literature. A requirement to disclose economic dependency was included in SAS No. 6, *Related Party Transactions*. But, partly in response to the issuance of FASB Statement No. 57, *Related Party Transactions*, the AICPA superseded SAS No. 6 in August 1983 with the issuance of SAS No. 43, *Omnibus Statement on Auditing Standards—1983*, which, among other things, "remov[ed] guidance on accounting considerations and disclosure standards . . . provided in FASB Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*." Statement No. 57 states, in turn, that it "does not address the issues pertaining to economic dependency."

B-30. The FASB observed in Statement No. 21, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises*, which was issued in April 1978 and which eliminated the requirement for nonpublic enterprises to disclose information about major customers, that FASB Statement No. 21 "does not affect the disclosure of information about economic dependency when such disclosure may be necessary for a fair presentation." That observation, however, refers to the now-superseded SAS No. 6.

B-31. AcSEC believes that disclosure in the notes to financial statements about current vulnerability due to concentrations of customers, grantors, and contributors is necessary for a fair presentation when the criteria in paragraph .21 of this SOP are met. Assessing the likelihood of loss of relationships with these parties would often present difficulties, however. Accordingly, for purposes of this SOP, it is always considered at least reasonably possible that any of these relationships will be lost in the near term. Similarly, because of the difficulty in assessing the political and economic risks associated with operations located outside an entity's home country, for purposes of this SOP, it is always considered at least reasonably possible that those operations might be disrupted in the near term. This SOP does not, however, prohibit entities from also stating in disclosures of concentrations related to customers, grantors, or contributors or operations located outside the entity's home country that the entity does not expect that the business relationship will be lost or does not expect that the foreign operations will be disrupted if such is the case.

B-32. AcSEC considered whether it would be useful to establish quantitative criteria for disclosure of concentrations, either in place of or in addition to the qualitative criteria provided. AcSEC believes that a quantitative approach might not provide meaningful information about an enterprise (for example, a critical supplier is not necessarily a major supplier). Any potential simplification in implementing the disclosure requirements that might result from a quantitative approach would be outweighed by deterioration in the quality of information provided.

Current SEC Requirements

B-33. The SEC requirement for information to be included in MD&A expands the information that financial reporting otherwise provides to include certain specific kinds of information related to liquidity, capital resources, and results of operations. It further expands the information to include management analysis of trends and other factors. Thus, management's subjective analysis is a significant part of the information users obtain from financial reporting of publicly held business enterprises as the data for their decisions.

B-34. The FASB's Concepts Statements present the view that such analysis is helpful to users. For example, in Concepts Statement No. 1, the FASB observes that financial reporting should include explanations and interpretations and cites as an example management's explanation of the information as a significant aid to users.

B-35. Under SEC requirements relating to MD&A, publicly held business enterprises are required to describe, among other things, "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations" (Regulation S-K, Item 303(a)(3)(ii)). SEC Financial Reporting Release (FRR) No. 36 clarifies that disclosure is required unless management determines that the trend or uncertainty is not reasonably likely to occur or that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur. Publicly held business enterprises are encouraged but not required to include forward-looking information relevant to a full understanding of their past and anticipated operations.

B-36. The disclosure of current vulnerability due to certain concentrations required by paragraph .21 of this SOP differs from the MD&A requirement in two important respects. First, the MD&A rules apply broadly to "any known trends or uncertainties," whereas paragraph .21 applies only to certain known concentrations. Second, this SOP requires disclosure only if the effect would cause a severe impact in the near term—a higher threshold than "material" used for MD&A purposes. AcSEC believes a higher threshold is needed for these disclosures to avoid required disclosure of lengthy lists of risks related to concentrations that are reasonably possible in today's environment and at the same time still meet the objective of providing an early warning of the potential for a disruptive set of events occurring in the near term.

B-37. The SEC also requires registrants, "where appropriate," to include in prospectuses offering securities to the public "a discussion of the principal factors that make the offering speculative or one of high risk." Among the factors cited are "the financial position of the registrant" and "the nature of the business in which the registrant is engaged or proposes to engage" (Regulation S-K, Item 503(c)).

B-38. This information required by the SEC is not now required for entities not subject to SEC regulation. However, expanding the scope of financial statements to include some of such information is compatible with the objectives of financial reporting. This SOP requires disclosure in the notes to financial statements of some of the information now reported in MD&A or as risk factors but might also require disclosure of certain information not currently required in either place.

Comments Received on Exposure Draft

B-39. An exposure draft of a proposed Statement of Position, *Disclosure of Certain Significant Risks and Uncertainties and Financial Flexibility*, was issued for public comment on March 31, 1993, and distributed to approximately 20,000 interested parties to encourage comment by those who would be affected by the proposal. Over 300 comment letters were received in response to the exposure draft. Substantially all of the responses expressed reservations regarding the exposure draft's required disclosures of certain significant estimates, current vulnerability due to concentrations, and financial flexibility, while relatively few respondents expressed concerns regarding the disclosure of the nature of the reporting entity's operations or the use of estimates in the preparation of financial statements.

B-40. The most significant and pervasive concerns can be summarized in three areas:

a. The cost of determining the necessity of the disclosures will exceed the benefit received from providing them, particularly for small, privately owned entities, and particularly with respect to the requirements for disclosure of financial flexibility.

b. Requiring disclosures based on information "of which management is reasonably expected to have knowledge" is too subjective and unnecessarily expands costs and liability as well as the "expectation gap."

c. "Reasonably possible" is too low a threshold and is an insufficiently objective criterion for disclosure of a broad range of possible future events.

B-41. AcSEC considered the comments received on the exposure draft and took the following actions in response to them.

a. The requirement for disclosure of financial flexibility has been eliminated from this SOP. Financial flexibility was the exposure draft's most controversial requirement, with deep concerns expressed about the cost of compliance. Other concerns were expressed regarding the overlap between the exposure draft's requirements and the requirements of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, and the ability of the exposure draft's criteria to highlight meaningful information and to differentiate among entities that have different risks.

AcSEC does, however, continue to consider financial flexibility disclosures to be relevant early warnings for financial statement users. AcSEC also believes that disclosure requirements such as those included in SAS No. 59 should be included in accounting rather than auditing standards. Therefore, AcSEC and the AICPA's Auditing

Standards Board are considering forming an interdivisional task force to develop accounting standards to provide the appropriate early warnings of possible financial difficulties and to replace disclosure requirements currently included only in auditing standards.

b. This SOP requires disclosure of certain defined concentrations known to management rather than a wider range of concentrations based on information of which management "is reasonably expected to have knowledge." Further, because of the continuing activity of the FASB in establishing disclosure requirements related to financial instruments, none of the defined concentrations relate specifically to financial instruments. The disclosures are to be made when (*a*) the concentrations are known to exist at the date of the financial statements, (*b*) they make the enterprise vulnerable to the risk of a near-term severe impact, and (*c*) it is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

AcSEC considered eliminating the reasonably possible and severe-impact disclosure criteria, but decided that retention of these criteria should promote disclosures that are more significant and useful than standardized listings that might otherwise result.

c. The requirements to disclose certain significant estimates have been clarified to make them more consistent with the requirements of FASB Statement No. 5. This SOP requires discussion of estimates when, based on known information available prior to the issuance of the financial statements, it is reasonably possible that the estimate will change in the near term and the effect of the change will be material. AcSEC responded to concerns regarding the predictive nature of this disclosure requirement by stipulating that it is the estimate of the effect of a change in a condition, situation, or set of circumstances that existed at the date of the financial statements that must be disclosed and that the evaluation should be based on known information available prior to issuance of the financial statements.

AcSEC also revised the disclosure requirements included in the exposure draft applicable to estimates not involving loss contingencies covered by FASB Statement No. 5. With respect to such estimates, this SOP does not require the disclosure of the possible loss or range of loss or the statement that such an estimate cannot be made.

Placement of Disclosures

B-42. A significant number of commentators recommended that, because of the subjectivity associated with some of the disclosures required by this SOP, they should be presented outside the basic financial statements, either as supplemental information or in MD&A.

B-43. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, distinguishes between information that should be part of the basic financial statements and that which should be provided as supplementary information. Paragraph 7 of Concepts Statement No. 5 emphasizes that information disclosed as part of the basic financial statements amplifies or explains information recognized in financial statements and is essential to understanding that information. FASB Statement No. 107, however, points out in paragraph 75 a need for disclosure about "many important items . . . not recognized as assets and liabilities in financial statements, and many transactions and other events . . . not recognized when they occur but only later when uncertainty about them is reduced sufficiently so that their effects are clear."

B-44. The disclosures required by this SOP build on disclosures already included in the basic financial statements and, like them, serve one of the major purposes of disclosure summarized in Appendix D of FASB Statement No. 105, that is, to help in assessing risks and potentials. AcSEC also believes that the changes made in response to the comments received on the exposure draft have significantly reduced the subjectivity of the disclosures. Accordingly, AcSEC concluded that all of the disclosures now required by this SOP should be included in the basic financial statements.

Scope

B-45. The exposure draft of this SOP would have applied to state and local governmental units. However, concern was expressed that inclusion of such entities unduly complicated the SOP. Further, resolving financial reporting issues unique to state and local governments that were brought up by commentators on the exposure draft—especially in the light of the other substantive changes made to the exposure draft—would have unduly delayed the issuance of this SOP. AcSEC believes the understandability of this SOP is improved by not including state and local governmental units in its scope.[29]

B-46. Many commentators on the exposure draft recommended that other reporting entities, especially smaller nonpublic reporting entities, be exempted from this SOP's disclosure requirements. AcSEC considered those recommendations and concluded that the disclosures required by this SOP are no less relevant for such entities and that the changes made to the exposure draft sufficiently mitigate the concerns expressed by commentators.

B-47. Some commentators requested that AcSEC clarify the applicability of the SOP's requirements to financial statements prepared using an Other Comprehensive Basis of Accounting (OCBOA). AcSEC concluded that the applicability of disclosures required by GAAP to OCBOA financial statements is a pervasive issue that is beyond the scope of this SOP.

Field Tests

B-48. The March 31, 1993 exposure draft *Disclosure of Certain Significant Risks and Uncertainties and Financial Flexibility* was subjected to limited field testing in which the exposure draft was applied to small and medium-size busi-

[29] Under the provisions of Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, paragraph 7, proprietary activities may apply *all* FASB Statements and Interpretations issued after November 30, 1989, *except for* those that conflict with or contradict GASB pronouncements. Paragraph 33 of the "Basis for Conclusions" of that Statement explains that, for proprietary activities that apply paragraph 7, an AICPA SOP that does not include governmental entities in its scope but that has been cleared by the Financial Accounting Standards Board (FASB) would be considered category (b) guidance under Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, issued by the Auditing Standards Board of the AICPA.

nesses, a not-for-profit organization, and case studies. The issues highlighted by the results of those tests were similar to the issues raised in the comment letters on the exposure draft. The results of the field tests were considered by AcSEC in its deliberations of this SOP.

Cost/Benefit

B-49. AcSEC believes the disclosures required by this SOP will improve financial reporting by providing, in a number of situations, information that will assist financial statement users in assessing certain risks and uncertainties inherent in financial reporting. AcSEC also believes the changes made to the exposure draft, which are discussed in paragraph B-41, are reasonably responsive to concerns expressed by commentators about the cost of determining the need for and making those disclosures.

B-50. FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, states in paragraph 142 that:

> The costs and benefits of a standard are both direct and indirect, immediate and deferred. They may be affected by a change in circumstances not foreseen when the standard was promulgated. There are wide variations in the estimates that different people make about the dollar values involved and the rate of discount to be used in reducing them to a present value . . . [It has been observed that] "the merits of any Standard, or of the Standards as a whole, can be decided finally only by judgments that are largely subjective. They cannot be decided by scientific test."

B-51. While a reliable evaluation of costs versus benefits is not possible, AcSEC believes that the benefits of the disclosures required by this SOP will outweigh their costs.

AICPA Special Committee on Financial Reporting

B-52. In the Spring of 1991, the AICPA's Board of Directors formed a Special Committee on Financial Reporting to address increasing concerns about the relevance and usefulness of financial reporting. The committee's charge is to recommend to standards setters and regulators (1) the nature and extent of information that should be made available to others by management and (2) the extent to which auditors should report on the various elements of that information. The focus of the Special Committee's work is on the information needs of investors and creditors, and its recommendations will be responsive to those needs.

B-53. In its November 1993 report on the information needs of today's users of financial reporting, *The Information Needs of Investors and Creditors*, the Special Committee stated:

> Users want operating opportunities and risks identified based on the company and its segments rather than on an industry-wide basis. They also want information about opportunities and risks resulting from concentrations in assets, customers and suppliers.

B-54. AcSEC considered the Special Committee's preliminary findings in developing this SOP, and AcSEC may reconsider the guidance in this SOP in the light of the Special Committee's recommendations, if and when the conclusions are implemented by standards-setting bodies.

Accounting Standards Executive Committee (1993-1994)

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Section 10,650

Statement of Position 95-1 Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises

January 18, 1995

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Introduction and Background

.01 Most mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies (hereafter collectively referred to as *mutual life insurance enterprises*) issue financial statements prepared in conformity with statutory accounting practices. Practice, however, has been to consider statutory accounting practices as generally accepted accounting principles (GAAP), and mutual life insurance enterprises' statutory financial statements have been described as being in accordance with GAAP.

.02 In April 1993, the FASB issued Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, which concludes that financial statements based on statutory accounting practices can no longer be described as prepared in conformity with GAAP. FASB Interpretation No. 40, as amended by FASB Statement of Financial Accounting Standards No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, is effective for financial statements issued for fiscal years beginning after December 15, 1995. (FASB Statement No. 120 does not change the disclosure and other transition provisions of Interpretation No. 40.) Accordingly, mutual life insurance enterprises that wish to prepare GAAP financial statements in 1996 and beyond will have to apply pertinent authoritative accounting pronouncements, such as FASB Statements and Interpretations, Accounting Principles Board Opinions, and AICPA Statements of Position, that do not explicitly exempt mutual life insurance companies.

.03 When FASB Interpretation No. 40 was issued, FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, exempted mutual life insurance companies from their provisions. Furthermore, the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies* does not apply to mutual life insurance companies.[1] Accordingly, there was no authoritative guidance that explicitly addressed how to account for certain insurance activities of mutual life insurance enterprises. Recognizing the lack of authoritative guidance, the FASB urged the AICPA to take on a project to address accounting and reporting by mutual life insurance enterprises for their insurance activities. This SOP was prepared in response to that request. Furthermore, concurrent with the issuance of this SOP, the FASB has issued Statement No. 120, which removes the exemption for mutual life insurance enterprises from FASB Statement Nos. 60, 97, and 113 and recognizes that participating life insurance contracts that meet the conditions in paragraph .05 of this SOP should be accounted for under this SOP.

Applicability and Scope

.04 This SOP applies to all mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies. This SOP also applies to stock life insurance subsidiaries of mutual life insurance enterprises.

.05 This SOP applies to life insurance contracts that have both of the following characteristics:

a. They are long-duration participating contracts that are expected to pay **dividends to policyholders**[2] based on actual experience of the insurance enterprise.

b. **Annual policyholder dividends** are paid in a manner that identifies divisible surplus and distributes that surplus in approximately the same proportion as the contracts are considered to have contributed to divisible surplus (commonly referred to in actuarial literature as the *contribution principle*).

.06 FASB Statement No. 97 should be applied to investment contracts, limited-payment contracts that do not have the characteristics described in paragraph .05, and universal life-type contracts as defined in FASB Statement No. 97. FASB Statement No. 60 should be applied to short-duration contracts with fixed and variable terms and to long-duration contracts that do not have the characteristics described in paragraph .05 and are not covered by FASB Statement No. 97. FASB Statement No. 113 should be applied to reinsurance contracts.

Accounting and Reporting Models

.07 The accounting and reporting model for long-duration insurance contracts issued by insurance enterprises other than mutual life insurance enter-

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[1] The AICPA plans to issue an exposure draft of a revised life and health insurance enterprises audit guide, which will apply to mutual life insurance enterprises. This SOP will be incorporated into the revised guide.

[2] Terms defined in the Glossary [paragraph .65] are in **boldface type** the first time they appear in this SOP.

prises was established in FASB Statement Nos. 60 and 97. FASB Statement No. 60 addresses long-duration contracts, such as whole-life, guaranteed-renewable term-life, and annuity contracts that are expected to remain in force for an extended period and that are characterized by fixed and guaranteed terms. FASB Statement No. 97 addresses other long-duration contracts such as universal life-type insurance contracts—that are characterized by flexibility and discretion granted to one or both parties to the contract, limited payment contracts, and investment contracts.

FASB Statement No. 60

.08 Under FASB Statement No. 60, premiums for long-duration insurance contracts are recognized as revenue when due from policyholders. A liability for future policy benefits is accrued when premium revenue is recognized. The liability—which represents both the present value of estimated future policy benefits to be paid to or on behalf of policyholders, and related expenses less the present value of estimated future net premiums[3] to be collected from policyholders is based on a uniform percentage of anticipated premiums and on estimates of expected **investment yields**, mortality, morbidity, terminations, and expenses applicable at the time the insurance contracts are made. FASB Statement No. 60 also requires a provision for the risk of adverse deviation. Original assumptions ordinarily continue to be used in subsequent accounting periods to determine changes in the liability for future policy benefits (referred to as *lock-in*), unless a premium deficiency exists. Costs that vary with, and are primarily related to, the acquisition of new and renewal insurance contracts (**acquisition costs**) are capitalized and charged to expense in proportion to premium revenue recognized.

FASB Statement No. 97

.09 FASB Statement No. 97 requires that a retrospective deposit method be used to account for universal life-type insurance contracts. That accounting method establishes a liability for policy benefits at an amount determined by the account or contract balance that accrues to the benefit of the policyholder. Premiums are not reported as revenues: Rather, revenues from those contracts represent amounts assessed against policyholders and are reported in the period that the amounts are assessed, unless evidence indicates that the amounts are designed to compensate the insurer for services to be provided over more than one period. FASB Statement No. 97 also requires that capitalized acquisition costs associated with universal life-type contracts be amortized, based on a constant percentage of the present value of estimated gross profit amounts. Estimates of gross profits should be evaluated regularly, and the total amortization recorded to date is adjusted if actual experience or other evidence suggests earlier estimates should be revised.

Participating Contracts

.10 FASB Statement No. 60 addresses accounting for traditional forms of participating contracts issued, but does not address the participating contracts issued by mutual life insurance enterprises, which are covered by this SOP.

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[3] FASB Statement No. 60 defines *gross premium* as "the premium charged to a policyholder for an insurance contract." That Statement defines *net premium* as "the portion of the gross premium required to provide for all benefits and expenses."

Furthermore, FASB Statement No. 97 addresses those participating contracts with contract terms that suggest that they are, in substance, universal life-type contracts.

Conclusions on Financial Reporting

.11 The following conclusions should be applied to insurance contracts described in paragraph .05 of this SOP and should be read in conjunction with "Background Information and Basis for Conclusions," beginning in paragraph .26 of this SOP. Furthermore, AICPA Practice Bulletin 8, *Application of 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, *to Insurance Enterprises* [section 12,080], provides interpretative guidance that, if applicable, should be followed for the contracts covered by this SOP.

Revenue Recognition

.12 Premiums from participating insurance contracts should be reported as revenue in the statement of earnings when due from policyholders.

Benefits Recognition

.13 Death and surrender benefits incurred should be reported as expenses in the statement of earnings.

Dividends

.14 Annual policyholder dividends should be reported separately as an expense in the statement of earnings, and should be based on estimates of amounts incurred for the policies in effect during the period. For example, if a policy has an anniversary date of June 30, at which time annual dividends are paid, at December 31, 19X1, dividends should be accrued for the period July 1, 19X1, through December 31, 19X1, and should be reported separately on the balance sheet. (See paragraph .17 for information on accounting for terminal dividends as part of the liability for future policyholder benefits.)

Liability for Future Policy Benefits

.15 A liability for future policy benefits relating to participating life insurance contracts should be equal to the sum of—

a. The **net level premium reserve** for death and endowment policy benefits.

b. The liability for **terminal dividends.**

c. Any probable loss (premium deficiency) as described in paragraphs 35 to 37 of FASB Statement No. 60.

.16 The net level premium reserve should be calculated based on the **dividend fund interest rate**, if determinable, and mortality rates guaranteed in calculating the cash surrender values described in the contract. If the dividend fund interest rate is not determinable, the **guaranteed interest rate** used in calculating cash surrender values described in the contract should be used. If the dividend fund interest rate is not determinable and there is no guaranteed interest rate, the interest rate used in determining guaranteed nonforfeiture values should be used. Finally, if none of the above rates exists, then the interest rate used to determine minimum cash surrender values—as set by the National Association of Insurance Commissioners' (NAIC) model standard nonforfeiture law—for the year of issue of the contract should be used. Regardless of the rate used, net premiums should be calculated as a constant percentage of the gross premiums.

.17 **Terminal dividends** should be accrued in the liability for future policy benefits if the following conditions are both met:[4]

a. Payment of the dividend is probable.

b. The amount can be reasonably estimated.

If the two conditions are met (and they ordinarily will be), the terminal dividends should be recognized as an expense over the life of a book of participating life insurance contracts, at a constant rate based on the present value of the estimated gross margin amounts expected to be realized over the life of the book of contracts. The present value of estimated gross margins should be computed using the expected investment yield (net of related investment expenses). If significant negative gross margins are expected in any period, then the present value of gross margins before annual dividends, estimated gross premiums, or the balance of insurance in force should be substituted as the base for computing the expense amount to be recognized. (The base substituted in this calculation should be the same one substituted in the amortization of deferred acquisition costs discussed in paragraph .20.)

.18 Increases in the liability for future policy benefits should be reported as an expense in the statement of earnings.

Acquisition Costs

.19 This SOP uses the definition of *acquisition costs* contained in FASB Statement No. 60,[5] and in the following sentence describes those that are ineligible for capitalization under this SOP. Acquisition costs (such as premium taxes) that vary in a constant relationship to premiums or insurance in force, that are recurring in nature, or that tend to be incurred in a level amount from period to period, should be charged to expense in the period incurred.

.20 Capitalized acquisition costs should be amortized over the life of a book of participating life insurance contracts at a constant rate, based on the present value of the estimated gross margin amounts expected to be realized over the life of the book of contracts. The present value of estimated gross margins should be computed using the expected investment yield. If significant negative gross margins are expected in any period, then the present value of gross margins before annual dividends, estimated gross premiums, or the balance of insurance in force should be substituted as the base for computing amortization.

.21 In computing amortization, interest should accrue to the unamortized balance of capitalized acquisition costs at the rate used to discount expected gross margins. Estimates of expected gross margins used as a basis for amortization should be evaluated regularly, and the total amortization recorded to date should be adjusted by a charge or credit to the statement of earnings if actual experience or other evidence suggests that earlier estimates should be

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[4] These conditions should be used in the same sense that they are used in FASB Statement No. 5, *Accounting for Contingencies*.

[5] Acquisition costs are addressed in paragraphs 28 to 31 of FASB Statement No. 60.

revised. The interest rate used to compute the present value of revised estimates of expected gross margins should be either the rate in effect at the inception of the book of contracts or the latest revised rate applied to the remaining benefit period. The approach selected to compute the present value of revised estimates should be applied consistently in subsequent revisions to computations of expected gross margins.

Estimated Gross Margins

.22 *Estimated gross margin*, as the term is used in this SOP, should include estimates of the following:

a. Amounts expected to be received from premiums, plus

b. Amounts expected to be earned from investment of policyholder balances (that is, the net level premium reserve described in paragraph .15*a*), less

c. All benefit claims expected to be paid, less

d. Costs expected to be incurred for contract administration (including acquisition costs not included in capitalized acquisition costs), less

e. Expected change in the net level premium reserve for death and endowment benefits, less

f. Expected annual policyholder dividends, plus or less

g. Other expected assessments and credits, however characterized

Estimated gross margins should be determined on a best estimate basis, without provision for adverse deviation.

.23 Several dividend options may be available to the policyholder, in which instances the options generally can be changed during the life of the contract. In estimating gross margins, insurance enterprises should use the best estimate of the dividend options that policyholders will elect.

Disclosures

.24 The following should be disclosed in the financial statements with respect to participating contracts:

a. The methods and assumptions used in estimating the liability for future policy benefits

b. The average rate of assumed investment yields used in estimating expected gross margins

c. The nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period

Effective Date and Transition

.25 This SOP is effective for financial statements for fiscal years beginning after December 15, 1995. Earlier application is encouraged. The effect of initially applying this SOP should be reported retroactively through restatement of all previously issued annual financial statements presented for comparative purposes for fiscal years beginning after December 15, 1992. Previously issued financial statements for any number of consecutive periods preceding that date may be restated to conform to the provisions of this SOP. The cumulative effect of adopting this SOP should be included in the earliest year restated.

Background Information and Basis for Conclusions

.26 The AICPA Accounting Standards Executive Committee's (AcSEC's) conclusions about accounting and reporting for participating life insurance contracts covered by this SOP are based on how the economic substance of those contracts differs fundamentally from nonparticipating contracts (traditional and universal life-type contracts) and from participating contracts that do not have the characteristics described in paragraph .05 of this SOP. The following sections (*a*) describe the factors differentiating the contracts covered by this SOP from those other contracts, (*b*) discuss AcSEC's reasons for concluding that neither FASB Statement No. 60 nor FASB Statement No. 97 in its entirety is appropriate for the contracts covered by this SOP, and (*c*) discuss other considerations deemed significant by AcSEC in reaching its conclusions.

Participating Contracts

.27 Participating life insurance contracts are issued for a gross premium that provides policyholders with certain guaranteed benefits as well as with dividends. Generally, the gross premium is calculated with sufficient margin so that each class of contracts is self-supporting. Annual policyholder dividends paid generally reflect the company's experience and performance in investment activity, mortality experience, and contract administration for each class of contracts. It is the dividend determination and distribution that distinguishes participating life insurance from nonparticipating life insurance.

.28 The nature of the annual dividend determination varies from company to company but is generally a two-step process. The first step is to determine divisible surplus, which is a determination each company makes based on its financial results. The second step is to distribute divisible surplus to policyholders in an equitable manner. Actuarial standards require divisible surplus to be distributed among contracts in the same proportion as the contracts contributed to divisible surplus.

Applicability and Scope

.29 AcSEC's charge was to address, as much as possible, the accounting and reporting of mutual life insurance enterprises' insurance activities within the framework established in FASB Statement Nos. 60 and 97. In reaching the conclusions in this SOP, AcSEC believes the contracts covered by this SOP are transactions between mutual life insurance enterprises and their customers. After reviewing the nature of a variety of mutual life insurance enterprise contracts, AcSEC concluded that this SOP should address the accounting only for life insurance contracts with the characteristics described in paragraph .05 of this SOP. The dividend scales on such contracts are often referred to as *actively managed*, because dividends paid are based on actual experience; that is, dividend scales are adjusted to reflect significant changes on a reasonably timely basis. FASB Statement No. 120 requires that other insurance contracts of mutual life insurance enterprises, such as annuity contracts, group insurance contracts, disability contracts, universal life-type contracts, and pension guaranteed contracts, should be accounted for under FASB Statement Nos. 60 and 97.

.30 AcSEC concluded that separate consideration of the participating life insurance contracts covered by this SOP is justified by the differences between those contracts and both traditional nonparticipating life insurance contracts, covered by FASB Statement No. 60, and universal life-type contracts, covered by FASB Statement No. 97. Participating life insurance contracts covered under this SOP have attributes of the contracts covered by FASB Statement Nos. 60 and 97. AcSEC concluded, therefore, that contracts covered by this SOP were not sufficiently similar to those covered by either FASB Statement to warrant applying either of them in its entirety.

.31 Participating life insurance contracts covered by this SOP are similar to the conventional life contracts contemplated by FASB Statement No. 60 in the following respects:

a. Permanent participating life insurance is based on the traditional concept of level premiums over the life of the contract.

b. The individual contract functions related to interest, mortality, and expenses are not separately displayed to policyholders and are not explicitly stated in the policy.

c. The pattern of premium payments is specified in the contract and cannot normally be varied after issue.

d. There is no explicit account balance for each policyholder.

.32 Despite those similarities in form to FASB Statement No. 60 contracts, the dividend feature introduces a variable that affects the substance of the earnings flow to the company. The dividend feature causes the contracts covered by this SOP to more closely resemble contracts in which the earnings emerge in relation to margins rather than contracts in which earnings emerge proportional to the level of premiums received in that year. Participating policies covered by this SOP share in the results of investment activity, mortality experience, and contract administration costs through dividends, which are not fixed or guaranteed by contract terms. As a result, earnings on these products, after annual policyholder dividends, tend to emerge as the margin recognized on investments, mortality, and expenses.

.33 AcSEC concluded that because the earnings after annual policyholder dividends from the contracts covered by this SOP tend to evolve in a manner similar to universal life-type contracts, most of the provisions of FASB Statement No. 97 should be applied to the contracts covered by this SOP. Nevertheless, AcSEC concluded that because the contracts covered by this SOP have terms similar to the terms of conventional life products, it was not feasible or appropriate to apply FASB Statement No. 97 in its entirety.

.34 The recommendations in this SOP differ from the accounting in FASB Statement No. 97 for universal life-type contracts in two significant respects:

a. Whereas under FASB Statement No. 97 premiums are not reported as revenue and benefit payments representing a return of policyholder balances are not reported as expenses in the statement of earnings, under this SOP premiums should be recognized as revenue and benefit payments charged to expense.

b. Whereas FASB Statement No. 97 does not address dividends, under this SOP dividends should be charged to expense.

.35 AcSEC recognizes that the FASB chose to exclude traditional participating life insurance contracts issued by stock life insurance companies from the scope of FASB Statement No. 97. However, AcSEC notes that in making that decision, the FASB did not consider participating policies of mutual life insurance enterprises, which AcSEC believes differ substantively from many of the participating policies issued by stock life insurance companies. Furthermore, the FASB's consideration of participating policies may have been influenced by the fact that participating policies are generally a less significant portion of stock life insurance companies' business than of mutual life insurance enterprises' business.

Revenue Recognition

.36 AcSEC recognizes that reporting premiums as revenues may appear inconsistent with the accounting model set forth in this SOP. AcSEC believes, however, that recognizing premiums as revenue for the contracts covered by this SOP is justified for two reasons, both of which are based on the economic substance of the relationship between the issuer and the policyholder.

.37 First, premiums received under participating contracts fit the definition of *revenues* in FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*. AcSEC believes the fact that premiums generally are level, fixed, and payable at predetermined points in return for a guaranteed death benefit and cash surrender value is significant. Furthermore, unlike the purchaser of a universal life-type insurance contract, the purchaser of a participating life insurance contract generally cannot vary the amount and timing of premium payments, and no account balance information is communicated to the policyholder. In addition, premiums are not credited to a policyholder account balance. Accordingly, AcSEC believes reporting premiums as revenues is consistent with the FASB Concepts Statement No. 6 definition of *revenues* as inflows from delivering services that constitute an entity's ongoing major or central operations.

.38 Second, for many mutual life insurance enterprises it would not be practicable or meaningful to report premiums received as deposits. AcSEC considered how mutual life insurance companies would report premiums as such and concluded that mortality, expense, and surrender charges would be reported as revenues. For those amounts to be relevant, the elements of dividends related to each would have to be determined. AcSEC believes that making such allocations would be arbitrary. AcSEC further believes the costs of making such allocations would far exceed the benefits derived from reporting the amounts separately. Furthermore, the lack of an explicit policyholder balance or separate assessments or charges for contract services and credits for interest—which exist for universal life-type contracts—makes separate measurement of the advance funding and contract service functions impractical.

Benefit Recognition

.39 AcSEC concluded that to be consistent with the reporting of premiums as revenues when due from the policyholder, actual death and surrender benefits incurred during the accounting period should be reported as expenses.

Dividends

.40 FASB Statement No. 97 does not explicitly address the treatment of dividends for participating contracts accounted for as universal life-type contracts. Some may believe that under that model, annual policyholder dividends would be allocated among interest credited, death benefits or mortality charges, and expenses, rather than reported as an expense. Others may believe that the entire annual policyholder dividend is one of the "other assessments and credits" described in paragraph 23 of FASB Statement No. 97. AcSEC concluded that, especially because this SOP recommends premiums should be reported as revenues when due from the policyholder, actual dividends incurred during the accounting period should always be reported as an expense; dividends should not be charged directly to equity in any circumstance.

.41 Furthermore, FASB Statement No. 60 defines two alternative accounting treatments for policyholder dividends based on whether the contracts included restrictions on the net income amount that may be distributed to stockholders. For participating contracts that have no net income restrictions, and that use life insurance dividend scales unrelated to actual net income, policyholder dividend liabilities should be accrued over the premium-paying period of the contracts (1) based on dividends anticipated in determining gross premiums, or (2) as shown in published dividend illustrations at the date insurance contracts are made. For contracts limiting the amount of net income that may be distributed to stockholders, the net income amount that cannot be distributed to shareholders is excluded from stockholders' equity by a charge to operations and a credit to a liability, a method similar to the accounting for net income applicable to minority interests. However, for either type of participating contract, dividends are reported as expenses in the statement of earnings as "dividends to policyholders" or "provision for policyholders' share of earnings on participating business."

.42 Annual policyholder dividends of participating contracts covered by this SOP are based on actual company performance. Accordingly, AcSEC believes dividends on participating contracts covered by this SOP are not similar to either of the types of dividends discussed in FASB Statement No. 60. While AcSEC acknowledges that segregating undistributed accumulated earnings on participating contracts in a manner similar to minority interests may be meaningful in a stock life insurance company, it is not meaningful for a mutual life insurance enterprise, because the objective of such presentation is to identify amounts that are not distributable to stockholders.

Capital Gains and Losses

.43 The guidance in FASB Statement No. 97, as amended by FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, on capital gains and losses, which also is incorporated in FASB Statement No. 60, applies to the contracts covered in this SOP. Paragraph 28 of FASB Statement No. 97, as amended, states:

> Realized gains and losses on all investments (except investments that are classified as trading securities and those that are accounted for as hedges as described in FASB Statements No. 52, *Foreign Currency Translation*, and No. 80, *Accounting for Futures Contracts*) shall be reported in the statement of earnings as a component of other income, on a pretax basis. Realized gains and losses shall be presented as a separate item in the statement of earnings or disclosed in the notes to the financial statements. Realized gains and losses shall not be deferred, either directly or indirectly.

Furthermore, in paragraph 77 in appendix A of FASB Statement No. 97, the FASB addressed the issue of whether certain realized gains and losses should be deferred and recognized over the remaining life of the insurance contracts with the following:

> The Board notes that generally accepted accounting principles require that realized investment gains and losses be reflected in the period in which they

occur. The Board acknowledges that some contracts with policyholders may entitle policyholders to an amount equal to a portion of specific investment performance. The recording of liabilities to reflect amounts to which those policyholders are entitled is appropriate, but the deferral of realized gains and losses is not justified.

Liability for Future Policy Benefits

Proxy for Account Balance

.44 Under FASB Statement No. 97, the liability for future policy benefits includes the policyholder's account balance as of the balance sheet date. However, because participating contracts usually lack a stated account balance, a proxy for account balance had to be determined. AcSEC considered six possible proxies:

a. **Dividend fund**

b. Net level premium reserve, using statutory valuation mortality and interest

c. Commissioners reserve valuation method (CRVM) reserves

d. Cash surrender value

e. Net level premium reserve, using guaranteed mortality and interest

f. Net level premium reserve, using the guaranteed mortality and dividend fund interest

.45 After considering all the above possible account balances, AcSEC concluded that the net level premium reserve using the guaranteed mortality and dividend fund interest generally should be used as the proxy for account balance. Furthermore, AcSEC notes that there may be policies that do not meet normal underwriting standards for which additional amounts may be included in the net level premium reserve.

.46 If experience is more favorable than what was anticipated in determining the dividends guaranteed in the policy, a mutual life insurance enterprise's objective is to distribute the favorable experience as dividends. If experience is less favorable than what was anticipated in determining the dividends guaranteed, the company must at least provide the guaranteed values. Therefore, if there is an unfavorable experience, a premium deficiency may result, which would be recognized under paragraph .15*c* of this SOP. Accordingly, the liability determined, based on guaranteed benefits, provides an appropriate measure of the liability to policyholders because, to the extent experience is more favorable than the guarantees, the company pays the difference to policyholders in dividends. This estimate of the liability is consistent with the view that the mutual life insurance enterprise is liable for the guaranteed provisions of the policies it sells and for paying dividends related to favorable experience. AcSEC believes that for many participating policies the net level premium reserve for guaranteed benefits will best reflect the amount that has accrued to the benefit of policyholders for participating contracts. AcSEC therefore concluded that the net level premium reserve is consistent with FASB Statement No. 97's description of the liability as "the balance that accrues to the benefit of individual policyholders [that] represents the minimum measure of an insurance enterprise's liability . . . ."

.47 Nevertheless, this SOP recommends that a mutual life insurance enterprise with a determinable dividend fund interest rate should calculate the net level premium reserve for guaranteed benefits based on the dividend fund interest rate rather than on the rate used in determining guaranteed cash surrender values. AcSEC believes that in practice the dividend fund interest rate and the interest rate guaranteed in computing cash surrender values often will be the same. If those interest rates differ, the calculation based on the dividend fund interest rate usually reflects the pattern of anticipated annual policyholder dividends more accurately.

.48 Some mutual life insurance enterprises have a dividend fund for participating policies. Though that dividend fund generally is not disclosed to the policyholder, it is the amount specified by management at contract inception to which interest is credited and from which mortality and expense charges are assessed in the dividend determination mechanism. Accordingly, many believe the dividend fund is the economic equivalent of the account balance of universal life-type contracts. Though most companies with dividend funds define the dividend fund account balance in their dividend resolutions, there are a variety of ways in which a dividend fund is defined but no consistent practices for company management to apply in defining the amount. Furthermore, not all mutual life insurance enterprises have a dividend fund. Accordingly, AcSEC concluded that the dividend fund lacked the objectivity and comparability necessary to be an appropriate proxy for the account balance.

.49 AcSEC also rejected the statutory net level premium reserve and the statutory CRVM as proxies for account balance, because the assumptions used in determining such amounts are based on statutory requirements, which are not necessarily related to either policy nonforfeiture guarantees or the dividend calculation.

.50 AcSEC also rejected the cash surrender values as the proxy for account balance, because AcSEC believes the amount does not reflect the amount that accrues to a continuing policyholder's benefit. AcSEC believes the decision not to use cash surrender values as the proxy for account balance is consistent with FASB Statement No. 97, which requires the use of an account balance instead of the cash surrender value when both exist. Though participating policies lack an explicit account balance, AcSEC believes the net level premium reserve determined under this SOP is an appropriate proxy for the account balance. AcSEC notes that cash surrender values generally will be less than the liability for future policy benefits calculated under this SOP. Cash surrender values are frequently developed using methods similar to those used to compute the liability for future policy benefits calculated under this SOP, but are net of an implicit surrender charge.

Terminal Dividends

.51 AcSEC believes the rights to terminal dividends accumulate to policyholders over a policy's life. Accordingly, the event that creates the liability is the continuance of the contract by the policyholder, not the termination of the policy. If the payment of terminal dividends is probable and the amount can be reasonably estimated, the liability should be recognized. Furthermore, AcSEC believes terminal dividends are similar to amounts previously assessed against policyholders that are refundable on the contract's termination under paragraph 17*c* of FASB Statement No. 97.

Adverse Deviation

.52 FASB Statement No. 60 requires that assumptions used in calculating the liability for future policy benefits include a provision for the risk of adverse deviation. The notion of adverse deviation is (1) to include in benefit reserves the risk assumed by the insurer that actual experience will be more adverse than the basic assumptions underlying premium rates, and (2) to include the gradual release from this risk in periodic net income as actual experience emerges. However, under FASB Statement No. 97, a provision for adverse deviation is not permitted. Because the liability for future policy benefits defined in this SOP generally follows the FASB Statement No. 97 model, AcSEC concluded that provision for adverse deviation should not be made. AcSEC agrees with the FASB's reasons for rejecting adverse deviation in FASB Statement No. 97. Furthermore, for participating contracts covered by this SOP, most adverse experience could be recovered from policyholders, as it emerges, through lower future dividends.

Acquisition Costs

.53 FASB Statement No. 97 requires that gross profit estimates used as a basis for amortizing capitalized acquisition costs be evaluated regularly, and that total amortization recorded to date be adjusted by a charge or credit to the statement of earnings if actual earnings or other evidence suggests revision of earlier estimates of expected gross profits. AcSEC concluded that the expected gross margins resulting from participating life contracts issued by mutual life insurance companies are economically similar to the expected gross profits of universal life-type contracts. Accordingly, because the conclusions in this SOP are primarily based on the conclusions in FASB Statement No. 97, AcSEC decided to retain the retrospective adjustment of deferred acquisition costs in this SOP.

Estimated Gross Margins

.54 Under FASB Statement No. 97, the emergence of earnings for universal life-type contracts is based on gross profits. Similarly, under this SOP profits would emerge based on gross margins. However, due to the different way in which values are communicated to the policyholder and maintained by a mutual life insurance company, gross margins need to be determined differently from universal life-type contracts.

.55 Paragraph 23 of FASB Statement No. 97 defines the terms to be considered in calculating the estimated gross profits for universal life-type contracts, as follows:

a. Amounts expected to be assessed for mortality (sometimes referred to as the *cost of insurance*) less benefit claims in excess of related policyholder balances

b. Amounts expected to be assessed for contract administration less costs incurred for contract administration (including acquisition costs not included in capitalized acquisition costs)

c. Amounts expected to be earned from investment of policyholder balances less interest credited to policyholder balances

d. Amounts expected to be assessed against policyholder balances upon termination of a contract (sometimes referred to as *surrender charges*)

e. Other assessments and credits, however characterized

.56 Those terms are presented in the form of specific margins. Participating life contracts have similar margins but the charges and credits are not structured in the same way as in universal life-type contracts. Because of this difference, certain items used in determining gross profits for universal life-type contracts are not readily available for participating contracts. AcSEC resolved this problem by using a list of elements, which AcSEC believes develops gross margins consistent with the FASB Statement No. 97 definition of *gross profit*.

.57 The gross margin elements used in this SOP are not identical to the elements used in FASB Statement No. 97. Specifically, the following elements are included in FASB Statement No. 97 but not in this SOP:

a. Amounts expected to be assessed for mortality

b. Amounts expected to be assessed for contract administration

c. Interest credited to policyholder balances

The following are elements in this SOP that are not in FASB Statement No. 97:

a. Amounts expected to be received from premiums

b. The expected change in the net level premium reserve for death and endowment policy benefits

c. Expected annual policyholder dividends

.58 Those lists differ because, for participating contracts covered under this SOP, dividends, premiums, and the liability for policy benefits are not separated into the various charges, credits, and deposits. This different view of gross margins is consistent with the proposed presentation of earnings for participating contracts under this SOP.

Interest Rates

.59 Under FASB Statement No. 97, the rate that accrues to policyholder balances (the *contract rate*) is used to accrue interest to policyholder balances, to compute the present value of estimated gross profits, and to accrue interest to the unamortized balance of capitalized acquisition costs. AcSEC believes the dividend interest rate is the rate most comparable to the contract rate. However, AcSEC has concluded that using the dividend fund interest rate to determine the net level premium reserve is preferable to using the dividend interest rate, because the dividend fund interest rate is more objectively determinable. AcSEC concluded that using the investment yield to calculate the present value of estimated gross margins, and to accrete interest on the unamortized balance of capitalized acquisition costs, is preferable to using the dividend interest rate because the investment yield is more objectively determinable and would result in approximately the same income pattern as if the dividend fund interest rate were used.

Other Methods Considered

.60 AcSEC considered, and rejected, a modified FASB Statement No. 60 approach whereby the earnings from mutual life participating insurance contracts would emerge in relation to premiums and not in relation to expected gross margins. This consideration was prompted by a concern that reporting premiums as revenues, but having profits emerge based upon gross margins, may produce incongruous results. In addition, the lack of an explicit policyholder's account balance, and the lack of a predominant function or service representative of the pooling of the aggregation of services, are characteristics of insurance contracts as defined under FASB Statement No. 60. FASB Statement No. 60 requires that expenses should be recorded (and therefore earnings would emerge) in relation to premiums.

.61 A modification to FASB Statement No. 60 was discussed, however, to provide for mutual life insurance contracts in which dividend scales are actively managed. Each change in the dividend scale represents, in essence, a repricing and the establishment of new expectations. Therefore, the emergence of earnings based upon the original pricing assumptions no longer would be relevant to financial measurements.

.62 In applying FASB Statement No. 60 to mutual life insurance contracts in which the dividend scales are actively managed, each change in the dividend scale would result in an unlocking of the previously used assumptions. The new assumptions would be used in subsequent accounting periods, until the dividend scales are changed again. The unlocking of assumptions would be prospective in nature and would provide stability to the matching of benefits and expenses with revenue.

.63

Appendix A

Illustration of Computation of Gross Margins

Schedule 1—Computation of Estimated Gross Margins

Year	*Premium*	*Interest on NLPR*	*Interest on Current Activity*	*Death Benefits Incurred*	*Surrender Benefits Incurred*
	(*a*)	(*b*)	(*c*)	(*d*)	(*e*)
1	$ 210,000	$ 0	$ 16,244	$ (9,000)	$ 0
2	184,611	10,719	14,280	(10,549)	0
3	169,621	19,994	13,120	(13,731)	(7,148)
4	155,763	27,955	12,048	(14,835)	(14,984)
5	142,990	34,735	11,060	(15,661)	(21,760)
6	131,222	40,440	10,150	(15,622)	(17,237)
7	124,333	46,665	9,617	(16,578)	(20,989)
8	117,768	52,317	9,109	(16,824)	(24,427)
9	111,526	57,417	8,627	(17,526)	(27,566)
10	105,582	61,982	8,167	(18,603)	(30,406)
11–20	779,517	760,283	60,296	(311,112)	(398,831)
21–55	589,392	1,222,685	45,589	(1,187,632)	(686,079)
Total	$2,822,325	$2,335,192	$218,307	$(1,647,673)	$(1,249,427)

Present values at earned rate of 8.5%:

(*continued*)

(*a*) Gross premiums.

(*b*) Interest, at the 8.5% earned rate, on net level premium reserve (NLPR) at the end of the previous year. The NLPR is based on guaranteed mortality and the dividend fund interest rate.

(*c*) Interest, at the 8.5% earned rate, on current-year cash flow. This illustration assumes premiums are received, and all expenses incurred, at the start of the year. This illustration assumes death benefits, surrender benefits, and dividends are all at the end of the year.

(*d*) Death benefits, not reduced by related NLPR.

(*e*) Surrender benefits, not reduced by related NLPR.

(*f*) Recurring expenses not included in capitalized acquisition costs.

(*g*) Net decrease (increase) in aggregate NLPR in the year.

(*h*) Policyholder dividends for the year.

(*i*) Sum of (*a*) through (*h*) inclusive.

Recurring Expenses Incurred	*(Increase) Decrease in NLPR*	*Dividends Incurred*	*Post-dividend Gross Margins*	*Revised Gross Margins at Year 2*
(*f*)	(*g*)	(*h*)	(*i*)	
$ (18,900)	$(126,103)	$ (18,857)	$ 53,384	$ 53,384
(16,615)	(109,116)	(21,399)	51,931	50,546
(15,266)	(93,669)	(24,230)	48,691	47,419
(14,019)	(79,754)	(26,574)	45,600	44,432
(12,869)	(67,117)	(28,509)	42,869	41,797
(11,810)	(73,236)	(30,043)	33,864	32,880
(11,190)	(66,499)	(32,301)	33,058	32,126
(10,599)	(60,005)	(34,367)	32,972	32,089
(10,037)	(53,706)	(36,230)	32,505	31,669
(9,502)	(47,485)	(37,915)	31,820	31,028
(70,157)	(162,077)	(424,092)	233,827	227,980
(53,041)	938,767	(669,668)	200,013	195,591
$(254,005)	$ (0)	$(1,384,185)	$840,534	$820,941
			$371,261	$362,945

Schedule 2—Computation of Amortization Rate

		Original Estimate	*Revised Estimate*
Present value of estimated gross margins, years 1-55, evaluated at issue (from Schedule 1)	*(a)*	$371,261	$362,945
Present value of capitalized acquisition costs, years 1-55, evaluated at issue	*(b)*	$263,309	$263,309
Amortization rate = (*b*) / (*a*)	*(c)*	70.923%	72.548%

Schedule 3—Illustration of Amortization

Capitalized costs, year 1		$241,500	$241,500
Interest accrual at 8.5%	*(d)*	20,528	20,528
Amortization, year 1 Gross margin of 53,384 (from Schedule 1) at rate (*c*) above	*(e)*	(37,862)	(38,729)
Balance, end of year 1	*(f)*	224,166	223,299
Additional capitalized costs, year 2		9,231	9,231
		233,397	232,530
Interest accrual at 8.5%	*(g)*	19,839	19,765
Amortization, year 2 Gross margin of 50,546 (from Schedule 1, revised column) at revised rate (*c*) above	*(h)*	(36,670)	(36,670)
Balance, end of year 2		$216,566	$215,625
Balance based on original estimate		$216,566	
Balance based on revised estimate		215,625	
Adjustment required		$ (941)	
Net amortization recognized: In year 1 (*d* + *e*)		$ 17,334	
In year 2 (*g* + *h* based on revised estimates + difference between *f* at original estimate and at revised estimate)		$ 17,772	

.64

Appendix B

Discussion of Comments Received on Exposure Draft

An exposure draft of a proposed statement of position, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, was issued on March 24, 1994, and distributed to a variety of interested parties to encourage comment by those who would be affected by the proposal. Thirty-five comment letters were received on the exposure draft. The most significant and pervasive comments received were in the following five areas: (*a*) the FASB Statement No. 60 approach, (*b*) limited-payment contracts, (*c*) dividend utilization in estimated gross margin calculations, (*d*) retrospective adjustment of deferred acquisition costs balances, and (*e*) effective date.

FASB Statement No. 60 Approach

Several respondents preferred a modified FASB Statement No. 60 approach whereby the earnings from mutual life participating insurance contracts would emerge in relation to premiums and not in relation to expected gross margins. AcSEC considered most of the arguments in favor of the modified FASB Statement No. 60 approach in the comment letters during the process leading up to the exposure draft, and continues to support the approach recommended in this SOP.

Limited-Payment Contracts

The exposure draft would have required revenue recognition for limited-payment contracts to be in a constant relationship to insurance in force to the extent that gross premiums exceed net premiums. Many respondents asked AcSEC to reconsider that accounting, because it is inconsistent with the fundamental premise of the SOP that income should be recognized in relation to gross margins. AcSEC believes that for limited-payment contracts with actively managed dividend scales those arguments are persuasive. Accordingly, AcSEC was convinced that the accounting model in the SOP would preclude inappropriate front-end recognition of income on most limited-payment contracts, and eliminated the special accounting requirement for limited-payment contracts.

Dividend Utilization in Estimated Gross Margin Calculations

A variety of dividend options are available to policyholders, including receiving the dividends in cash and purchasing additional paid-up insurance. The exposure draft would have required, in many instances, mutual life insurance enterprises to assume that annual policyholder dividends are paid in cash in estimating gross margins, regardless of the options actually used. Many respondents noted that, for many mutual life insurance enterprises, dividends are more often used to purchase additional paid-up insurance, and that reliable estimates of the effects of dividend options can be made. In response to that information, AcSEC changed paragraph .23 of this SOP to require mutual life insurance enterprises to make the best estimate of the dividend options that policyholders will elect.

Retrospective Adjustment of Deferred Acquisition Costs Balances

Many respondents from the mutual life insurance industry objected to the retrospective adjustment of deferred acquisition costs. They believe that because dividends are actively managed and will be used to prospectively recover or pay out differences that result from changes in expectations, the accounting for such changes should also be prospective. Furthermore, they note that retrospective calculations are much more complicated and difficult to understand than prospective calculations. However, AcSEC continues to believe that retrospective adjustment of deferred acquisition costs, consistent with the provisions of FASB Statement No. 97, is appropriate for policies covered by this SOP for the reasons discussed in paragraph .53.

Effective Date

In the exposure draft the effective date was for financial statements issued for fiscal years beginning after December 15, 1994, consistent with the effective date of FASB Interpretation No. 40. A majority of respondents considered that effective date unreasonable, given the magnitude and significance of the changes that mutual life insurance enterprises will have to make to prepare financial statements in accordance with GAAP. AcSEC agreed and extended the effective date by one year, and urged the FASB to extend the effective date of Interpretation No. 40 similarly. The FASB subsequently issued FASB Statement No. 120, which amends FASB Interpretation No. 40, to be effective for financial statements issued for fiscal years beginning after December 15, 1995.

.65

Glossary

Acquisition costs. Costs incurred in the acquisition of new and renewal insurance contracts. Acquisition costs include costs that vary with, and are primarily related to, the acquisition of insurance contracts (for example, agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees).

Annual policyholder dividends. Amount of dividends to policyholders calculated and paid each year, representing the policyholders' share of divisible surplus.

Dividend fund. The amount specified by management at contract inception to which interest is credited and from which mortality and expense charges are assessed in the dividend determination mechanism.

Dividend fund interest rate. The interest rate determined at policy issuance used to determine the amount of the dividend fund. It is the rate used to credit interest to the dividend fund, and against which experience is measured to determine the amount of the interest portion of dividends paid to individual policyholders.

Dividend interest rate. The total interest rate the company pays on its dividend fund.

Dividends to policyholders. Nonguaranteed amounts distributable to policyholders of participating insurance contracts and based on actual performance of the insurance enterprise. Under various state insurance laws, dividends are apportioned to policyholders on an equitable basis. Dividends to policyholders include annual policyholder dividends and terminal dividends.

Guaranteed interest rate. The interest rate guaranteed in a policy's cash surrender value or nonforfeiture value calculation.

Investment yield. The interest rate the company expects to earn on the assets supporting the policies, net of investment expense.

Net level premium reserve. The excess, if any, of the present value of future guaranteed death and endowment benefits over the present value of future **net premiums.**

Net premiums. A constant ratio of guaranteed maximum gross premiums. The ratio is calculated at issue, so that the present value of all guaranteed death and endowment benefits is equal to the present value of all net premiums.

Terminal dividends. Dividends to policyholders calculated and paid upon termination of a contract, such as on death, surrender, or maturity.

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Section 10,660

Statement of Position 95-2 Financial Reporting by Nonpublic Investment Partnerships

May 19, 1995

NOTE

Statements of Position (SOPs) of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA SOPs as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this SOP should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

SOP 95-2 is amended by SOP 01-1, *Amendment to Scope of Statement of Position 95-2*, Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools*. SOP 01-1 is effective for financial statements issued for periods ending after December 15, 2001. Earlier application is encouraged.

SOP 95-2 is amended by SOP 03-4, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2*, Financial Reporting by Nonpublic Investment Partnerships. SOP 03-4 is effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application, except for the provisions to require certain nonregistered investment partnerships to compute and disclose internal rate of return from inception.

Introduction

.01 Investment partnerships are identified as a type of investment company in the AICPA's Audit and Accounting Guide *Audits of Investment Companies* (the Guide). The Guide uses the term *investment company* to mean "*generally* . . . an entity that pools shareholders' funds to provide the shareholders with professional investment management (paragraph 1.01)" [*emphasis added*]. The Guide states that it uses the term to refer to an entity with the attributes described in chapter 1 rather than to conform with the legal definition of an investment company in the federal securities laws.

.02 The Guide refers to investment partnerships in chapter 1 (paragraph 1.03):

> Several types of investment companies exist: management investment companies, unit investment trusts, . . . investment partnerships . . . .

.03 The Guide also states:

> The accounting principles and auditing procedures discussed in this guide *generally* apply to all investment companies, though the guide has been written

> *primarily* for auditors of mutual funds and closed-end companies registered with the Securities and Exchange Commission (SEC) under the 1940 Act (paragraph 1.04) [*emphasis added*].
>
> To comply with SEC rules and regulations, registered investment companies must make certain disclosures in addition to those required by generally accepted accounting principles. Those additional requirements are not presented in illustrative financial statements because they are not otherwise required by generally accepted accounting principles (paragraph 5.46).

.04 The illustrative financial statements of management investment companies in the Guide contain a detailed schedule of investments.

Scope

.05 This SOP applies to investment partnerships that are exempt from SEC registration under the Investment Company Act of 1940 and defined as investment companies in the Guide, with one exception.[1] This SOP does not apply to investment partnerships that are brokers and dealers in securities subject to regulation under the Securities Exchange Act of 1934 (registered broker-dealers) and that manage funds only for those who are officers, directors, or employees of the general partner. Investment partnerships identified in the previous sentence as being exempt from the scope of this SOP should comply with the financial reporting requirements in the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*. [As amended, effective for financial statements issued for periods ending after December 15, 2001, by Statement of Position 01-1.]

.06 Investment partnerships that are SEC registrants must comply with the financial statement reporting requirements as set forth in the Guide and as required by Articles 6 and 12 of the SEC's Regulation S-X. [Paragraph added, effective for financial statements issued for periods ending after December 15, 2001, by Statement of Position 01-1.]

Background

.07 There has been diversity in practice in the application of certain provisions of the Guide—specifically, the requirement for a schedule of investments, the format of the statement of operations, and the reporting of management fees. [Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

.08 *Schedule of Investments.* The Guide requires investment companies to list all of their individual securities in the statement of net assets or in an accompanying schedule of investments. Many nonpublic investment partnerships do not present such a list in their financial statements. [Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

.09 *Statement of Operations.* Investment companies present their results of operations in a statement of operations as specified in the Guide. The Guide requires separate disclosure of dividends and interest income and of realized and unrealized gains (losses) on securities. Some investment partnerships combine these items and present them as one income-statement caption with no separate disclosure. [Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

---

[1] Investment partnerships that are commodity pools subject to regulation by the Commodity Futures Trading Commission (CFTC) should also comply with the financial statement reporting requirements of Part 4 of the CFTC Regulations. [As amended, effective for financial statements issued for periods ending after December 15, 2001, by Statement of Position 01-1.]

.10 *Management Fees and Allocations.* Investment companies normally enter into an investment advisory agreement under which they receive investment management. The fee for that service is usually based on a specified percentage of average assets being managed. Some agreements may provide for a performance fee or allocation, which includes the normal fee plus a bonus (or less a penalty) if the company's performance exceeds (or fails to exceed) a preestablished benchmark. Many investment companies reflect such fees, including the bonus portion, as an expense in the statement of operations. If an investment company is organized as a limited partnership, however, the payment may take the form of an allocation of earnings based on a predetermined formula specified in the partnership agreement. In such cases, some investment partnerships reflect this allocation of partnership income through a reallocation of partners' net income from the limited partners to the general partner within the equity section of the statement of assets and liabilities rather than as an expense. [Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

Conclusions

.11 *Schedule of Investments.* The financial statements of an investment partnership, when prepared in conformity with GAAP, should, at a minimum, include a condensed schedule of investments in securities owned by the partnership at the close of the most recent period. Such a schedule should do the following.

a. Categorize investments by the following:

   (1) Type (such as common stocks, preferred stocks, convertible securities, fixed-income securities, government securities, options purchased, options written, warrants, futures, loan participations, short sales, other investment companies, and so forth).

   (2) Country or geographic region.

   (3) Industry.

   Report the percent of net assets that each such category represents and the total value and cost for each category in *a*(1) and *a*(2). Derivatives for which the underlying is not a security should be categorized by broad category of underlying (for example, grains and feeds, fibers and textiles, foreign currency, or equity indices) in place of categories *a*(2) and *a*(3).

b. Disclose the name, shares or principal amount, value, and type of the following:

   (1) Each investment (including short sales) constituting more than 5 percent of net assets, except for derivative instruments as discussed in items *d* and *e* below.

   (2) All investments in any one issuer aggregating more than 5 percent of net assets, except for derivative instruments as discussed in items *d* and *e* below.

   In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.

c. Aggregate other investments (each of which is 5 percent or less of net assets) without specifically identifying the issuers of such investments, and categorize them as required by *a* above.

d. Disclose the number of contracts, range of expiration dates, and cumulative appreciation (depreciation) for open futures contracts of a particular underlying (such as wheat, cotton, specified equity index, or U.S. Treasury Bonds), regardless of exchange, delivery location, or delivery date, if cumulative appreciation (depreciation) on the open contracts exceeds 5 percent of net assets.

In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.

e. Disclose the range of expiration dates and fair value for all other derivatives (such as forwards, swaps [such as interest rate and currency swaps], and options) of a particular underlying (such as foreign currency, wheat, specified equity index, or U.S. Treasury Bonds) regardless of counterparty, exchange, or delivery date, if fair value exceeds 5 percent of net assets.

In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.

f. Provide the following additional qualitative description for each investment in another nonregistered investment partnership whose fair value constitutes more than 5 percent of net assets:

- The investment objective
- Restrictions on redemption (that is, liquidity provisions)

[Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001. As amended, effective for annual financial statements issued for fiscal years ending after December 15, 2003, by Statement of Position 03-4.]

.12 Investments in other investment companies (investees), such as investment partnerships and limited liability investment companies, should be considered investments in securities for the purpose of applying paragraphs .11*a* and .11*b*, above. If the reporting partnership's proportional share of any security owned by any individual investee exceeds 5 percent of the reporting partnership's net assets at the reporting date, each such security should be named as required in paragraph .11*b* above, and categorized as required in paragraph .11*a* above. If information about the investee's portfolio is not available, that fact shall be disclosed. These investee disclosures should be made either in the condensed schedule of investments (as components of the investment in the investee) or in a note to that schedule. [Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

.13 *Statement of Operations.* Investment partnerships should present their statements of operations in conformity with the requirements for statements of operations of management investment companies in paragraphs 5.24 through 5.35 of the Guide, which include, among other things, separate disclosure of dividend income and interest income and realized and unrealized gains (losses) on securities for the period. [Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

.14 *Management Fees and Allocations.* Investment companies organized as limited partnerships typically receive advisory services from the general partner. For such services, a number of partnerships pay fees chargeable as expenses to the partnership, whereas others allocate net income from the limited partners' capital accounts to the general partner's capital account, and still others employ a combination of the two methods. The amounts of any such payments or allocations should be presented in either the statement of operations or the statement of changes in partners' capital, and the method of computing such payments or allocations should be described in the notes to the financial statements. [Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

Effective Date

.15 This SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994. Earlier application is encouraged but not required. [Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

Basis for Conclusions

.16 This section discusses considerations that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others. [Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

.17 Practice is diverse in applying the Guide's requirements to investment partnerships. Nevertheless, AcSEC believes that the Guide should apply, except for the requirement to present a detailed schedule of investments, to investment partnerships of all kinds, including hedge funds, limited liability companies, and limited duration companies. The Guide includes investment partnerships in its definition of investment companies. Paragraph 1.04 indicates that its principles and procedures ". . . *generally* apply to all investment companies, though the guide has been written *primarily* for auditors of mutual funds . . . under the 1940 Act" [*emphasis added*]. AcSEC agrees that some of the SEC Regulation S-X and 1940 Act requirements may not apply to nonpublic investment partnerships. AcSEC believes that the disclosure of material information, such as condensed information about the investment portfolio, dividend income, interest income, realized and unrealized gains or losses, and activities in partners' capital accounts, should be required for a fair presentation of financial statements of investment partnerships. [Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

.18 *Schedule of Investments.* Disclosure should provide financial statement users with information that aids decision making. FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, states in paragraph 40 that, "the benefits of information may be increased by making it more understandable and, hence, useful to a wider circle of users." The Guide requires a complete listing of investments consistent with the SEC's disclosure requirements. This SOP requires nonpublic investment partnerships to present at least a condensed schedule of investments in which investments are organized by type, focusing on geographic and industry concentrations, and requires that material investments (more than 5 percent of net assets) in any one investee be disclosed separately.[2] AcSEC concluded that a complete list of all investments that individually represents an immaterial portion of the investment portfolio would present little additional information that is of value to users of nonpublic investment partnerships' financial statements. The condensed disclosures required by this SOP of the types of investments, the geographical and industry concentrations, and the significant investees are informative to users without burdening them with unnecessary details. AcSEC believes this presentation will enable users to make their decisions

[2] AcSEC has not reconsidered the Guide's disclosure requirements for public investment partnerships. Further, AcSEC does not have the authority to amend SEC requirements concerning disclosures in filings with the SEC.

focusing on the risk and opportunities associated with the type of investment, a geographical area, and industry by investee. [Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

.19 The Investment Company Act of 1940 and the Internal Revenue Code define investment portfolio diversification to exclude, for certain purposes, securities whose values represent more than 5 percent of the total value of an investment company's assets. The implication of those definitions is that investment concentrations above 5 percent impose a level of risk that requires special consideration. After reviewing the comments to the exposure draft, AcSEC concluded that a 5 percent of net assets criterion should be included as a requirement of this SOP. Net assets (instead of total assets) was chosen because net asset value is the focus of investment company financial reporting. [Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

.20 AcSEC recognizes that the 5 percent of net assets criterion for reporting separate investments is arbitrary. Accounting, however, contains many arbitrary disclosure criteria. [Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

.21 *Statement of Operations.* Because the operations of public (SEC registered) investment companies and nonpublic investment partnerships are similar (they both invest in securities to generate dividend income, interest income, and realized or unrealized gains), AcSEC concluded that investment partnerships' statements of operations should be presented in conformity with the Guide as required by paragraph .13 above. [Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

.22 *Management Fees and Allocations.* A number of partnerships record an expense for fees due the general partner, a number allocate net income from the limited partners' capital accounts to the general partner's capital account, and others combine the two methods. Typically, accounting for such arrangements is based on the partnership agreement that specifies the fee or allocation arrangement. In a typical limited investment partnership agreement, the general partner is entitled to a fixed advisory or management fee (such as one percent of net assets), plus an allocation of profits (such as 20 percent of net realized and unrealized gains). Public investment companies or public partnerships normally do not have incentive arrangements, but if they do, they are generally limited to an amount that does not exceed one percent of net assets. The relatively material allocation of profits provided for in nonpublic partnership agreements may be considered either a disproportionate partnership income allocation, based on the fact that the general partner has incurred material cost and effort in organizing the partnership, managing the partnership, and incurred disproportionate risk as the general partner (that is, unlimited personal liability), or a compensation arrangement. Although AcSEC recognizes that issuing definitive standards is desirable, it believes that this SOP cannot provide definitive guidance on accounting for payments to general partners because such guidance would have to result from deliberation of broader partnership issues. AcSEC therefore concluded that the accounting should conform to the structure of the partnership agreement, with the financial statement disclosures set forth in paragraph .14 of this SOP. [Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

.23

Appendix A

Condensed Schedule of Investments

The following is an illustration of how to apply the SOP.[*] However, it does not address all possible circumstances that may arise in applying the SOP.

ABC Associates, Ltd.
Condensed Schedule of Investments
December 31, 199X

Shares		*Value*
	COMMON STOCKS (54.9%)	
	United States (33.8%)	
	Airlines (7.2%)	
53,125	Flight Airlines, Inc. (3.6%)[†]	$1,811,297
	Other (3.6%)	1,819,074
		3,630,371
	Banks (1.9%)	937,099
	Financial Services (2.9%)	1,433,210
	Foods (7.1%)	
106,607	Andrews Midlands Co. (5.7%)	2,825,078
	Other (1.4%)	702,824
		3,527,902
	Hospital Supplies and Services (5.6%)	
100,404	Chelsea Clinics Inc.	2,811,297
	Technology (4.1%)	2,039,578
	Utilities (5.0%)	2,480,556
	Total United States (cost $16,850,954)	16,860,013
	Hong Kong (5.7%)	
	Drugs (0.6%)	330,741
	Retail (4.0%)	1,984,445
	Utility—Telephone (1.1%)	552,235
	Total Hong Kong (cost $2,756,959)	2,867,421
	Italy (5.6%)	
	Airlines (0.2%)	110,247
	Financial Services (1.8%)	881,975
	Leisure Related (3.5%)	1,763,951
	Office Supplies (0.1%)	55,123
	Total Italy (cost $2,912,465)	2,811,296
	Spain (5.4%)	
	Banks (2.4%)	1,212,716
	Oil (1.7%)	826,852
	Railroads (1.3%)	661,482
	Total Spain (cost $2,643,197)	2,701,050
	United Kingdom (4.4%)	
	Financial Services (2.3%)	1,157,593
	Technology (2.1%)	1,047,346
	Total United Kingdom (cost $2,145,246)	2,204,939
	TOTAL COMMON STOCKS (cost $27,308,821)	27,444,719

The accompanying notes are an integral part of these financial statements.

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[*] Percent of net assets is shown for each category; net assets are assumed to be $50,000,000 for this illustration.

[†] Securities of Flight Airlines, Inc., aggregate 5.6 percent of net assets of ABC Associates, Ltd.

ABC Associates, Ltd.
Condensed Schedule of Investments
December 31, 199X
(continued)

Shares or Principal Amount		*Value*
	LONG-TERM DEBT SECURITIES (41.3%)	
	United States (21.4%)	
	Airlines (2.0%)	
$ 1,000,000	Flight Airlines, Inc. 12%, 1998‡	$ 1,000,000
	Government (19.4%)	
$ 3,000,000	U.S. Treasury Bonds, 7.875%, 2021	3,031,791
$ 6,600,000	U.S. Treasury Bonds, 6.875%–8.125% 1999–2021	6,686,175
		9,717,966
	Total United States (cost $15,015,200)	10,717,966
	Spain (19.8%)	
$10,000,000	Spanish Treasury Bonds 4.50%–5.125%, 1994–1997 (cost $10,000,000)	9,922,224
	TOTAL LONG-TERM DEBT SECURITIES (cost $25,015,200)	20,640,190
	(The following investments are all in United States enterprises.)	
	LONG PUT AND CALL OPTIONS (2.4%) (cost $1,225,800)	1,212,716
	LOAN PARTICIPATIONS (1.3%) (cost $465,000)	661,482
	WARRANTS (2.2%) (cost $1,110,247)	1,110,247
	INTEREST IN INVESTMENT PARTNERSHIP (10.0%) (cost $4,000,000) XYZ Hedge Fund, L.P. (35% owned)‖	5,000,000
	(XYZ Hedge Fund L.P. owns 6,000 shares, valued at $9,000,000 of Leisure Cruises, Inc., which is a United States company in the leisure time industry.)	
	TOTAL INVESTMENTS (112.1%) (cost $59,125,068)	$56,069,354
	SECURITIES SOLD SHORT (5.7%)	
106,607	Andrews Midlands Co. (Proceeds $2,715,000)	($ 2,825,078)

The accompanying notes are an integral part of these financial statements.

[Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

‡ Securities of Flight Airlines, Inc., aggregate 5.6 percent of net assets of ABC Associates, Ltd.

‖ Leisure Cruises, Inc., is named because the proportionate share of ABC Associates, Ltd., equity in it is greater than 5 percent of ABC's net assets. If information about the investments of XYZ was not available, that would have been stated either parenthetically or in a note to this schedule.

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Appendix B

Discussion of Comments Received on the Exposure Draft

B-1. An exposure draft of a proposed statement of position, *Financial Reporting for Investment Partnerships*, was issued for public comment in September 1993 and distributed to a variety of interested parties to encourage comments by those that would be affected by the proposal. It proposed that investment partnerships—

- Include a detailed schedule of investments in securities, as illustrated in the Guide for management investment companies, with GAAP financial statements.
- Present a statement of operations in the format illustrated in the Guide.
- Account for performance fees in accordance with partnership agreements and disclose the amounts of and how such fees are computed.

B-2. The exposure draft included the minority view of AcSEC that a condensed schedule of investments, which was illustrated, be required instead of a detailed schedule of investments, as required by the Guide.

B-3. Sixty-nine comment letters on the exposure draft were received. The most significant and pervasive comments received related to the proposed requirement that investment partnerships include a detailed schedule of investments with their financial statements. For the reasons stated in paragraphs .18 through .20 of this SOP, AcSEC agreed that the condensed schedule of investments provided more meaningful information.

Schedule of Investments

B-4. Most respondents to the exposure draft stated that detailed disclosures about the investment portfolio would reveal information, such as trading strategies, that is considered to be confidential. They believe that reporting either detailed or condensed information publicly could be detrimental economically to partnership investors. AcSEC noted that in the absence of any portfolio information, financial statements might merely present a single asset line item titled "investments" that would approximate total assets. Such limited disclosure would undermine the meaningfulness of financial statements.

B-5. Others expressed the view that basic financial statements should provide meaningful summarized information rather than a complete listing of all items included in a particular financial statement caption, such as investments in securities. They pointed out that other financial enterprises, such as banks, property and liability insurance companies, stock life insurance companies, and broker-dealers do not disclose their investments in a similar level of detail. AcSEC concluded that a condensed schedule of investments, that includes disclosures of material investments, would provide sufficient information about the composition of partnerships' portfolios.

B-6. Many respondents stated that investment strategies must be kept confidential to achieve the best results for investors. They expressed concern about disclosing information that they deem to be confidential trade secrets, which might lead other investment firms to "piggyback" the reporting partnership's positions.

B-7. Although AcSEC recognizes the need to balance a fair presentation with protection of proprietary information, complete confidentiality of investments is not a compelling reason for excluding information on material items from financial statements. AcSEC acknowledges that disclosure can produce certain detriments, but AcSEC believes that the need for adequate disclosure outweighs the possibility of negative results. Furthermore, as noted by several respondents, although the disclosure of investment positions may be detrimental to some funds that have material short positions outstanding at a reporting date, many such positions will have expired or will have been covered before the availability of the financial statements.

B-8. *Investor Expectations and Needs.* Respondents noted that investors in investment partnerships frequently are sophisticated investors with a high net worth who neither need nor expect the type of reporting required of mutual funds. Additionally, a number noted that partnership agreements provide for partner access to records, thus enabling a partner to obtain additional information if necessary, whereas others noted that partners sometimes agree not to seek such information.

B-9. AcSEC acknowledges that many, but not necessarily all, investment partners are sophisticated investors, but believes their need for financial information is difficult to differentiate from that of less sophisticated investors. How to assess financial statement users' needs is a pervasive issue in formulating accounting standards and is considered in AcSEC and FASB deliberations. Further, it is questionable whether investment partnerships can be distinguished from other investment companies based on the sophistication of their investors because some public investment companies registered under the 1940 Act—

a. Can engage in similar trading strategies, such as hedging and investing in derivatives.

b. Have sophisticated investors.

c. Have minimum investment levels equal to or in excess of those called for by some nonpublic investment partnerships.

B-10. An investor's willingness to take increased risk in return for an expected higher return does not necessarily equate to a lack of desire for information about an investment company's investments. In the absence of any portfolio information, financial statements might merely present a single asset line item titled "investments" that would approximate total assets. Such limited disclosure would undermine the meaningfulness of financial statements.

B-11. *Cost.* A number of respondents addressed the issue of cost benefit in terms of their belief that including either a detailed or condensed schedule of investments with financial statements would jeopardize the confidentiality required to protect their trading strategies and the gains that they engender. They mentioned, as consequences, that others could mimic their strategies or even devise strategies to profit at the expense of an investment partnership, such as in a short squeeze. AcSEC acknowledges that disclosure of condensed schedules of investments may be detrimental in certain cases. Nevertheless, AcSEC believes that reporting basic information about investments is vital for a fair presentation of investment partnerships' financial statements.

B-12. Other respondents expressed a belief that the incremental cost to assemble, present, and audit the investment information would not be outweighed by the benefits of the disclosures. AcSEC believes that such costs should not be material because much of the information required appears to be readily available.

Statement of Operations and Partners' Fees and Allocations

B-13. Most respondents directed their comments to the proposed requirement for investment partnerships to present a schedule of investments, as discussed above. Comments on the proposed statement of operations and partners' fees and allocations were as follows:

- Most respondents who expressed opinions on the proposed statement of operations supported it, but a number objected to it because they believe that the format is appropriate for public mutual funds, but not for nonpublic investment partnerships. One commentator suggested imposing a uniform requirement for both broker-dealers and investment companies, and another suggested a different format altogether.
- A number of respondents who expressed opinions on reporting partners' fees and allocations supported the proposed reporting, and most of the remainder recommended that one or the other accounting method be required, although most did not state a preference for one method or another.

B-14. AcSEC has decided not to make any significant changes to those requirements proposed in the exposure draft. AcSEC believes that because both public (SEC registered) investment companies and nonpublic investment partnerships have similar operations, their statements of operations should also be similar. Although AcSEC recognizes that issuing definitive standards is desirable, it continues to believe that this SOP cannot provide definitive guidance on accounting for payments to general partners because such guidance would have to result from deliberations of broader partnership accounting issues.

Regulatory Considerations

B-15. *Broker-Dealer Requirements*. The financial statements of broker-dealers need not include a detailed or condensed schedule of investments or a separate disclosure of realized and unrealized gains (losses). In the AICPA's Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*, securities brokers and dealers are described as follows (paragraph 1.01):

> Brokers, acting in an agency capacity, buy and sell securities and commodities for their customers and charge a commission. Dealers or traders, acting in a principal capacity, buy and sell for their own account and trade with customers and other dealers.

B-16. Representatives of the broker-dealer industry have expressed the view that investment partnerships that are registered as broker-dealers and that manage funds only for directors, officers, or employees of the partnership's general partner, should be permitted to follow broker-dealer accounting, which does not require the presentation of a schedule of investments. They point out that such investment partnerships are registered as broker-dealers to more readily obtain credit to invest on behalf of the broker-dealers' owners or employees, who are defined as "affiliated persons" by the Securities Exchange

Act of 1934. Because those investment partnerships are registered broker-dealers, they are required to prepare financial statements filed with the SEC the way that broker-dealers are. Such financial statements comply with the format for broker-dealers specified in the Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*. Were such entities required to apply the requirements in this SOP, they would have to prepare financial statements using two different formats: those in the broker-dealer Guide and those specified by this SOP.

B-17. AcSEC believes that investment partnerships that are registered broker-dealers and that invest funds only for directors, officers, or employees of a partnership's general partner should be exempt from the requirements of this SOP. GAAP for broker-dealers is set forth in the broker-dealer Guide, and such partners can readily obtain the information that a condensed schedule of investments and a statement of operations in the format of an investment company would afford them.

B-18. *Commodity Pool Requirements*. Some investment partnerships are registered with the Commodity Futures Trading Commission (CFTC) as commodity pool operators and, as such, are required by the CFTC to file financial statements that are prepared in conformity with GAAP. Commentators recommend that such entities be exempt from the scope of the SOP because—

a. A detailed or condensed schedule of investments may not be meaningful and may even be misleading because of the volatility of most commodity portfolios.

b. The format of the statement of operations currently in use for commodity pools is more meaningful than that proposed in the SOP.

c. The Chief Accountant of the CFTC Division of Trading and Markets has issued an interpretation on how to report allocations of investment partnership equity or other interests to general partners in financial statements filed with the CFTC. That interpretation requires that such allocations be reported in the statement of operations immediately after net income and, as such, is consistent with the conclusions in this SOP.

B-19. In addition to the foregoing, AcSEC notes that an AICPA task force is drafting an audit and accounting guide that will apply to commodity pools, including investment partnerships that are commodity pools. Accordingly, AcSEC has exempted from the scope of this SOP investment partnerships that are commodity pools subject to regulation under the Commodity Exchange Act of 1974.

[Paragraph renumbered by the issuance of Statement of Position 01-1, March 2001.]

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[The next page is 80,161.]

Section 10,670

Statement of Position 95-3 Accounting for Certain Distribution Costs of Investment Companies

July 28, 1995

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Introduction and Background

.01 The Audit and Accounting Guide *Audits of Investment Companies* (the Guide) describes how to account for distribution costs of open-end investment companies that are registered under the Investment Company Act of 1940 (1940 Act), as amended, and that have adopted plans of distribution pursuant to rule 270.12b-1 of the 1940 Act. Paragraph 8.35 of the Guide states the following:

> Rule 270.12b-1 of the 1940 Act permits an investment company, in compliance with specified conditions, to pay for costs incurred to distribute its shares. Payments are made pursuant to a plan, commonly known as a "12b-1 plan," adopted by the board of directors. There are many forms of such plans, and the auditor should review their provisions. Distribution expenses paid with an investment company's assets are accounted for as operating expenses. [Rule 6-07.2(f) of Regulation S-X]

.02 Open-end investment companies, referred to in this SOP as funds, are permitted to finance the distribution of their shares under a plan pursuant to rule 270.12b-1 of the 1940 Act.

Under rule 270.12b-1, a fund's board of directors is required to perform an annual review of the plan and determine whether to continue or terminate it.

Under a **traditional 12b-1 plan,**[1] fund's **distributor** may be compensated or reimbursed for its distribution efforts or costs through one or more of the following methods:

- A 12b-1 fee, payable by the fund, based on an annual percentage of the fund's average net assets (a **compensation plan**) or based on an annual percentage of the fund's average net assets limited to actual costs incurred, after deducting **contingent-deferred sales loads (CDSLs)** received by the distributor (a **reimbursement plan**). Therefore, a compensation plan differs from a reimbursement plan only in that the latter provides for annual or cumulative limits, or both, on fees paid. Fees for both kinds of plans are treated as expenses in a fund's statement of operations.
- A front-end load, which is assessed on purchasing shareholders at the time fund shares are sold.
- A CDSL imposed directly on redeeming shareholders. The CDSL usually is expressed as a percentage, which declines with the passage of time, of the lesser of redemption proceeds or original cost. The CDSL normally ranges from 4 percent to 6 percent and typically is reduced by 1 percent (for example, from 6 percent to 5 percent) a year until the sales charge reaches zero percent.

.03 Rule 12b-1 plans historically have provided that a fund's board of directors may terminate the plan with no penalty to the fund. (Termination of the plan does not necessitate termination of the fund.) Redeeming shareholders still would be subject to the CDSL, which would be paid to the distributor that sold the shares to those shareholders. However, with a traditional 12b-1 plan, the 12b-1 fees normally would be discontinued on plan termination. Some traditional reimbursement 12b-1 plans provide that, when the plan is terminated, the fund's board of directors has the option, but not the requirement, to pay the distributor for any costs incurred by the distributor in excess of the cumulative CDSL and 12b-1 fees the distributor has received. Such a plan is referred to in this SOP as a **board-contingent plan**. Under traditional reimbursement 12b-1 plans, including board-contingent plans, CDSL payments by shareholders continue to be remitted to the distributor until excess costs are fully recovered, after which the CDSL payments usually are remitted to the fund instead of the distributor.

.04 With an **enhanced 12b-1 plan**, the fund is required to continue paying the 12b-1 fee after termination of the plan to the extent the distributor has **excess costs**. CDSL payments by shareholders would continue to be remitted to the distributor to further offset excess costs. Thus, the major distinction between traditional and enhanced 12b-1 plans is the requirement for the fund to continue such payments upon plan termination.

.05 The following table summarizes the 12b-1 plan attributes enumerated above.

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[1] Words that are defined in the accompanying glossary [paragraph .23] are set in boldface the first time they appear.

	Traditional			Enhanced
	Compensation	Reimbursement		
		Nonboard Contingent	Board Contingent	
Annual review and approval of plan by board, with ability to terminate plan	X	X	X	X
Fund Payment Terms[*]				
Payment based on average net assets	X	X	X	X
Annual or cumulative limitation, or both, based on actual distribution costs		X	X	X
Upon termination of 12b-1 plan, board has option, but not obligation, to pay excess costs			X	
Upon termination of 12b-1 plan, fund is required to continue paying 12b-1 fee to the extent the distributor has excess costs				X

Scope

.06 This Statement of Position (SOP) applies to annual and interim financial statements of investment companies that adopt plans that comply with rule 270.12b-1 of the Investment Company Act of 1940.

Conclusions

.07 A liability, with a corresponding charge to expense, should be recognized by a fund with an enhanced 12b-1 plan for excess costs. The amount of the liability should be equal to the cumulative **distribution costs** incurred by the distributor less the sum of (*a*) cumulative 12b-1 fees paid, (*b*) cumulative CDSL payments, and (*c*) future cumulative CDSL payments by **current shareholders**, if reasonably estimable. Any future cumulative CDSL payments should be based on (*a*) current net asset value per share, (*b*) the number of shares currently outstanding and the number of years that they have been outstanding, and (*c*) estimated shareholder **persistency** based on historical fund data or, if historical fund data are not available, group or industry data for a similar class of shares. Changes in the liability should be recognized in the statement of operations as an expense or reduction in expense.

.08 The liability should be reported at its present value, calculated using an appropriate current interest rate, if (*a*) the amount and timing of cash flows are reliably determinable and (*b*) the distribution costs are not subject to a reasonable interest charge. If these conditions are not met, the liability should be calculated without discounting to present value.

[*] Excludes front-end and CDSL payments, which are made by shareholders and not the fund.

.09 A liability for excess costs, computed in the same way as for an enhanced 12b-1 plan, should be recorded by a fund with a board-contingent plan when the fund's board commits to pay such costs.

.10 For both traditional and enhanced plans, funds should disclose in their financial statements the principal terms of such plans and any plan provisions permitting or requiring payments of excess costs after plan termination. For board-contingent and enhanced plans, the aggregate amount of distribution costs subject to recovery through future payments by the fund pursuant to the plan and through future CDSL payments by current shareholders should be disclosed. For enhanced plans, funds should disclose the methodology used to estimate future CDSL payments by current shareholders.

.11 An excess of cumulative 12b-1 fees and CDSL payments to date and future CDSL payments by current shareholders over the cumulative costs incurred by the distributor should not be reported as an asset.

Effective Date and Transition

.12 This SOP is effective for annual financial statements for fiscal years beginning after December 15, 1995, and for interim financial statements for periods in such years. The cumulative effect of changes caused by adopting this SOP should be reflected in the calculation of net asset value on the first day of the fiscal year of adoption.[2] Restatement of financial statements presented for comparative purposes, including financial highlights, is not permitted. Pro forma financial information is not required. Early application is encouraged.

Basis for Conclusions

.13 This section discusses factors that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

.14 For enhanced 12b-1 plans, AcSEC considered three alternatives with respect to accounting for excess costs: (1) immediate recognition of a liability when the distributor incurs excess costs; (2) recognition of a liability upon termination of the plan; and (3) no recognition of a liability.

.15 AcSEC believes that a fund is unconditionally committed to pay excess costs at the formation of an enhanced 12b-1 plan and that a liability for such costs should be reported by the fund when the costs are incurred by the distributor. Although an enhanced 12b-1 plan requires annual board approval for its continuance, the payment for excess costs is not contingent on such approval. Termination of the plan by the fund's board would not change the obligations under the plan. Any operational difficulties, such as the daily calculation of the share net asset values, does not change the fact that the fund is liable for excess costs.

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[2] Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 74, *Disclosures Regarding Accounting Standards Issued But Not Yet Adopted*, expresses the SEC staff's views concerning disclosures of the impact that recently issued accounting standards will have on the financial statements when adopted in a future period. The impact of this standard should be disclosed for all investment companies, including those not subject to SAB No. 74.

.16 The amount of the liability, as calculated pursuant to paragraph .07 of this SOP, includes a reduction for the future cumulative CDSL payments by current shareholders, if reasonably estimable. That is analogous to accounting for the disposal of a segment of a business when the anticipated future cash flows that will result from an original lease and a sublease are taken into account in determining the overall gain or loss on the disposal.[3] In the case of a terminated 12b-1 plan, future CDSL payments on redemption by shareholders pursuant to the prospectus terms reduce the fund's obligation to the distributor, although the amount of those payments is subject to estimation.

.17 Funds account for 12b-1 fees as expenses, in accordance with Regulation S-X and the Guide. AcSEC observes that accounting for excess costs as expenses is consistent with that and the way that funds account for other costs of raising capital (such as state registration fees and legal fees). That accounting is based on the principle that raising capital is an integral part of a fund's business. Such costs are analogous to ordinary and necessary period costs in nonfinancial businesses.

.18 AcSEC believes that the liability for excess costs should be accounted for at its present value, if (*a*) the amount and timing of cash flows are reliably determinable and (*b*) the distribution costs are not subject to a reasonable interest charge. That is consistent with the consensus in Emerging Issues Task Force (EITF) Issue 93-5, *Accounting for Environmental Liabilities*.

.19 Board-contingent plans provide that on a plan's termination, the fund's board of directors has the option, but not the obligation, to pay the distributor for any excess costs incurred. AcSEC believes that a liability for excess costs, computed in the same way as for an enhanced 12b-1 plan, should be recorded for a board-contingent plan only when the fund's board commits to pay such costs and communicates its intent to do so. A commitment by the board, in effect, converts a board-contingent plan into an enhanced plan. That is, the fund is then obligated to continue to pay the 12b-1 fee after termination of the plan to the extent that the distributor has excess costs.

.20 AcSEC believes that the disclosures required for traditional and enhanced plans are necessary to provide users with adequate information regarding the assumptions used to compute the liabilities for certain distributions costs of enhanced 12b-1 plans and contingent excess costs for traditional 12b-1 plans.

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[3] FASB Interpretation No. 27, *Accounting for a Loss on a Sublease*, paragraph 3.

.21

Appendix A

Illustration

To illustrate application of this SOP, the following assumptions are made for a fund with an enhanced 12b-1 plan:

Total distribution costs incurred	$5,000,000
12b-1 payments	(750,000)
CDSL payments received by distributor	(250,000)
	4,000,000
Estimated future CDSL payments to be received by distributor from current shareholders at current asset levels†	(1,000,000)
	$3,000,000

Assuming that the 12b-1 fee is paid at the end of the year, the following calculation would be made:

Current fund net assets (10 million shares at $10.00 per share)	$100,000,000
12b-1 fee as a percentage of net assets	.0075
Annual 12b-1 fee payments (75 basis points)	$ 750,000
Estimated number of years to pay excess costs ($3,000,000 ÷ $750,000/year)	4
Present value of 12b-1 payments of $750,000 for 4 years, discounted at an assumed rate of 8 percent (assuming discounting is appropriate)	$ 2,484,000

Accordingly, upon adoption of the SOP on January 1, 19X1, the fund would recognize a liability of $2,484,000 and a corresponding expense, which would be reported as the cumulative effect of a change in accounting principle pursuant to Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*.

The following illustrates the impact of adopting this SOP in the 19X1 Financial Statements after making the following additional assumptions:

There are no further distribution costs incurred or capital share activity during 19X1.

CDSLs received during 19X1 are $250,000, and anticipated CDSLs with respect to current shareholders expected to be received after 19X1 are $750,000 (that is, the assumption at the beginning of 19X1 that $1,000,000 of CDSLs would be received still is considered valid).

† Assuming amounts are reasonably estimable.

Statement of Operations

Investment income	$X,XXX,XXX
Expenses	
Distribution fees	—
Interest	199,000[‡]
Other	X,XXX,XXX
Realized and unrealized gains	X,XXX,XXX
Net increase in net assets resulting from operations before cumulative effect of change in accounting principle	X,XXX,XXX
Cumulative effect of change in accounting principle (Note)	(2,484,000)
Net increase in net assets resulting from operations	X,XXX,XXX

The statement of changes in net assets should separately reflect the inclusion of the cumulative effect of the accounting change in a similar manner.

The liability at the end of 19X1 would be $1,933,000 ($2,484,000 + $199,000 of interest amortization - $750,000 of annual 12b-1 fees paid) and would be reflected on the statement of assets and liabilities as accrued distribution expenses payable. That amount can be proved as the present value of three consecutive payments of $750,000, which represents the fund's undiscounted liability of $2,250,000.

Financial Highlights

Net asset value—beginning of year	$ .XX
Net investment income	.XX
Realized and unrealized gains	X.XX
	X.XX
Cumulative effect of adoption of accounting standard (Note)	(.25)
Net increase in net assets resulting from operations	$X.XX

Note

Effective January 19X1, the fund adopted AICPA Statement of Position No. 95-3, which requires that a fund record a liability and expense for excess costs, as defined, for enhanced 12b-1 plans. Prior thereto the fund recognized an expense under its 12b-1 plan based on a percentage of the fund's net assets. Under an enhanced 12b-1 plan, the fund is obligated to reimburse the distributor for any costs it has incurred in excess of cumulative 12b-1 and CDSL payments it has received. As of January 1, 19X1, the fund has recorded a liability of $2,484,000 for such costs, representing the cumulative effect of the change in accounting. It is equal to the $4,000,000 of aggregate costs incurred by the distributor in excess of cumulative 12b-1 and CDSL payments through that date, less future estimated CDSL payments of $1,000,000, discounted at 8 percent. At December 31, 19X1, the liability of $1,933,000 represents the aggregate excess costs of $3,000,000 less estimated future CDSL payments of $750,000, discounted at 8 percent. Future CDSL payments were estimated based on the net asset value per share of the fund as of December 31, 19X1, the

‡ $2,484,000 at 8 percent.

number of shares currently outstanding and the number of years that they have been outstanding, and estimated shareholder persistency based on historical fund data.

Change in Estimate

Assume that at the end of 19X1, actual CDSLs received in year one exceed those anticipated by $250,000 and the distributor's estimate of future CDSLs after 19X1 is increased by a further $500,000. The undiscounted liability would be reduced from $2,250,000 to $1,500,000; the discounted liability would be $1,337,000. In this situation, the distribution fees included in the 19X1 statement of operations would be a contra expense of $596,000 (interest expense would be unchanged) and not an adjustment of the cumulative effect of adoption.

If it is assumed instead that year-end CDSLs fell short by $250,000 and the estimate of future CDSLs from current shareholders fell by another $500,000, the undiscounted liability would increase to $3,000,000. The discounted liability would increase to $2,484,000, and the 19X1 statement of operations would include distribution fees of $551,000.

In practice, the periodic remeasurement of the liability also will have to incorporate new fund share sales, additional costs incurred during the period, and the effect of changes in net asset value on the discounting process. In addition, such calculations would have to be made at each net asset value determination date.

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Appendix B

Discussion of Comments Received on the Exposure Draft

B-1. An exposure draft of a proposed statement of position, *Accounting for Certain Distribution Costs for Investment Companies*, was issued for public comment in April 1994 and distributed to a variety of interested parties to encourage comments by those that would be affected by the proposal. The conclusions proposed in the exposure draft on how to account for such costs have been adopted in this SOP. A majority of commentators supported or did not object to the conclusions proposed.

B-2. A minority of commentators objected to the conclusion that investment companies should account for excess costs under enhanced 12b-1 plans as liabilities and expenses. One objection acknowledged that the SOP may be based on existing accounting theory, but objected to it on the grounds that it will not afford equal and fair treatment to fund shareholders. Another commentator objected because of the belief that the likelihood of the termination of a 12b-1 plan is "highly unlikely, remote," as defined in FASB Statement No. 5, *Accounting for Contingencies*.

B-3. As to the first objection, AcSEC observes that Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, in discussing the concept of neutrality, states: "Neutrality means that either in formulating or implementing standards, the primary concern should be the relevance and reliability of the information that results, not the effect that the new rule may have on a particular interest."

B-4. The second objection fails to recognize that the promise made at the inception of an enhanced 12b-1 plan to pay unconditionally any distribution costs creates a liability. That liability is measured by the amount of excess costs. Terminating an enhanced 12b-1 plan only determines when the existing liability is to be paid.

B-5. A further objection to reporting enhanced 12b-1 excess costs as expenses is that doing so may cause a violation of regulatory limitations on 12b-1 fees. This objector argues that, if excess costs are accounted for as liabilities, a portion of those costs should be recorded as an asset to recognize the future economic benefits of increased fund assets. In considering this objection, AcSEC relied on the concept of neutrality cited above and notes that items are frequently treated differently for GAAP and regulatory purposes. Further, AcSEC believes that the benefits cited—lower expenses (on a pro rata per share basis) and increased cash flows that enhance investment strategy—do not meet the essential characteristic of an asset in paragraph 26 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, that, "(a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows."

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Glossary

Board-contingent plan. A reimbursement 12b-1 plan that provides that, on the plan's termination, a fund's board of directors has the option, but not the requirement, to pay the distributor for any excess costs incurred by the distributor.

Compensation plan. A plan that provides for a 12b-1 fee, payable by the fund, based on a percentage of the fund's average net assets. The 12b-1 fee may be more or less than the costs incurred by the distributor.

Contingent-deferred sales load (CDSL or back-end load). A sales charge imposed directly on redeeming shareholders based on a percentage of the lesser of the redemption proceeds or original cost. The percentage may decrease or be eliminated based on the duration of share ownership (frequently decreases by one percent a year).

Current shareholders. Shareholders of a fund, or a class of shares of a fund, at an evaluation or measurement date. Amounts attributable to current shareholders are based on shares outstanding at that date and do not include estimates of future reinvestments or other share purchases.

Distribution costs. Costs, as defined in a distribution agreement between a distributor and a fund, incurred by a distributor in distributing a fund's shares. Such costs may include commission payments to sales representatives, promotional materials, overhead allocations, and interest.

Distributor. Usually the principal underwriter that sells the fund's capital shares by acting as an agent (intermediary between the fund and an independent dealer or the public) or as a principal, buying capital shares from the fund at net asset value and selling shares through dealers or to the public (see definition of *underwriter* in section 2(a)(40) of the Investment Company Act of 1940).

Enhanced 12b-1 plan. A reimbursement 12b-1 plan that provides that, on termination of the plan, the fund is required to continue paying the 12b-1 fee to the extent the distributor has excess costs.

Excess costs. The cumulative distribution costs incurred by the distributor less the sum of (*a*) cumulative 12b-1 fees paid, (*b*) cumulative CDSL payments, and (*c*) future cumulative CDSL payments by current shareholders, if reasonably estimable.

Persistency. The length of time a shareholder owns shares of a particular fund or class of shares of a fund before redemption.

Reimbursement plan. A plan that provides for a 12b-1 fee, payable by the fund, that may not exceed the lesser of an annual percentage of the fund's average net assets or actual costs incurred by the distributor net of CDSL received by the distributor.

Traditional 12b-1 plan. A compensation or reimbursement plan pursuant to rule 270.12b-1 of the Investment Company Act of 1940 that permits the use of a fund's assets to pay distribution-related expenses under certain conditions. The 12b-1 fees under traditional 12b-1 plans are normally discontinued upon plan termination, but may continue to be paid after plan termination under a board-contingent plan (see above).

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Section 10,680

Statement of Position 96-1
Environmental Remediation Liabilities

October 10, 1996

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Part 1

Overview of Environmental Laws and Regulations

.01 The objective of this part is to provide accountants with an overview of key environmental laws and regulations. It is intended to be a separate, nonauthoritative component of this Statement of Position (SOP).

.02 Although the remainder of this SOP focuses on environmental remediation liability issues, this part includes brief discussions of key pollution control and other environmental laws as well as a more extensive discussion of environmental remediation liability laws.

Chapter 1
INTRODUCTION

.03 Beginning in the early 1970s, Congress and state governments began paying increased attention to legislation designed to protect the environment. In just twenty years, these efforts have changed dramatically the manner in which business is carried out in the United States.

.04 For instance, today, new loan agreements only rarely do not contain extensive environmental representations, warranties, and indemnities. Real estate development is likewise affected by environmental considerations, such as whether the project area contains wetlands or whether past activities could have adversely affected the soil or groundwater. The possibility of becoming subject to liability for environmental **remediation**[1] costs associated with past waste **disposal** practices based on strict liability can affect transactions involving the acquisition or merger of enterprises or the purchase of land. In sum, the explosion of federal and state environmental laws and regulations has affected all manner of business transactions.

.05 Although this SOP focuses on both state and federal United States laws and regulations, environmental considerations are also important for foreign operations. Environmental laws and regulations in many countries are similar to United States laws. The legal and regulatory climates in other countries are evolving. Regardless of whether the host countries' environmental laws are as stringent as those in the United States, entities can often be held liable for environmental damages under a variety of nonenvironmental statutes and broad legal theories.

.06 Environmental laws may be thought of as being of two kinds. First, there are laws that impose liability for remediation of environmental pollution arising from some past act. Second, there are pollution control and pollution prevention laws. Some environmental laws cover both categories. This SOP focuses principally on federal laws, but many states have enacted analogous statutes.

.07 The first kind of environmental law, environmental remediation liability laws, includes individual statutes as well as response provisions in other statutes. The most important of these are the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), as amended by the Superfund Amendments and Reauthorization Act of 1986 (SARA), which together are referred to as Superfund, and the **corrective action** provisions of the Resource Conservation and Recovery Act of 1976 (RCRA). Under Superfund's current broad liability provisions, the U.S. Environmental Protection Agency (EPA) may order liable parties to remediate sites or use Superfund money to remediate them and then seek to recover its costs and additional damages. Similarly, under the corrective action provisions of RCRA, the EPA may order "facilities that treat, store, or dispose of **hazardous waste**" to clean up **releases** of **hazardous waste constituents** associated with past or ongoing practices.

.08 Environmental laws of the second kind, laws intended to control or prevent pollution, are directed at identifying or regulating pollution sources or

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[1] Terms defined in the glossary [paragraph .178] are in **boldface** type the first time they appear in this SOP.

reducing emissions or discharges of pollutants. Myriad statutes regulate sources of pollution, including the pollution control provisions of RCRA (solid and hazardous wastes), the Clean Water Act (discharge of pollutants into the waters of the United States and to publicly owned treatment works, or POTWs), and the Clean Air Act (emission of pollutants into the atmosphere). Other examples are the Emergency Planning and Community-Right-to-Know Act (EPCRA) and the Pollution Prevention Act of 1990. Pursuant to EPCRA, facilities that store chemicals over threshold amounts must submit certain information to local, state, and federal environmental and emergency response authorities. EPCRA also includes requirements for reporting of episodic releases of toxic chemicals, as well as annual reporting of toxic chemical releases that occur as a result of normal business operations for specified manufacturing and other activities. The Pollution Prevention Act, among other things, requires facilities subject to EPCRA's reporting requirements to also report pollution source reduction and recycling activities.

.09 Before discussing key statutes in more detail, it is worth mentioning two legal concepts that are expressly or implicitly incorporated into Superfund: strict liability, and joint and several liability. Strict liability statutes, such as CERCLA, impose liability without regard to the liable party's fault. Thus, a waste generator that disposed of its waste at approved facilities, in accordance with all then-current requirements, having exercised "due care," would nevertheless be liable. Where liability is joint and several, any party deemed liable is potentially responsible for all of the associated costs. Under CERCLA, for instance, a waste generator that is responsible for a small percentage of the total amount of waste at a site may be held liable for the entire cost of remediating the site.

.10 Also noteworthy is that wastes need not be hazardous wastes for there to be environmental remediation liability. If the waste generator "arranged for disposal" of wastes containing **hazardous substances** (at any concentration level and regardless of whether the substances were defined as, or known to be, hazardous at the time of disposal), and a "release" of hazardous substances has or could occur, the waste generator could be subject to environmental remediation liability.

Chapter 2

ENVIRONMENTAL REMEDIATION LAWS

.11 The vast majority of federal environmental remediation provisions are contained in the Superfund laws, the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and the Superfund Amendments and Reauthorization Act (SARA), and in the corrective action provisions of the Resource Conservation and Recovery Act of 1976 (RCRA). Typically, the United States Environmental Protection Agency (EPA) utilizes Superfund to clean up facilities that are abandoned or inactive or whose owners are insolvent; however, Superfund can be and is also applied to sites still in operation. RCRA provisions apply to hazardous waste treatment, storage, and disposal facilities that are still in operation or have closed recently.

Superfund

.12 Congress enacted CERCLA in 1980 to facilitate the remediation of abandoned waste sites. CERCLA established a program to identify sites where hazardous substances have been or might be released into the environment; to ensure that they are remediated by responsible parties or the government; to compensate the United States, states, municipalities, and tribes for damages to natural resources; and to create a procedure for claims against responsible parties by parties who have cleaned up sites or spent money to restore natural resources. The act also created a $1.6 billion trust fund to cover the costs associated with **orphan sites** and costs incurred while the EPA seeks reimbursement from **potentially responsible parties (PRPs)**. In 1986, SARA increased the amount of the trust fund to $8.5 billion, broadened the provisions of Superfund, provided more detailed standards for remediation and settlement provisions, and broadened criminal sanctions. The increase in the trust fund is supported by increased taxes on the petroleum industry and a tax on corporate alternative minimum taxable income. At the time of this writing, Superfund is again in the process of reauthorization, and there is a potential for further changes to the law as part of this process.

.13 Superfund places liability on the following four distinct classes of responsible parties:

a. Current owners or operators of sites at which hazardous substances have been disposed of or abandoned

b. Previous owners or operators of sites at the time of disposal of hazardous substances

c. Parties that "arranged for disposal" of hazardous substances found at the sites

d. Parties that transported hazardous substances to a site, having selected the site for treatment or disposal

This liability is imposed regardless of whether a party was negligent, whether the site was in compliance with environmental laws at the time of the disposal, or whether the party participated in or benefitted from the deposit of the hazardous substance. Parties that disposed of hazardous substances many years ago—including the years preceding CERCLA's enactment—at sites where there is, was, or may be a release into the environment, may be liable for remediation costs.

.14 *Hazardous substance* is a much broader term than *hazardous waste*. It includes any substance identified by the EPA by regulation, pursuant to a number of federal statutes. Covered, for example, are substances considered to be *toxic pollutants* under the Clean Water Act or *hazardous air pollutants* under the Clean Air Act. The various lists of hazardous substances identified by the EPA contain more than one thousand chemicals and chemical compounds.

.15 Petroleum and any derivative or fraction that is not specifically listed or designated as a hazardous substance are specifically excluded from the federal definition of a hazardous substance contained in Superfund. Also excluded are natural gas, natural gas liquids, liquefied natural gas, and synthetic gas of pipeline quality. (Discharges of petroleum into the surface waters or shorelines of the United States are covered under several other federal laws.) The protection afforded by this petroleum exclusion is narrow, however. For example, lead (a hazardous substance) that is added to gasoline would not be covered by the petroleum exclusion because it is not an indigenous constituent of petroleum. Further, many state laws that are analogous to Superfund do not provide for a petroleum exclusion.

.16 Hazardous substances are often integral components of materials that are not hazardous wastes. And, although a threshold quantity of a hazardous substance must be released in order to create a reporting obligation, there is no threshold quantity that gives rise to liability. Thus, discarding industrial equipment on which there is leaded paint may not trigger a reporting obligation, but if that equipment is discovered at a Superfund site, it may be sufficient to identify the disposer as a PRP.

.17 The courts have interpreted CERCLA to impose strict liability. In other words, responsible parties are liable regardless of fault. Moreover, through EPA-initiated legal action, liability under CERCLA may be joint and several. If a PRP can prove, however, that the harm is divisible and there is a reasonable basis for apportionment of costs, the PRP may ultimately be responsible only for its portion of the costs. This scheme of liability means that any responsible party can potentially be liable for the entire cost of remediating a site, notwithstanding that the party is responsible for only a small amount of the total hazardous substances or waste at the site and did nothing improper.

.18 Statutory defenses to CERCLA liability are limited. Essentially, they are an act of God; an act of war (but not a response to an act of war, such as the manufacturing of munitions); and, in limited circumstances, an act or omission of a third party. There is an additional defense available to owners of property affected by hazardous substances known as the *innocent landowner* defense, which applies to landowners that acquired properties after hazardous substances were disposed of on them and that did not know or have reason to know about the existence of the hazardous substances. In order to use this defense, however, a landowner must establish that it made "all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice." What constitutes "all appropriate inquiry" has been the subject of substantial litigation. It can be said, however, that a landowner that gains such actual knowledge and subsequently transfers the property without disclosure forfeits this defense.

.19 In order to mitigate the potentially harsh effects of the strict, joint and several, and retroactive liability scheme, however, Superfund does permit responsible parties to sue other responsible parties to make them contribute to the cost of the remediation or to recover money spent on remediation.

.20 The EPA has several potent enforcement tools available to it under Superfund. Most significant is the EPA's power to issue a **unilateral administrative order** to responsible parties requiring them to take a **response action** at a site where there is "an imminent and substantial endangerment to the public health or welfare or the environment because of an actual or threatened release [of a hazardous substance] from a facility." A respondent who fails to perform the response action or fails to report as required under CERCLA is potentially subject to $25,000 per day in penalties. In addition, if the EPA performs the action, it may recover up to four times its costs in damages and penalties (that is, actual costs plus treble damages). Judicial review of an EPA administrative order is not available until after the remedy is implemented, money is spent, and the EPA commences an enforcement action for cost recovery. Thus, even a party with a reasonably good defense to liability takes great risk in not complying with an EPA order.

.21 Costs to a PRP may include cleanup costs (**containment, removal, remedial action**), enforcement costs (for example, legal), government oversight costs, and natural resource damages (see the section herein entitled "Natural Resource Damages Under Superfund" in paragraphs .48 through .50). Though CERCLA does not provide for personal injury or property damage suits, suits for injury to health or property (referred to as toxic torts) may also be brought by third parties under various legal theories.

Stages of the Superfund Remediation Process

.22 The following is a discussion of the Superfund remediation process. The stages of this process are also depicted in figure 1, "Sequence of a Typical Superfund Remediation Process," in paragraph .39. The subsequent section, "Potentially Responsible Parties Identification and Allocation" [paragraphs .40 through .47], discusses stages of PRP involvement in the remediation process.

Site Identification and Screening

.23 Beginning in 1981, the EPA identified more than thirty thousand sites for scrutiny based on reports filed by companies pursuant to section 103(c) of CERCLA in which they disclosed locations where they had disposed of hazardous substances. This information formed the basis for a database called the **Comprehensive Environmental Response, Compensation, and Liability Information System (CERCLIS or CERCLA Information System).**

.24 Each site in the CERCLIS database has undergone or will undergo a preliminary assessment of available information as a first step in determining what, if any, action is needed at the site. Based on this information, a site may be dropped from further consideration, or a site investigation or inspection may be performed. This involves a visit to the site by EPA representatives and, usually, limited sampling, which provides the information necessary to rank the site according to the Hazard Ranking System, a mathematical rating scheme that combines the potential of a release to cause harm to people or the environment with the severity or magnitude of these potential situations and the number of people that could be affected. Using the numerical scores from this scheme, the EPA and the states prioritize sites and allocate resources for further investigation, enforcement of remediation, and remediation. Sites receiving high scores (28.5 or above) are proposed for inclusion on the **National Priorities List (NPL)** for remedial action, which generally is a long-term operation involving permanent solutions to the extent practicable.

Removal Action

.25 Some sites may be determined to require a **removal action**, which is a relatively short-term or emergency response taken where there is an imminent and substantial endangerment to the public health or welfare or the environment. In such cases, the EPA may undertake or order PRPs to undertake any appropriate removal action to prevent, abate, stabilize, minimize, mitigate, or eliminate a release or threatened release. A removal action may occur at any stage of the remediation process. Moreover, sites need not be on the NPL for the EPA to undertake or order removal actions.

Remedial Investigation

.26 The remedial investigation is a comprehensive study, usually performed by environmental engineers, that seeks to delineate the nature and extent of hazardous substances at a site, assess potential risks posed by the site, and define potential pathways for exposure. The remedial investigation usually involves extensive sampling of soil and groundwater in and around the vicinity of the site.

Risk Assessment

.27 A site-specific **baseline risk assessment** identifies hazards, assesses exposure to the hazardous substances and their toxicity, and characterizes and quantifies the potential risks posed by the site. A baseline risk assessment often is performed during the feasibility study phase.

Feasibility Study

.28 Following the remedial investigation, a feasibility study is performed. The feasibility study uses the information generated by the remedial investigation to evaluate alternative remedial actions and recommend one. The feasibility study—

- Identifies a list of potential remedial alternatives.
- Estimates the cost of each remedial alternative.
- Screens the alternatives for their ability to meet technical, public health, and environmental requirements and, if other considerations are equal, their cost-effectiveness; evaluates their ability to be implemented in a reasonable time frame given available technologies; and eliminates inferior alternatives from further evaluation.
- Completes a detailed analysis of the screened alternatives with respect to the criteria established by the EPA.

.29 The **remedial investigation and the feasibility study (RI/FS)** together generally take a minimum of two years to complete and, depending on factors such as the types of hazardous substances, soil formations, and number of parties involved, may take more than five years, and they can cost well in excess of $1 million. The EPA oversees the progress of the RI/FS, and completion is sometimes performed in stages.

Remedial Action Plan

.30 Once the RI/FS is complete, a program must be decided on for remediation of the site.

.31 In selecting a remediation program, the EPA first decides what cleanup standards are to be applied to the site. (The remedy selected must achieve cleanup standards, standards of control, and other environmental protection requirements, criteria, or limitations, known as **applicable or relevant and appropriate requirements (ARARs).**) It then identifies which remediation methods can achieve the standards. Finally, it is specified which of the alternative remediation methods is most cost-effective. Thus, the cleanup standards to be applied are not weighed against the cost of achieving those standards in the decision process.

Public Comment and Record of Decision

.32 The program is contained in a proposed remedial action plan (PRAP), which is made available to interested parties for public comment. After reviewing any public comments received, the EPA modifies the remedial plan, if necessary, and issues a record of decision (ROD), which specifies the remedy, as well as the time frame in which the remedy is to be implemented. The final ROD is part of a written **administrative record** documenting the basis of the EPA's remedy selection.

.33 The EPA reviews the effectiveness of the remedial action periodically and can require changes to the plan or additional measures. EPA reviews typically occur every five years (often more frequently in the early stages of the remediation) and may continue well beyond delisting of the site from the NPL.

Remedial Design

.34 Following issuance of the ROD, the site enters into the remedial design phase. This phase includes development of a complete site remediation plan, including engineering drawings and specifications for the site remediation.

Remedial Action

.35 This phase includes actual construction and implementation of the remedial design that results in site remediation as specified in the ROD.

.36 There is a general presumption that the technology specified in the ROD must be used at the site. But the EPA sometimes agrees to innovative approaches using alternative, unproven technologies because one of the objectives embodied in Superfund is the promotion of improvements in remediation technology.

Operation and Maintenance (Including Postremediation Monitoring)

.37 After Superfund site remedial action is completed, activities must be conducted at the site to ensure that the remedy is effective and operating properly. For example, after a system to pump and treat groundwater is constructed (remedial action), the system must be operated and maintained. In addition, the EPA may require postremediation monitoring. These operation and maintenance activities may continue for thirty years or longer.

Government Oversight

.38 Under Superfund, the President of the United States has broad freedom to respond to actual or threatened releases of hazardous substances;

threatened, not actual, releases are enough to give rise to authority to act. Authority to abate the risk of harm from even threatened releases lies at the heart of the statute. The President has delegated this authority principally to the EPA for land, groundwater, and surface water. Thus, the Superfund program is controlled by the EPA throughout each step of the remediation process. This is reflected in continued agency oversight as the Superfund project unfolds.

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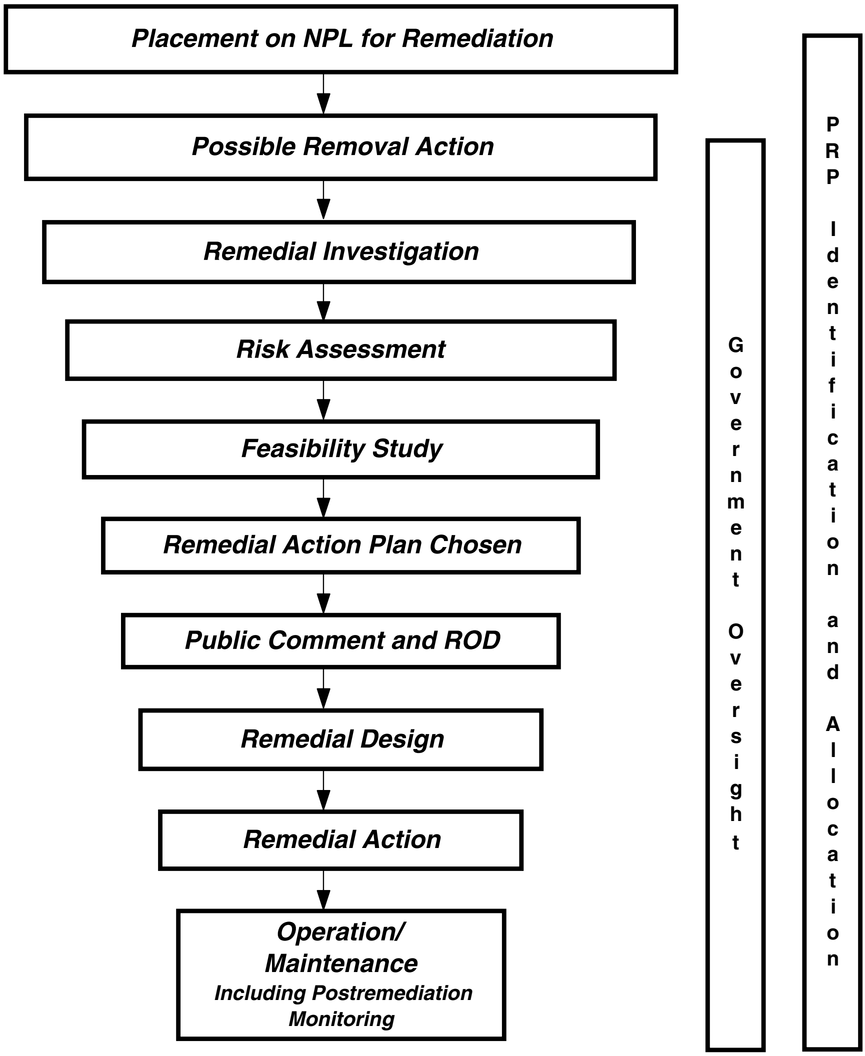
Figure 1

Sequence of a Typical Superfund Remediation Process



Potentially Responsible Parties Identification and Allocation

.40 The following is a discussion of the stages of PRP involvement in the Superfund remediation process. As depicted in figure 1 [paragraph .39], PRP identification and the allocation of costs among the PRPs is an ongoing process over the course of the remediation process; specific stages of PRP involvement do not necessarily correspond to specific stages of the remediation process.

Notification of Involvement

.41 A company may first learn of potential involvement in a Superfund site through the appearance of the site on a government list such as the NPL, in the CERCLIS database, or on a state priorities list. More often, an entity learns of involvement by receiving an information request [Section 104(e) Request] from the EPA regarding the wastes it may have sent to a designated site. But full-scale Superfund involvement usually begins when a company is notified by the EPA that it may be a PRP. The EPA may do this in several ways. It may—

- Issue a Notice Letter to all PRPs. A Notice Letter is the EPA's formal notice that Superfund-related action is to be undertaken at a site for which the PRP is considered potentially responsible.
- Issue a Special Notice Letter to PRPs stating that the government intends to initiate work at the site or issue an administrative order to force the PRPs to take response actions at the site unless the PRPs commit within a specified period (typically sixty to one-hundred twenty days) to take response actions.

  The Special Notice Letter provides the names and addresses of other targeted PRPs (to facilitate negotiations among the parties), and it may include a draft of a **consent decree** for each party to share in the costs or assume the responsibility for performing the RI/FS. The EPA also normally includes information about the nature of the material at the waste site and any knowledge it has obtained about the amount of waste contributed by each party.
- Summon all targeted PRPs to a meeting to discuss possible actions at a given site.

.42 Theoretically, the EPA should identify all of the PRPs and send each one of them a notice or summon them to a meeting. However, depending on the evidence it has collected to that point, the EPA may not be aware of all PRPs, leaving it up to the identified PRPs to perform an investigation to find others who may be liable and then file suits for cost recovery or contribution.

.43 PRPs are generally prohibited under Superfund from obtaining immediate judicial review of EPA decisions identifying them as liable or requiring them to take response actions; such review generally is available only after the EPA decides to bring an enforcement action for cost recovery, long after the remedy has been implemented.

Negotiations

.44 Once notified, the PRPs face the difficult task of organizing to negotiate with the government and perhaps assuming responsibility for carrying out the investigation or remedial work.[2, 3] Many PRPs consider it in their best in-

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[2] The negotiations do not require participation by all PRPs.

[3] A useful source of information is the *PRP Organization Handbook*, published by the Information Network for Superfund Settlements c/o Morgan, Lewis & Bockius, 1800 M Street, NW, Washington, DC 20036.

terests to assume such responsibility; if the PRPs are unable to reach an agreement among themselves, however, the EPA has the power to clean up the site and sue for full reimbursement of the costs. The sixty- to one-hundred-twenty-day period given with the Special Notice Letter is intended to give multiple PRPs sufficient time to organize and to make a good faith offer to the government to perform a specified activity.

.45 Negotiations often take place in stages. For example, PRPs may organize and agree to perform the RI/FS and to divide the costs among themselves in a particular way while continuing to negotiate how and whether to address the remediation itself.[4] Such preliminary cost-sharing agreements are often based on the volume of waste contributed to a site by each party (without regard to its relative toxicity), with an understanding that the allocation may be subsequently revised as additional information about the site becomes available.

.46 The process ultimately results in one of three outcomes:

a. *Negotiated settlement among the parties.* The parties and the EPA agree on who will clean up the site and how the cost sharing will take place. The EPA sometimes provides some assistance in this area through a *nonbinding allocation of responsibility*—a nonbinding judgment by the EPA as to who should be responsible for what share of the cost.

One or more minor participants may negotiate a de minimis settlement with the EPA in which they agree to pay their shares, usually with an agreement from the EPA that their liability is completed at the time of settlement. Such shares typically include some kind of premium over the contributors' "fair share." De minimis settlement nevertheless saves the contributor from incurring further legal fees, and it is the closest thing a PRP can get to a final cash settlement.

For the EPA to be receptive to a de minimis settlement, one of the following conditions must be met: (*a*) both the amount and the toxicity or hazardous properties of substances the PRP contributed are minimal in comparison to other hazardous substances at the site or (*b*) the PRP is a current or past owner of the site, did not allow generation, transportation, storage, treatment, or disposal of any hazardous substance at the site, did not contribute to the release or threat of release at the site, and did not purchase the property knowing that it was used for generation, transportation, storage, treatment, or disposal of any hazardous substances. Further, de minimis settlements typically occur only when a participant's "share" of the liability is less than one percent. Moreover, the EPA typically is unwilling to commit time and resources to negotiate with de minimis contributors individually. The de minimis settlement must take place as part of negotiations with the larger PRP group or with a separate group of de minimis contributors.

PRPs usually establish and contribute to a trust fund, from which an independent contractor is paid to do the RI/FS and remedial work. The contractor's work typically is overseen by a technical committee

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[4] Some states, however, will not enter into agreements with PRPs concerning only stages of the remediation, such as the RI/FS; they require any agreement to cover the entire remediation effort.

of the contributing PRPs and either by a finance committee of those PRPs or by a management firm hired by the trust. PRPs seldom perform the RI/FS or remedial work themselves.

b. *Unilateral administrative order.* The EPA issues a unilateral administrative order under section 106 of CERCLA to compel a potentially responsible party (or parties) to clean up a site where there may be an "imminent and substantial endangerment" to human health or to the environment because of an actual or threatened release of a hazardous substance.

c. *Section 107.* The EPA remediates the site and seeks recovery of its costs from PRPs under section 107. To obtain reimbursement, the EPA issues letters to PRPs demanding payment for its response costs (costs of removal, remediation, and enforcement action). If these letters do not result in settlement, the EPA can seek reimbursement in the courts by referring the case to the Department of Justice.

Litigation

.47 PRPs that participate in the remediation can, and generally do, sue PRPs that did not participate in the remediation to recover costs, assuming those parties can be found and are solvent. Superfund expressly provides that any responsible party who pays Superfund response costs may sue other responsible parties to recover at least a part of such costs. In resolving such suits, courts are authorized by Superfund to apportion liability for response costs among responsible parties using "such equitable factors as the court determines are appropriate."

Natural Resource Damages Under Superfund

.48 There is a growing specter of liability for natural resource damages under the Superfund laws. CERCLA authorizes the recovery of damages for injury to, destruction of, or loss of natural resources, including reasonable costs for assessing such injury resulting from a release of a hazardous substance.

.49 Under CERCLA, natural resources are defined as land, fish, wildlife, biota, air, water, groundwater, drinking water supplies, and other such resources belonging to, managed or held in trust, or otherwise controlled by the United States, state or local governments, foreign governments, or Indian tribes.

.50 Natural resource damage claims include actual restoration costs and lost use values and may in the future include nonuse values, such as the intrinsic public value of protecting or restoring resources that may not be used but are valuable for their mere existence.

Reporting Releases Under Superfund Provisions

.51 Persons in charge of facilities must report releases of hazardous substances (spills) to the environment that exceed specified *reportable quantities.*

Remediation Provisions of the Resource Conservation and Recovery Act

.52 The RCRA of 1976, the pollution control provisions of which are discussed in chapter 3, provides for "cradle-to-grave" management standards for hazardous wastes. Section 7003 of RCRA also authorizes the EPA to conduct removal actions, seek affirmative injunctive relief, and maintain cost-recovery actions where an imminent and substantial endangerment to the public health or welfare or to the environment is determined to exist. Much like under Superfund, one who has "contributed to" the disposal of waste that is causing an imminent and substantial endangerment can be required to perform or pay for associated remediation under section 7003.

.53 The 1984 Hazardous and Solid Waste Amendments to RCRA expanded owner-operator responsibility for environmental remediation liability associated with releases of hazardous wastes or hazardous waste constituents at hazardous waste **treatment, storage, or disposal facilities (TSDFs).** As amended, RCRA requires facilities—whether they continue operating or intend to close—to remedy any such releases. These corrective action provisions of RCRA, which are separate from Superfund, apply only to facilities that are operating under RCRA permits (see chapter 3) or that have applied for such permits.[5] However, because the EPA generally takes the position that the facility includes all the property that is adjacent or contiguous to the TSDF, permitting of a very small TSDF can subject a much larger, unrelated part of a property to RCRA's corrective action provisions, which apply "fencepost-to-fencepost."

.54 RCRA corrective action may be initiated either as part of the RCRA permitting process or through an interim status corrective action order. Corrective action for releases of hazardous waste or its constituents from **solid waste management units (SWMUs)**, whether they are on- or off-site, is a condition for obtaining any operating or postclosure RCRA permit. The EPA may also order corrective action while a TSDF is in interim status (before it receives its permit) based on information that there is or has been a release to the environment from the TSDF. The EPA does not need to demonstrate imminent and substantial endangerment to human health or the environment from a real or threatened release to issue an interim status corrective action order.

.55 The RCRA corrective action process, which is depicted in figure 2 in paragraph .59, is divided into the following five stages.

.56 *RCRA Facility Assessment.* The RCRA facility assessment (RFA) identifies areas and units at the facility from which hazardous waste or hazardous waste constituents may have been released and collects all existing information regarding the releases. The RFA may be conducted by the EPA or the EPA's contractors, or by the facility owner. There is no analogous stage in the Superfund remediation process.

.57 *RCRA Facility Investigation.* The RCRA facility investigation (RFI) is a detailed investigation to characterize releases to the environment by identifying the environmental setting, characterizing the sources of hazardous substances releases, identifying potential receptors, determining if remediation is necessary, and, if so, collecting data to support the evaluation of remediation alternatives. This stage is analogous to the Superfund remedial investigation stage.

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[5] Facilities that have not actively applied for a permit may be deemed to have a "permit by rule" if the owner/operator (1) holds a permit under another qualifying program and (2) complies with certain RCRA requirements specified for the owner/operator's situation. In addition, operating a facility in a manner that was subject to permit requirements, even if an application was not submitted, triggers RCRA permit obligations, including corrective action.

.58 *Interim Corrective Measures.* Interim corrective measures (ICM) are measures (typically containment) conducted at any time before selection of the final remedy by the environmental agency. This stage is analogous to a removal action under Superfund.

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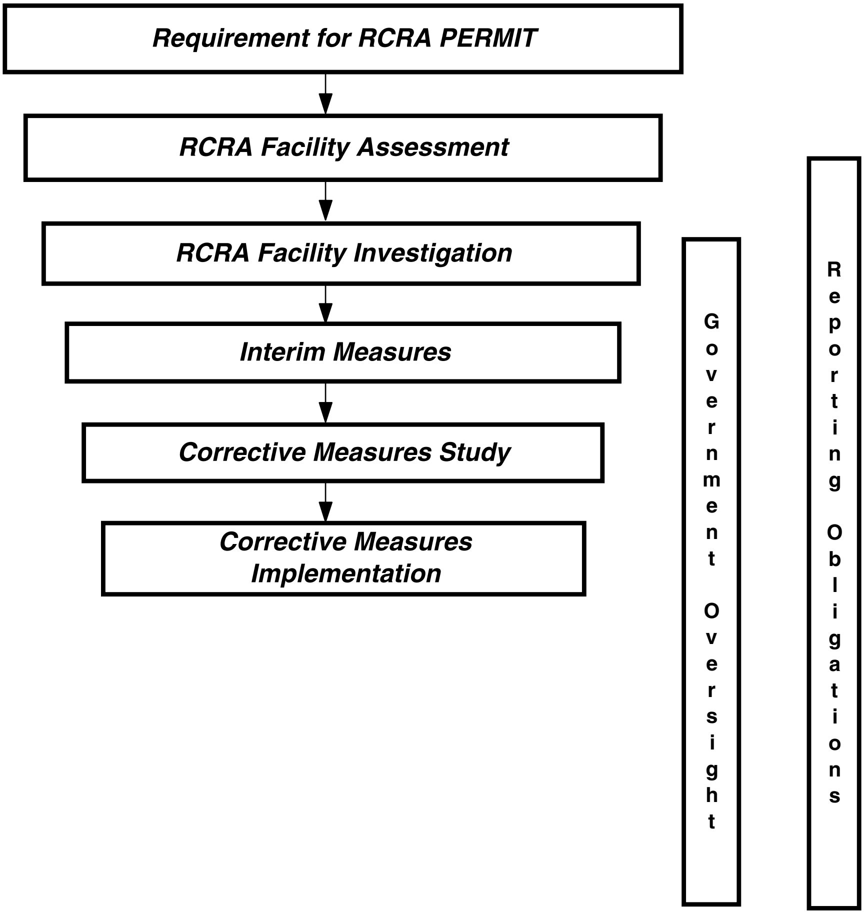
Figure 2

Sequence of RCRA Corrective Action Process



.60 *Corrective Measures Study.* If the RFI reveals a potential need for corrective measures, the agency requires the owner to perform a corrective measures study (CMS) to identify and recommend specific measures to correct the releases. The CMS assesses possible corrective measures in terms of technical feasibility, ability to protect public health and the environment, and possible adverse environmental effects of the corrective measures. Although analogous to the Superfund feasibility-study stage, this study is usually less complicated.

.61 *Corrective Measures Implementation.* This stage, corrective measures implementation (CMI), includes designing, constructing, operating, maintaining, and monitoring selected corrective measures that have been approved by the regulatory agency. This stage combines activities that are often segregated under Superfund as remedial design, remedial action, and operation and maintenance.

.62 *Owner/Operator Reporting and Government Oversight.* Beginning with the application for a RCRA permit, owner-operators are required to report to the EPA throughout the RCRA corrective action process, and the EPA oversees and controls each stage of the process.

.63 The 1984 amendments also created the Underground Storage Tank (UST) Program, which requires, among other things, that owners or operators of existing tank systems used for storage of petroleum and petroleum-based substances and certain other designated hazardous substances upgrade in accordance with standards specified by the EPA if those tank systems do not meet new tank standards. In addition, the 1984 amendments create an environmental remediation liability for known releases from USTs.

.64 RCRA regulations require financial assurance for closure and postclosure remediation of TSDFs and USTs.

State and Foreign Laws

.65 Many states have also enacted laws that are similar to the federal statutes. Furthermore, under certain federal statutes, such as RCRA, states are allowed to promulgate regulations to implement federal programs as long as the state law is at least as stringent as the federal law. In most such cases, states are free to enact more stringent provisions. Preparers and auditors of financial statements should also be aware that most developed countries and many other countries have enacted environmental laws, some of which may be similar to or more stringent than United States laws.

Chapter 3

POLLUTION CONTROL AND PREVENTION LAWS

The Resource Conservation and Recovery Act

.66 The Resource Conservation and Recovery Act (RCRA) provides comprehensive federal regulation of hazardous wastes from point of generation to final disposal. All generators of hazardous waste, transporters of hazardous waste, and owners and operators of hazardous waste treatment, storage, or disposal facilities (TSDFs) must comply with the applicable requirements of the statute.

.67 For generators of hazardous waste, those requirements include the following:

a. Hazardous waste determination

b. Manifest requirements

c. Packaging and labeling

d. Record keeping and annual reporting

e. Management standards

.68 Less stringent requirements under RCRA are imposed on certain small quantity generators (up to 1,000 kg of a waste per month).

.69 The key to RCRA compliance is the hazardous waste determination, in which the facility determines whether the material it handles is a hazardous waste. A step-by-step identification procedure is prescribed. Initially, one must determine whether the material is a "solid waste."[6] If so, one must determine whether that solid waste is hazardous. Some wastes that are specified by regulation are automatically deemed hazardous. These are the so-called "listed wastes." Other wastes must be evaluated to determine whether they exhibit any of four characteristics: toxicity, corrosivity, reactivity, or ignitability. If so, they, too, are deemed hazardous. Exclusions are provided for wastewaters regulated under the Clean Water Act and for certain types of reuse, recycling, and reclamation.

.70 With some exceptions, a waste generator that accumulates hazardous waste in excess of ninety days or treats the hazardous waste will be deemed the operator of a TSDF and be subject to the comprehensive TSDF regulations. These regulations require owners–operators to, among other things, obtain a permit.

.71 Each TSDF is also subject to specific requirements designed to prevent any release of hazardous waste into the environment and also may be required to perform groundwater monitoring to ensure proper compliance with TSDF regulations. These regulations require containers and tanks to be of sufficient integrity to contain hazardous wastes properly, and they require that, in certain cases, containers be separated or protected by dikes, berms, or walls. Surface impoundments, waste piles, and landfills must be equipped with liners to prevent any migration of wastes into soil, groundwater, or surface wa-

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[6] Under RCRA, a "solid waste" may be either a solid, a liquid, or a gas.

ter during the active life of the facility and must be constructed to prevent runoff or breaks. Land treatment units that treat hazardous wastes biologically must ensure that hazardous wastes are degraded, transformed, or immobilized within the treatment zone and do not reach the underlying water table.

.72 RCRA also contains provisions for **closure** of TSDFs and financial assurance requirements for closure and postclosure obligations.

.73 RCRA also requires the United States Environmental Protection Agency (EPA) to regulate underground storage tanks (USTs). Most states have enacted their own UST regulations as well. A brief summary of the federal program is presented below.

.74 The UST regulations apply only to underground tank systems containing the following regulated substances:

a. Petroleum and petroleum-based substances[7]

b. Hazardous substances designated pursuant to section 101(14) of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)

.75 The EPA's general performance standards rely heavily on detailed technical standards set forth in industry performance codes established by nationally recognized associations or independent testing laboratories.

.76 As a general rule, each new tank (or each existing tank upgraded to new tank standards) must be designed and constructed according to the standards of a nationally recognized organization or an independent testing laboratory. Like the tanks, the piping associated with a new UST system must be designed and constructed in accordance with industry codes. All tanks must also be equipped with spill and overfill prevention equipment. If existing tank systems do not currently meet the new tank standards, the owner or operator must upgrade them by December 22, 1998.

.77 As an alternative to installing new tanks or upgrading existing tanks, an owner or operator may choose to close some or all of its UST systems. The closure, however, must meet standards specified by the EPA. The regulations require that a closed tank be emptied and cleaned by removing all liquids and accumulated sludges. The tank must then be either removed from the ground or filled with an inert solid material.[8]

.78 The UST regulations also impose general operation and maintenance requirements on owners and operators of underground storage tank systems in the following five main areas: (*a*) spill and overfill control, (*b*) corrosion protection, (*c*) tank repair, (*d*) leak detection, and (*e*) record keeping. These regulations are designed to ensure that releases due to spilling, overfilling, corrosion, or poor maintenance do not occur. Record-keeping regulations require that records evidencing repairs, release detection systems, monitoring results, and corrosion and inspection reports be maintained at the plant or at a readily available alternative site.

.79 In addition, owners and operators must establish financial responsibility. The regulations specify several different methods of demonstrating fi-

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[7] Certain types of UST systems used for storing heating oil for consumptive use on the premises where stored are exempted.

[8] The regulations further require that the EPA or state agency be notified of the intent to close a tank system permanently at least thirty days before beginning the closure process.

nancial responsibility: self-insurance; guarantee; insurance or risk retention group; surety bond; letter of credit; trust funds; or state-provided financial assurance.

The Clean Air Act

.80 The Clean Air Act provides comprehensive federal regulation of all "sources" of air pollution. Under the Clean Air Act, every area of the United States is evaluated for its compliance with the National Primary and Secondary Ambient Air Quality Standards (NAAQS). In areas where the NAAQS have not been attained, new and significantly modified sources must use the most effective pollution control equipment available that results in the lowest achievable emissions rate (LAER). This determination is made without regard to cost. The permittee must also provide emissions offsets, or greater than one-to-one reduction, for any nonattainment pollutant that the source would emit in significant amounts. These offsets must be sufficient to provide a net air quality benefit in the affected area.

.81 In areas that have attained the NAAQS for particular pollutants, new or modified stationary sources that would emit these pollutants in significant amounts must obtain permits under the Prevention of Significant Deterioration (PSD) Program. Under the PSD program, a facility emitting air pollutants must apply the best available control technology (BACT). BACT is determined on a case-by-case basis, taking into account energy, environmental, and economic factors, and other costs and benefits of reduced air pollution.

.82 The Clean Air Act also contains new source performance standards (NSPS), which are applicable to stationary sources that are modified or built after the NSPS are proposed. The NSPS program is designed to ensure that new sources are built with state-of-the-art controls and that when existing sources are modified, new controls are installed. Each NSPS establishes design or performance criteria for a specific source. There are numerous specific industrial facilities and operations for which NSPS have been developed.

.83 Section 107(a) of the Clean Air Act directs that each state "shall have the primary responsibility for assuring air quality within the entire geographic area of such state." Toward that end, the EPA has developed regulations governing state implementation plans pursuant to which states assume Clean Air Act regulation of all facilities within their borders. The act also contains citizen suit provisions that augment government enforcement with citizen enforcement.

.84 Amendments to the Clean Air Act in the 1990s are designed to address issues such as acid rain, urban air pollution, toxic air pollutants, and ozone-depleting chemicals. The major provisions of the Clean Air Act amendments require emissions reduction in the electric utility industry, operating permits for existing facilities, an expansion of the air toxics program to regulate a large number of toxic air pollutants, and new source categories (including smaller sources, such as dry cleaners).

The Clean Water Act

.85 The Clean Water Act provides comprehensive federal regulation of all sources of water pollution. The primary means of obtaining national water quality is through the imposition of National Pollutant Discharge Elimination System (NPDES) permits on all facilities that discharge pollutants into the waters of the United States. The Clean Water Act also utilizes ambient water quality standards to set individual permit limitations and technology-based limitations that, in varying degrees, impose the most cost-effective pollution control technology on dischargers. These include effluent limitations utilizing specified technology, compliance with performance standards, use of specified practices for facility design and operation requirements, use of specified treatment or pretreatment methods, and detailed assessments and evaluations of the impact of proposed discharges. Although technology-based effluent limitations provide minimum discharge standards, the act also requires more stringent water-quality-based limitations to maintain or protect water quality in specific bodies of water.

.86 The Clean Water Act imposes standards on dischargers of conventional (less harmful), toxic (more harmful), and nonconventional pollutants requiring varying degrees of technology. As with the Clean Air Act, the Clean Water Act imposes more stringent standards on facilities whose construction or modification commenced after publication of applicable NSPS. In the promulgation of these standards, the EPA may consider incorporating alternative production processes, operating methods, and in-plant control procedures and other factors. Industrial facilities that discharge into publicly owned treatment works (POTWs) must also meet discharge standards, called pretreatment standards, designed to prevent pollutants from passing through treatment works without adequate treatment. The Clean Water Act also prohibits the discharge of pollutants from nonpermitted point sources. In addition, the EPA has issued regulations requiring permits for storm water discharges from industrial and municipal sources.

.87 The act authorizes cleanup, injunctive, and cost-recovery actions where an imminent hazard is caused by pollution. It also prohibits the discharge of oil and other hazardous substances to the navigable waters of the United States, imposes a criminal penalty for failure to notify the appropriate entity of such discharges, and provides for citizen suits.

.88 If a facility discharges pollutants into navigable waters pursuant to a Clean Water Act permit, it must file a discharge monitoring report (DMR) with the EPA or the appropriate state agency. The DMR gives notice to the authorities of any violations of the permit.

.89 The citizen suit provision of the Clean Water Act permits any citizen to, "commence a civil action . . . against any person . . . alleged to be in violation of an effluent standard or limitation under the Act." Numerous citizen groups have used the citizen suit provision to bring suits against companies based on violations reported in their DMRs.

.90 Most states have assumed enforcement of the act within their borders through state regulations that correspond to the federal regulations discussed above.

Chapter 4

OTHER ENVIRONMENTAL LAWS

.91 There are a variety of other statutes that relate to environmental matters. Two of the more significant ones, the Emergency Planning and Community Right-to-Know Act (EPCRA) and the Toxic Substances Control Act (TSCA), are discussed in this chapter.

The Emergency Planning and Community Right-to-Know Act

.92 EPCRA requires facilities that have certain quantities of *extremely hazardous substances* to notify their state emergency response commission that they are subject to the emergency planning requirements of the Superfund Amendments and Reauthorization Act of 1986 (SARA). They must also report releases to the local emergency planning committee.

.93 In addition, facilities that store chemicals over specified threshold amounts must submit material safety data sheets (MSDSs), or their equivalent, to the appropriate local emergency planning committee, the state emergency response commission, and the fire department with jurisdiction over the facility.

.94 Each facility subject to EPCRA reporting requirements must report the maximum amount of the hazardous chemical present at the facility and provide a description of the storage or use of the chemical and its location at the facility. This inventory report must be submitted to local and state emergency response officials annually.

.95 Section 313 of EPCRA also includes requirements for the annual reporting of releases of certain toxic chemicals that occur as a result of normal business operations (as distinguished from abnormal, emergency releases). Facilities subject to this reporting requirement are required to complete a Toxic Chemical Release Inventory Form (Form R) for specified chemicals. This form also includes source reduction and recycling information required under the Pollution Prevention Act of 1990. All the information described above is made available to the general public.

The Toxic Substances Control Act

.96 The TSCA regulates the manufacture, processing, and distribution in commerce of chemical substances and mixtures capable of adversely affecting health or the environment. The TSCA may require testing and may impose use restrictions, along with requirements for the reporting and retention of information on the risks of TSCA-regulated substances.

.97 The act requires that any person who manufactures, processes, or distributes in commerce a chemical substance or mixture and who obtains information that reasonably supports the conclusion that such substance or mixture presents a substantial risk of injury to health or the environment shall immediately inform the United States Environmental Protection Agency (EPA). The only excuse for not meeting this duty is actual knowledge that the EPA already has been adequately informed. The act also provides that any person who manufactures, processes, or distributes in commerce any chemical substance or mixture shall maintain records of significant adverse reactions to health or the environment alleged to have been caused by the substance or mixture. Records of any adverse health reactions of employees must also be kept. In addition, records of other problems, including those stemming from consumer complaints and reports of occupational diseases or injuries to nonemployees or harm to the environment, must be maintained. Any person who manufactures, processes, or distributes in commerce a listed chemical under this section must submit to the EPA lists of health and safety studies conducted by the person, known to the person, or reasonably ascertainable. TSCA also requires notification of substantial risk to human health or the environment.

.98 Regulations promulgated under the TSCA also govern the manufacturing, processing, and distribution in commerce of polychlorinated biphenyls (PCBs) and asbestos. The PCB regulations contain stringent requirements for the labeling, disposal, storage, and incineration of PCBs and should be reviewed carefully if PCB transformers or other PCB articles are present at a facility. Under the asbestos rules, all persons who manufacture, import, or process asbestos must report quantity, use, and exposure information to the EPA.

Part 2

Accounting Guidance

.99 The objective of Part 2 is to provide accounting guidance with respect to environmental remediation liabilities that relate to pollution arising from some past act, generally as a result of the provisions of Superfund, the corrective-action provisions of the Resource Conservation and Recovery Act, or analogous state and non-United States laws and regulations. The recognition and measurement guidance in this Part should be applied on a site-by-site basis.

Scope

.100 The provisions of this SOP apply to all entities that prepare financial statements in conformity with generally accepted accounting principles applicable to nongovernmental entities.

.101 This SOP provides guidance on accounting for environmental remediation liabilities and is written in the context of operations taking place in the United States; however, the accounting guidance in this SOP is applicable to all the operations of the reporting entity. This SOP does not provide guidance on accounting for pollution control costs with respect to current operations or on accounting for costs of future site restoration or closure that are required upon the cessation of operations or sale of facilities, as such current and future costs and obligations represent a class of accounting issues different from environmental remediation liabilities.[9] This SOP also does not provide guidance on accounting for environmental remediation actions that are undertaken at the sole discretion of management and that are not induced by the threat, by governments or other parties, of litigation or of assertion of a claim or an assessment. Furthermore, this SOP does not provide guidance on recognizing liabilities of insurance companies for unpaid claims or address asset impairment issues.

Effective Date and Transition

.102 The provisions of this SOP are effective for fiscal years beginning after December 15, 1996. Earlier application is encouraged. Although the effect of initially applying the provisions of this SOP will, in individual cases, have elements of a change in accounting principle and of a change in accounting estimate, those elements often will be inseparable. Consequently, the entire effect of initially applying the provisions of this SOP shall be reported as a change in accounting estimate [Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes,* paragraphs 31 through 33]. Restatement of previously issued financial statements is not permitted.

.103 The provisions of this SOP need not be applied to immaterial items.

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[9] On February 7, 1996, the Financial Accounting Standards Board (FASB) issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting for Certain Liabilities Related to Closure or Removal of Long-Lived Assets.* In June 2001, the FASB issued FASB Statement No. 143, *Accounting for Asset Retirement Obligations*. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 143.]

Chapter 5

RECOGNITION OF ENVIRONMENTAL REMEDIATION LIABILITIES

.104 Recognition has to do with when amounts should be reported in financial statements. This chapter addresses that issue. Measurement, which has to do with the amounts to be reported in financial statements, is addressed in chapter 6. Issues with respect to both recognition and measurement of potential recoveries are addressed in chapter 6.

Overall Approach

.105 FASB Statement No. 5, *Accounting for Contingencies,* requires the accrual of a liability if (*a*) information available prior to issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and (*b*) the amount of the loss can be reasonably estimated.

.106 An entity's environmental remediation obligation that results in a liability generally does not become determinable as a distinct event, nor is the amount of the liability generally fixed and determinable at a specific point in time. Rather, the existence of a liability for environmental remediation costs becomes determinable and the amount of the liability becomes estimable over a continuum of events and activities that help to frame, define, and verify the liability.

.107 The underlying cause of an environmental remediation liability is the past or present ownership or operation of a site, or the contribution or transportation of waste to a site, at which remedial actions (at a minimum, investigation) must take place. For a liability to be recognized in the financial statements, this underlying cause must have occurred on or before the date of the financial statements.

Probability That a Liability Has Been Incurred

.108 In the context of environmental remediation liabilities, FASB Statement No. 5's probability criterion consists of two elements; the criterion is met if both of the following elements are met on or before the date the financial statements are issued:

- Litigation has commenced or a claim or an assessment has been asserted, or, based on available information, commencement of litigation or assertion of a claim or an assessment is probable. In other words, it has been asserted (or it is probable that it will be asserted) that the entity is responsible for participating in a remediation process because of a past event.
- Based on available information, it is probable that the outcome of such litigation, claim, or assessment will be unfavorable. In other words, an entity will be held responsible for participating in a remediation process because of the past event.

What constitutes commencement or probable commencement of litigation or assertion or probable assertion of a claim or an assessment in relation to particular environmental laws and regulations may require legal determination.

.109 Given the legal framework within which most environmental remediation liabilities arise,[10] AcSEC concluded that there is a presumption that, (*a*) if litigation has commenced or a claim or an assessment has been asserted or if commencement of litigation or assertion of a claim or assessment is probable and (*b*) if the reporting entity is associated with the site—that is, if it in fact arranged for the disposal of hazardous substances found at a site or transported hazardous substances to the site or is the current or previous owner or operator of the site—the outcome of such litigation, claim, or assessment will be unfavorable.

Ability to Reasonably Estimate the Liability

.110 Estimating environmental remediation liabilities involves an array of issues at any point in time. In the early stages of the process, cost estimates can be difficult to derive because of uncertainties about a variety of factors. For this reason, estimates developed in the early stages of remediation can vary significantly; in many cases, early estimates later require significant revision. The following are some of the factors that are integral to developing cost estimates:

- The extent and types of hazardous substances at a site
- The range of technologies that can be used for remediation
- Evolving standards of what constitutes acceptable remediation
- The number and financial condition of other potentially responsible parties (PRPs) and the extent of their responsibility for the remediation (that is, the extent and types of hazardous substances they contributed to the site)

.111 FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss,* concludes that the criterion for recognition of a loss contingency in paragraph 8(b) of FASB Statement No. 5—that "the amount of loss can be reasonably estimated"—is met when a range of loss can be reasonably estimated.

.112 At the early stages of the remediation process, environmental remediation liabilities are not easily quantified, due in part to the uncertainties noted previously. As a practical matter, the range of an estimated remediation liability will be defined and refined as events in the remediation process occur.

.113 An estimate of the range of an environmental remediation liability typically is derived by combining estimates of various components of the liability (such as the costs of performing particular tasks, or amounts allocable to other PRPs but that will not be paid by those other PRPs), which are themselves likely to be ranges. For some of those component ranges, there may be amounts that appear to be better estimates than any other amount within the range; for other component ranges, there may be no such best estimates.

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[10] See the discussion of strict liability in the "Introduction" in paragraphs .03 through .10.

Accordingly, the overall liability that is recorded may be based on amounts representing the lower end of a range of costs for some components of the liability and best estimates within ranges of costs of other components of the liability.

.114 At the early stages of the remediation process, particular components of the overall liability may not be reasonably estimable. This fact should not preclude the recognition of a liability. Rather, the components of the liability that can be reasonably estimated should be viewed as a surrogate for the minimum in the range of the overall liability. For example, a sole PRP that has confirmed that it sent waste to a Superfund site and agrees to perform a remedial investigation and feasibility study (RI/FS) may know that it will incur costs related to the RI/FS. The PRP, although aware that the total costs associated with the site will be greater than the cost of the RI/FS, may be unable to reasonably estimate the overall liability because of existing uncertainties, for example, regarding the kinds and quantities of hazardous substances present at the site and the technologies available to remediate the site. This lack of ability to quantify the total costs of the remediation effort, however, should not preclude recognition of the estimated cost of the RI/FS. In this circumstance, a liability for the best estimate (or, if no best estimate is available, the minimum amount in the range) of the cost of the RI/FS and for any other component remediation costs that can be reasonably estimated, should be recognized in the entity's financial statements.

.115 Additional complexities arise if other PRPs are involved in an identified site. The costs associated with remediation of a site ultimately will be assigned and allocated among the various PRPs. The final allocation of costs may not be known, however, until the remediation effort is substantially complete, and it may or may not be based on an entity's relative direct responsibility at a site. An entity's final obligation depends, among other things, on the willingness of the entity and other PRPs to negotiate a cost allocation, the results of the entity's negotiation efforts, and the ability of other PRPs associated with the particular site to fund the remediation effort.

.116 Uncertainties relating to the entity's *share* of an environmental remediation liability should not preclude the entity from recognizing its best estimate of its share of the liability or, if no best estimate can be made, the minimum estimate of its share of the liability, if the liability is probable and the total remediation liability associated with the site is reasonably estimable within a range. (See the section entitled "Allocation of Liability Among Potentially Responsible Parties" in paragraphs .133 through .139.)

.117 Changes in estimates of the entity's remediation liability, including revisions to the entity's estimate of its share of the liability due to negotiation or identification of other PRPs, should be accounted for as changes in estimates, in consonance with APB Opinion No. 20, *Accounting Changes.*

Benchmarks

.118 Certain stages of a remediation effort or process and of PRP involvement (see chapter 2 for a discussion of these stages) provide benchmarks that should be considered when evaluating the probability that a loss has been incurred and the extent to which any loss is reasonably estimable. Benchmarks should not, however, be applied in a manner that would delay recognition beyond the point at which FASB Statement No. 5's recognition criteria are met.

.119 The following are recognition benchmarks for a Superfund remediation liability; analogous stages of the RCRA corrective-action process are also indicated. At a minimum, the estimate of a Superfund (or RCRA) remediation liability should be evaluated as each of these benchmarks occurs.

- *Identification and verification of an entity as a PRP.* The RCRA analogue is subjection to RCRA facility permit requirements. Receipt of notification or otherwise becoming aware that an entity may be a PRP compels the entity to action. The entity must examine its records to determine whether it is associated with the site.

  If, based on a review and evaluation of its records and all other available information, the entity determines that it is associated with the site, it is probable that a liability has been incurred. If all or a portion of the liability is reasonably estimable, the liability should be recognized.

  In some cases, an entity will be able to reasonably estimate a range of its liability very early in the process because the site situation is common or similar to situations at other sites with which the entity has been associated (for example, the remediation involves only the removal of underground storage tanks [USTs] in accordance with the UST program). In such cases, the criteria for recognition would be met and the liability should be recognized. In other cases, however, the entity may have insufficient information to reasonably estimate the minimum amount in the range of its liability. In these cases, the criteria for recognition would not be met at this time.

- *Receipt of unilateral administrative order.* The RCRA analogue is, generally, interim corrective measures. An entity may receive a unilateral administrative order compelling it to take a response action at a site or risk penalties of up to four times the cost of the response action. Such response actions may be relatively limited actions, such as the performance of a remedial investigation and feasibility study or performance of a removal action, or they may be broad actions such as remediating a site. Under section 106 of Superfund, the EPA must find that an "imminent and substantial endangerment" exists at the site before such an order may be issued. No preenforcement review by a court is authorized under Superfund if an entity elects to challenge a unilateral administrative order.

  The ability to estimate costs resulting from unilateral administrative orders varies with factors such as site complexity and the nature and extent of the work to be performed. The benchmarks that follow should be considered in evaluating the ability to estimate such costs insofar as the actions required by the unilateral administrative order involve these benchmarks. The cost of performing the requisite work generally is estimable within a range, and recognition of an environmental remediation liability for costs of removal actions generally should not be delayed beyond this point.

- *Participation, as a PRP, in the RI/FS.* The RCRA analogue is RCRA facility investigation. At this stage, the entity and possibly others have been identified as PRPs and have agreed to pay the costs of a study that will investigate the extent of the environmental impact of the release or threatened release of hazardous substances and identify site-remediation alternatives. Further, the total cost of the RI/FS generally is estimable within a reasonable range. In addition, the identification of other PRPs and their agreement to participate in funding the RI/FS typically provides a reasonable basis for determining the entity's allocable share of the cost of the RI/FS. At this stage, additional information may be available regarding the extent of environmental impact and possible remediation alternatives. This additional information, however, may or may not be sufficient to provide a basis for reasonable estimation of the total remediation liability. At a minimum, the entity should recognize its share of the estimated total cost of the RI/FS.

As the RI/FS proceeds, the entity's estimate of its share of the total cost of the RI/FS can be refined. Further, additional information may become available based on which the entity can refine its estimates of other components of the liability or begin to estimate other components. For example, an entity may be able to estimate the extent of environmental impact at a site and to identify existing alternative remediation technologies. An entity may also be able to identify better the extent of its involvement at the site relative to other PRPs; the universe of PRPs may be identified; negotiations among PRPs and with federal and state EPA representatives may occur; and information may be obtained that materially affects the agreed-upon method of remediation.

- *Completion of feasibility study.* The RCRA analogue is corrective measures study. At substantial completion of the feasibility study, both a minimum remediation liability and the entity's allocated share generally will be reasonably estimable.

  The feasibility study should be considered substantially complete no later than the point at which the PRPs recommend a proposed course of action to the EPA. If the entity had not previously concluded that it could reasonably estimate the remediation liability (the best estimate or, if no amount within an estimated range of loss was a better estimate than any other amount in the range, the minimum amount in the range), recognition should not be delayed beyond this point, even if uncertainties, for example, about allocations to individual PRPs and potential recoveries from third parties, remain.

- *Issuance of record of decision (ROD).* The RCRA analogue is approval of corrective measures study. At this point, the EPA has issued its determination specifying a preferred remedy. Normally, the entity and other PRPs have begun, or perhaps completed, negotiations, litigation (see the section, "Impact of Potential Recoveries" in paragraphs .140 and .141), or both for their allocated share of the remediation liability. Accordingly, the entity's estimate normally can be refined based on the specified preferred remedy and a preliminary allocation of the total remediation costs.

- *Remedial Design Through Operation and Maintenance, Including Postremediation Monitoring.* The RCRA analogue is corrective measures implementation. During the design phase of the remediation, engineers develop a better sense of the work to be done and are able to provide more precise estimates of the total remediation cost. Further information likely will become available at various points until the site is delisted, subject only to postremediation monitoring. The entity should continue to refine and recognize its best estimate of its final obligation as this additional information becomes available.

Chapter 6

MEASUREMENT OF ENVIRONMENTAL REMEDIATION LIABILITIES

.120 Measurement has to do with the amounts to be reported in financial statements. This chapter addresses that issue. Recognition, which has to do with when amounts should be reported in financial statements, is addressed in chapter 5.

Overall Approach

.121 Once an entity has determined that it is probable that an environmental remediation liability has been incurred, the entity should estimate that liability based on available information. (Also see the section entitled "Ability to Reasonably Estimate the Liability" in paragraphs .110 through .117.) The estimate of the liability includes the entity's—

a. Allocable share of the liability for a specific site.

b. Share of amounts related to the site that will not be paid by other potentially responsible parties (PRPs) or the government.

.122 Making the appropriate measurement of an entity's remediation liability involves the following issues:

- Costs that should be included in the measurement
- Whether the measurement should consider the effects of expected future events or developments, including discounting considerations
- How the measurement should be affected by the existence of other PRPs
- How the measurement should be affected by potential recoveries

.123 Two kinds of costs that may be involved in environmental remediation situations are not discussed in this chapter. These costs—natural resource damages and toxic torts—are identified in paragraphs .21 and .48 through .50 in chapter 2 of this SOP. Concepts and practices with respect to natural resource damages are still evolving, and third-party suits are too case-specific for general guidance. The accounting guidance with respect to litigation [FASB Statement No. 5, especially paragraphs 33 through 39] should be considered in accounting for and the disclosure of such costs.

Costs to Be Included

.124 The Accounting Standards Executive Committee (AcSEC) concluded that the costs to be included in the measurement are the following:

a. Incremental direct costs of the remediation effort

b. Costs of compensation and benefits for those employees who are expected to devote a significant amount of time directly to the remediation effort, to the extent of the time expected to be spent directly on the remediation effort

The remediation effort is considered on a site-by-site basis; it includes the following:

- Precleanup activities, such as the performance of a remedial investigation, risk assessment, or feasibility study and the preparation of a remedial action plan and remedial designs for a Superfund site, or the performance of a Resource Conservation and Recovery Act of 1976 (RCRA) facility assessment, RCRA facility investigation, or RCRA corrective measures studies
- Performance of remedial actions under Superfund, corrective actions under RCRA, and analogous actions under state and non-United States laws
- Government oversight and enforcement-related activities
- Operation and maintenance of the remedy, including required postremediation monitoring

.125 Examples of incremental direct costs of the remediation effort include the following:

- Fees to outside law firms for work related to determining the extent of remedial actions that are required, the type of remedial actions to be used, or the allocation of costs among PRPs
- Costs related to completing the remedial investigation/feasibility study (RI/FS)
- Fees to outside engineering and consulting firms for site investigations and the development of remedial action plans and remedial designs
- Costs of contractors performing remedial actions
- Government oversight costs and past costs; usually this is based on the cost incurred by the United States Environmental Protection Agency (EPA) or other governmental authority dealing with the site
- The cost of machinery and equipment that is dedicated to the remedial actions and that does not have an alternative use
- Assessments by a PRP group covering costs incurred by the group in dealing with a site
- Costs of operation and maintenance of the remedial action, including the costs of postremediation monitoring required by the remedial action plan

.126 Determining (*a*) the extent of remedial actions that are required, (*b*) the type of remedial actions to be used, and (*c*) the allocation of costs among PRPs is part of the remediation effort, and the costs of making such determinations, including legal costs, are to be included in the measurement of the remediation liability. The costs of services related to routine environmental compliance matters and litigation costs involved with potential recoveries are not part of the remediation effort. Litigation costs involved with potential recoveries should be charged to expense as incurred until realization of the claim for recovery is considered probable and an asset relating to the recovery is recognized, at which time any remaining such legal costs should be considered in the measurement of the recovery. The determination of what legal costs are for potential recoveries rather than for determining the allocation of costs among PRPs will depend on the specific facts and circumstances of each situation.

.127 Examples of employees who may devote a significant amount of time directly to the remediation effort include the following:

- The internal legal staff that is involved with the determination of the extent of remedial actions that are required, the type of remedial action to be used, and the allocation of costs among PRPs
- Technical employees who are involved with the remediation effort

Estimates of the compensation and benefits costs to be incurred for a specific site should be made in connection with the initial recording of the remediation liability and subsequently adjusted at each reporting date to reflect the current estimate of such costs to be incurred in the future.

Effect of Expected Future Events or Developments

.128 The time period necessary to remediate a particular site may extend several years, and the laws governing the remediation process and the technology available to complete the remedial action may change before the remedial action is complete. Additionally, the impact of inflation and productivity improvements can change the estimates of costs to be incurred.

.129 Existing authoritative accounting literature is inconsistent in the treatment of expected future events and developments in currently measuring assets and liabilities. AcSEC concluded that for purposes of measuring environmental remediation liabilities, the measurement should be based on enacted laws and adopted regulations and policies. No changes therein should be anticipated. The impact of changes in laws, regulations, and policies should be recognized when such changes are enacted or adopted.

.130 Remediation technology is changing constantly, and, in many cases, new technologies have resulted in modified costs for environmental remediation. The remedial action plan that is used to develop the estimate of the liability should be based on the methodology that is expected to be approved to complete the remediation effort. Once a methodology has been approved, that methodology and the technology available therefor should be the basis for estimating the liability until it is probable that there will be formal acceptance of a revised methodology.

.131 The measurement of environmental remediation liabilities should be based on the reporting entity's estimate of what it will cost to perform each of the elements of the remediation effort (determined in accordance with paragraphs .124, .126, .129, and .130) when those elements are expected to be performed. Although this approach is sometimes referred to in shorthand fashion as "considering inflation," it does not simply rely on an inflation index[11] and should take into account factors such as productivity improvements due to learning from experience with similar sites and similar remedial action plans. In situations in which it is not practicable to estimate inflation and such other factors because of uncertainty about the timing of expenditures, a current-cost estimate would be the minimum in the range of the liability to be recorded until such time as these cost effects can be reasonably estimated.

.132 The measurement of the liability, or of a component of the liability, may be discounted to reflect the time value of money if the aggregate amount of the liability or component and the amount and timing of cash payments for

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[11] Cost estimates submitted to the EPA usually include a prescribed inflation factor.

the liability or component are fixed or reliably determinable. (Note that these criteria would not be met in situations in which paragraph .131 permits use of a current-cost estimate.) For this purpose, the amount of the liability or component is the reporting entity's allocable share of the undiscounted joint and several liability for the remediation effort or of a component of that liability. This conclusion is consistent with the guidance in the FASB Emerging Issues Task Force (EITF) Issue 93-5.[12] For entities that file with the Securities and Exchange Commission (SEC), the guidance in Staff Accounting Bulletin (SAB) No. 92 with respect to the discount rate to be used—a rate that will produce an amount at which the environmental liability theoretically could be settled in an arm's-length transaction with a third party and that should not exceed the interest rate on monetary assets that are essentially risk-free and have maturities comparable to that of the environmental liability—should be followed.

Allocation of Liability Among Potentially Responsible Parties

.133 The environmental remediation liability recorded by an entity should be based on that entity's estimate of its allocable share of the joint and several remediation liability. The estimation of an entity's allocable share of the joint and several remediation liability for a site requires an entity to (*a*) identify the PRPs for the site, (*b*) assess the likelihood that other PRPs will pay their full allocable share of the joint and several remediation liability, and (*c*) determine the percentage of the liability that will be allocated to the entity.

Identification of PRPs for a Site

.134 For purposes of estimating an entity's allocable share of the joint and several remediation liability for a site, those parties that are potentially responsible for paying the remediation liability belong to one of the following five PRP categories:

a. *Participating PRPs.* **Participating PRPs** acknowledge their potential involvement with respect to a site. Some may participate in the various administrative, negotiation, monitoring, and remediation activities related to the site. Others may adopt a passive stance and simply monitor the activities and decisions of the more involved PRPs. This passive stance could result from a variety of factors such as the entity's lack of experience, limited internal resources, or relative involvement at a site. This category of PRPs (both active and passive) is also referred to as *players*.

b. *Recalcitrant PRPs.* **Recalcitrant PRPs** adopt a recalcitrant attitude toward the entire remediation effort even though evidence exists

[12] In developing this and certain other guidance in this SOP, AcSEC considered the guidance in EITF Issue 93-5, *Accounting for Environmental Liabilities.* By incorporating the guidance in EITF Issue 93-5 into this SOP and subjecting that guidance to the due process afforded SOPs, including public comment, the conclusions in that EITF consensus are effectively superseded. That guidance, now incorporated in this SOP, occupies a higher position in the hierarchy of sources of generally accepted accounting principles (GAAP) set forth in Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, than essentially the same guidance as it is presented in EITF Issue 93-5.

that points to their involvement at a site. Some may adopt this attitude out of ignorance of the law; others may do so in the hope that they will be considered a nuisance and therefore ignored. Typically, parties in this category must be sued in order to collect their allocable share of the remediation liability; however, it may be that it is not economical to bring such suits because the parties' assets are limited. This category of PRPs is also referred to as nonparticipating PRPs.

c. *Unproven PRPs.* **Unproven PRPs** have been identified as PRPs by the EPA but do not acknowledge their potential involvement because there is currently no substantive evidence to link them to the site. Some ultimately may be dropped from the PRP list because no substantive evidence is found to link them to the site. For others, substantive evidence eventually may be found that points to their liability. The presentation of that evidence to the entity would result in a reclassification of the party from this category of PRPs (sometimes referred to as "hiding in the weeds") to either the participating PRP or recalcitrant PRP category.

d. *Parties that have not yet been identified as PRPs.* At early stages of the remediation process, the list of PRPs may be limited to a handful of entities that either were significant contributors of waste to the site or were easy to identify, for example, because of their proximity to the site or because of labeled material found at the site. As further investigation of the site occurs and as remediation activities take place, additional PRPs may be identified. Once identified, the additional PRPs would be reclassified from this category to either the participating PRP or recalcitrant PRP category. The total number of parties in this category and their aggregate allocable share of the remediation liability varies by site and cannot be reliably determined prior to the specific identification of individual PRPs. This category of PRPs is sometimes referred to as **unknown PRPs.**

e. *Parties that are PRPs but cannot be located or have no assets.* Some of these parties may be identified by the EPA; others may be identified as the site is investigated or as the remediation is performed. However, no contributions will ever be made by these parties. This category of PRPs is sometimes referred to as the **orphan share.**

Over the duration of a remediation project, individual entities may move from one PRP category to another.

Allocation Process

.135 In estimating its allocable share of the joint and several remediation liability for a site, there is a rebuttable presumption that costs will be allocated only among participating PRPs, as that category exists at the date of issuance of the financial statements.

.136 There are numerous ways to allocate liabilities among PRPs. The four principal factors considered in a typical allocation process are the following:

a. *Elements of fair share.* Examples are the amount of waste based on volume; the amount of waste based on mass, type of waste, toxicity of waste; the length of time the site was used.

b. *Classification of PRP.* Examples are site owner, site operator, transporter of waste, generator of waste.

c. *Limitations on payments.* This characteristic includes any statutory or regulatory limitations on contributions that may be applicable to a PRP. For example, in the reauthorization of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), it has been proposed that the statute limit the contribution of a municipality to 10 percent of the total remediation liability, irrespective of the municipality's allocable share.

d. *Degree of care.* This refers to the degree of care exercised in selecting the site or in selecting a transporter.

.137 PRPs may reach an agreement among themselves as to the allocation method and percentages to be used, they may hire an allocation consultant whose conclusions may or may not be binding, or they may request a nonbinding allocation of responsibility from the EPA. The allocation method or percentages used may change as the remediation project moves forward. An agreement to reallocate the preliminarily allocated liability at the end of the remediation project may exist, or the allocation percentages may be adjusted during the project to reflect prior allocations that subsequently are agreed to have been inequitable.

.138 An entity should determine its allocable share of the joint and several remediation liability for a site based on its estimate of the allocation method and percentage that ultimately will be used for the entire remediation effort. The primary sources for this estimate should be the allocation method and percentages that (*a*) the PRPs have agreed to (whether that agreement applies to the entire remediation effort or to the costs incurred in the current phase of the remediation process), (*b*) has been assigned by a consultant, or (*c*) has been determined by the EPA. If the entity's estimate of the ultimate allocation method and percentage differs significantly from the method or percentage from these primary sources, the entity's estimate should be based on objective, verifiable information. Examples of objective, verifiable information include existing data about the kinds and quantities of waste at the site, experience with allocation approaches in comparable situations, reports of environmental specialists (internal or external), and internal data refuting EPA allegations about the entity's contribution of waste (kind, volume, and so forth) to the site.

.139 An entity should assess the likelihood that each PRP will pay its allocable share of the joint and several remediation liability. That assessment should be based primarily on the financial condition of the participating PRP. This assessment requires the entity to gain an understanding of the financial condition of the other participating PRPs and to update and monitor this information as the remediation progresses. The entity should include in its liability its share of amounts related to the site that will not be paid by other PRPs or the government.

Impact of Potential Recoveries

.140 Potential recoveries of amounts expended for environmental remediation are distinguishable from the allocation of costs subject to joint and several liability, which is discussed in the preceding section, "Allocation of Liability Among Potentially Responsible Parties," in paragraphs .133 through .139. Potential recoveries may be claimed from a number of different parties or sources, including insurers, PRPs other than participating PRPs (see the section entitled "Identification of PRPs for a Site" in paragraph .134), and governmental or third-party funds. The amount of an environmental remediation liability should be determined independently from any potential claim for recovery, and an asset relating to the recovery should be recognized only when realization of the claim for recovery is deemed probable.[13] If the claim is the subject of litigation, a rebuttable presumption exists that realization of the claim is not probable.

.141 Fair value should be used to measure the amount of a potential recovery. The concept of fair value requires consideration of both transaction costs related to the receipt of the recovery (see paragraph .126) and the time value of money. However, the time value of money should not be considered in the determination of the recorded amount of a potential recovery if (*a*) the liability is not discounted and (*b*) the timing of the recovery is dependent on the timing of the payment of the liability. In most circumstances, the point in time at which a liability for environmental remediation is both probable and reasonably estimable will precede the point in time at which any related recovery is probable of realization.

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[13] The term *probable* is used in this SOP with the specific technical meaning in FASB Statement No. 5, paragraph 3.

Chapter 7
DISPLAY AND DISCLOSURE

.142 This chapter addresses display and disclosure of environmental remediation-related matters in the context of financial statements prepared in conformity with GAAP. Entities subject to the rules and regulations of the SEC must also adhere to various SEC guidance that applies to environmental matters, particularly SAB No. 92; Regulation S-K Rules 101, 103, and 303; and Financial Reporting Release No. 36.

.143 Display issues are discussed in the context of: (*a*) the balance sheet and (*b*) the income statement. Disclosure issues are discussed in the context of: (*a*) accounting principles, (*b*) environmental remediation loss contingencies, (*c*) environmental remediation costs recognized currently, and (*d*) conclusions on loss contingencies and other matters. The disclosures discussed in these contexts are two-tiered: (*a*) disclosures that are required and (*b*) disclosures that are encouraged, but not required. This SOP does not discourage entities from disclosing additional information that they believe will further users' understanding of the entity's financial statements.

Balance Sheet Display

.144 An entity's balance sheet may include several assets that relate to an environmental remediation obligation. Among them are the following:

- Receivables from other PRPs that are not providing initial funding
- Anticipated recoveries from insurers
- Anticipated recoveries from prior owners as a result of indemnification agreements

.145 Chapter 6 addresses an entity's recognition and measurement of potential recoveries related to its environmental remediation liabilities (see the section entitled "Impact of Potential Recoveries" in paragraphs .140 through .141). FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts,* addresses the issue of offsetting environmental liabilities and related recoveries in the balance sheet. FASB Interpretation No. 39 states that a right of setoff exists only when all of the following conditions are met.

- Each of *two* parties owes the other determinable amounts.
- The reporting party has the right to set off the amounts owed with the amount owed the other party.
- The reporting party intends to set off.
- The right of setoff is enforceable at law.

.146 A debtor that has a right of setoff that meets all of these conditions may offset the related asset and liability and report the net amount. It would be rare, if ever, that the facts and circumstances surrounding environmental remediation liabilities and related receivables and potential recoveries would meet all of these conditions.

Income Statement Display

.147 Recording an environmental remediation liability usually results in a corresponding charge to income, and the guidance herein with respect to the income statement refers to such charges. In certain situations, such as those described in FASB EITF Issues 90-8 and 89-13 (see reprints of these EITF Issues in appendix A [paragraph .173]), it may be appropriate to capitalize environmental remediation costs. Also, in conjunction with the initial recording of a purchase business combination or the final estimate of a preacquisition contingency at the end of the allocation period following the guidance in FASB Statement No. 141, *Business Combinations*, the environmental remediation liability is considered in the determination and allocation of the purchase price.* By analogy to the accounting for a purchase business combination, the recording of an environmental remediation liability in conjunction with the acquisition of property would affect the amount recorded as an asset. Finally, the recording of the receipt of property as a contribution received following the guidance in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made,* should include the effect of any environmental remediation liability that is recorded in conjunction with the contribution. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 141.†]

.148 APB Opinion No. 30, *Reporting the Results of Operations*, as amended by FASB Statements No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*, sets forth the criteria for reporting extraordinary items. The incurrence of environmental remediation obligations is not an event that is unusual in nature. As such, the related costs and recoveries do not meet the criteria for classification as extraordinary. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statements No. 144 and No. 145.]

.149 Furthermore, it is particularly difficult to substantiate the classification of environmental remediation costs as a component of nonoperating expenses. Because the events underlying the incurrence of the obligation relate to an entity's operations, remediation costs should be charged against operations. Although charging the costs of remediating past environmental impacts against current operations may appear debatable because of the time between the contribution or transportation of waste materials containing hazardous substances to a site and the subsequent incurrence of remediation costs, environmental remediation-related expenses have become a regular cost of conducting economic activity. Accordingly, environmental remediation-related expenses should be reported as a component of operating income in income statements that classify items as operating or nonoperating. Credits arising from recoveries of environmental losses from other parties should be reflected in the same income statement line. Any earnings on assets that are reflected on the entity's financial statements and are earmarked for funding its environmental liabilities should be reported as investment income.

.150 Environmental remediation-related expenses and related recoveries attributable to discontinued operations that were accounted for as such in accordance with APB Opinion No. 30, as amended by FASB Statements No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and No. 145,

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* Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141 (revised 2007), *Business Combinations*, should be applied. [Footnote added, May 2008, due to the issuance of FASB Statement No. 141(R).]

† FASB Statement No. 141, *Business Combinations*, supersedes APB Opinion No. 16, *Business Combinations*. [Footnote renumbered due to the issuance of FASB Statement No. 141(R), May 2008.]

Rescission of FASB Statements No. 4, 44, and 64, Amendment to FASB Statement No. 13, and Technical Corrections, should be classified as discontinued operations. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statements No. 144 and No. 145.]

Disclosure of Accounting Principles

.151 APB Opinion No. 22, *Disclosure of Accounting Policies,* provides guidance regarding accounting principles that should be described in the accounting policies note to the financial statements. APB Opinion 22, paragraph 12, indicates that entities should disclose those accounting principles that "materially affect the determination of financial position or results of operations." Particularly, entities should disclose accounting principles and the methods of applying those principles where alternatives exist.

.152 With respect to environmental remediation obligations, financial statements should disclose whether the accrual for environmental remediation liabilities is measured on a discounted basis. If an entity utilizes present-value measurement techniques, additional disclosures are appropriate, and are discussed further in the section entitled "Recognized Losses and Recoveries of Losses, and Reasonably Possible Loss Exposures" in paragraphs .160 through .164.

.153 Because environmental remediation costs have become increasingly significant, and because the accounting for many environmental loss contingencies often involves subjective judgments, disclosure of accrual benchmarks for remediation obligations is useful to further users' understanding of the entity's financial statements. Accordingly, entities are encouraged, but not required, to disclose the event, situation, or set of circumstances that generally triggers recognition of loss contingencies that arise out of the entity's environmental remediation-related obligations (for example, during or upon completion of the feasibility study).[14] Also, entities are encouraged to disclose their policy concerning the timing of recognition of recoveries.

.154 An illustration of an accounting policies note disclosure for environmental remediation-related costs follows (information that is italicized and enclosed in brackets is not required):

> *Environmental Remediation Costs—[Enterprise A accrues for losses associated with environmental remediation obligations when such losses are probable and reasonably estimable. Accruals for estimated losses from environmental remediation obligations generally are recognized no later than completion of the remedial feasibility study.*
>
> *Such accruals are adjusted as further information develops or circumstances change.]* Costs of future expenditures for environmental remediation obligations are not discounted to their present value. *[Recoveries of environmental remediation costs from other parties are recorded as assets when their receipt is deemed probable.]*

Disclosures for Environmental Remediation Loss Contingencies

.155 FASB Statement No. 5 provides the primary guidance applicable to disclosures of environmental remediation loss contingencies. Paragraphs 9 and 10 of FASB Statement No. 5 state:

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[14] An accrual benchmark cannot operate in a manner that would delay the accrual of a loss contingency beyond the point required by the provisions of FASB Statement No. 5, *Accounting for Contingencies.*

9. Disclosure of the nature of an accrual made pursuant to the provisions of paragraph 8 [of Statement No. 5], and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.

10. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable. [*footnotes omitted*]

.156 The disclosure requirements of SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* [section 10,640], also apply to environmental remediation liabilities. SOP 94-6, paragraphs 12 through 14 [section 10,640.12 through .14] state in part:

12. In addition to disclosures required by FASB Statement No. 5 and other accounting pronouncements, this SOP requires disclosures regarding estimates used in the determination of the carrying amounts of assets or liabilities or disclosure of gain or loss contingencies, as described below.

13. Disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that *both* of the following criteria are met:

- It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.
- The effect of the change would be material to the financial statements.

14. The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term. If the estimate involves a loss contingency covered by FASB Statement No. 5, the disclosure should also include an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required.

.157 This SOP incorporates the disclosure requirements set forth in EITF Issue 93-5 concerning discounting of environmental remediation liabilities and of assets that are recognized relating to recovery of a portion or all of such a liability.

.158 Uncertainties associated with environmental remediation loss contingencies are pervasive, and they often result in wide ranges of reasonably possible losses with respect to such contingencies. Further, resolution of the uncertainties and the cash-flow effects of the loss contingencies often occur over a span of many years. Accordingly, this SOP encourages, but does not require, additional specific disclosures[15] with respect to environmental remediation loss contingencies that would be useful to further users' understanding of the entity's financial statements.

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[15] Nothing in this SOP eliminates disclosures that are required by FASB Statement No. 5 or SOP 94-6 [section 10,640].

.159 Paragraphs 9 and 10 of FASB Statement No. 5 provide for disclosures related to three different aspects of loss contingencies: (*a*) recognized losses and reasonably possible (additional) loss exposures, (*b*) probable but not reasonably estimable losses, and (*c*) unasserted claims. Following are the disclosures that are required or encouraged by Statement No. 5, SOP 94-6 [section 10,640], and this SOP for each aspect.

Recognized Losses and Recoveries of Losses, and Reasonably Possible Loss Exposures

.160 If the FASB Statement No. 5 criteria of remote, reasonably possible, and probable were mapped onto a range of likelihood of the existence of a loss spanning from zero to 100 percent, the reasonably possible portion would span a significant breadth of the range starting from remote and ending with probable. The potential outcomes of environmental remediation loss contingencies often span a range of possibilities. If a loss is deemed probable and it is reasonably estimable, it is recognized; however, beyond the recognized losses, there may be additional exposure to loss that is reasonably possible. This often happens in situations in which a range of possible outcomes is identified and, in accordance with FASB Interpretation No. 14, the entity records either a best estimate within the range or the minimum amount in the range, thus leaving unrecorded amounts of additional possible loss for the higher cost outcomes.[16] In other situations, no loss may be probable, but a loss is reasonably possible. There may also be situations where a loss is probable, but no amount that would be material to the entity is reasonably estimable (see the subsequent section entitled "Probable But Not Reasonably Estimable Losses" in paragraphs .165 through .167).

.161 With respect to recorded accruals for environmental remediation loss contingencies and assets for third-party recoveries related to environmental remediation obligations, financial statements should disclose the following:

a. The nature of the accruals, if such disclosure is necessary for the financial statements not to be misleading, and, in situations where disclosure of the nature of the accruals is necessary, the total amount accrued for the remediation obligation, if such disclosure is also necessary for the financial statements not to be misleading

b. If any portion of the accrued obligation is discounted, the undiscounted amount of the obligation and the discount rate used in the present-value determinations

c. If the criteria of SOP 94-6 [section 10,640] are met with respect to the accrued obligation or to any recognized asset for third-party recoveries, an indication that it is at least reasonably possible that a change in the estimate of the obligation or of the asset will occur in the near term

.162 With respect to reasonably possible loss contingencies, including reasonably possible loss exposures in excess of the amount accrued, financial statements should disclose the following:

a. The nature of the reasonably possible loss contingency, that is, a description of the reasonably possible remediation obligation, and an estimate of the possible loss exposure or the fact that such an estimate cannot be made

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[16] When an overall liability is estimated by combining estimates of various components of the liability, additional possible losses present in the component estimates must be considered in determining an overall additional possible loss.

b. If the criteria of SOP 94-6 [section 10,640] are met with respect to estimated loss (or gain) contingencies, an indication that it is at least reasonably possible that a change in the estimate will occur in the near term

.163 Entities also are encouraged, but not required, to disclose the following:

a. The estimated time frame of disbursements for recorded amounts if expenditures are expected to continue over the long term

b. The estimated time frame for realization of recognized probable recoveries, if realization is not expected in the near term

c. If the criteria of SOP 94-6 [section 10,640] are met with respect to the accrued obligation, to any recognized asset for third-party recoveries, or to reasonably possible loss exposures or disclosed gain contingencies, the factors that cause the estimate to be sensitive to change

d. If an estimate of the probable or reasonably possible loss or range of loss cannot be made, the reasons why it cannot be made

e. If information about the reasonably possible loss or the recognized and additional reasonably possible loss for an environmental remediation obligation related to an individual site is relevant to an understanding of the financial position, cash flows, or results of operations of the entity, the following with respect to the site:

- The total amount accrued for the site
- The nature of any reasonably possible loss contingency or additional loss, and an estimate of the possible loss or the fact that an estimate cannot be made and the reasons why it cannot be made
- Whether other PRPs are involved and the entity's estimated share of the obligation
- The status of regulatory proceedings
- The estimated time frame for resolution of the contingency

.164 The following is an illustration of disclosure for a situation in which—

a. An entity is involved in a single environmental site at which a number of potential outcomes may occur.

b. There is a probable, reasonably estimable recovery from a third party.

c. The entity has accrued for the most likely outcome within a range of possible outcomes for each component.

d. The nature of the amounts accrued for remediation and the related probable recovery are necessary to be disclosed in order for the financial statements not to be misleading.

e. There is a reasonably possible loss exposure in excess of the amount accrued that is material and it is reasonably possible that a change in estimate that would be material to the financial statements will occur in the near term.

Information that is not required is italicized and enclosed in brackets.

Enterprise A has been notified by the United States Environmental Protection Agency (EPA) that it is a potentially responsible party (PRP) under Superfund legislation [*with respect to XYZ site in Sometown, USA, a disposal site previously used in its chemical-fertilizer business. The EPA has also identified ten other PRPs for XYZ. A remedial investigation and feasibility study has been completed, and the results of that study have been forwarded to the EPA. The study indicates a range of viable remedial approaches, but agreement has not yet been reached with the EPA on the final remediation approach. The PRP group has preliminarily agreed to an allocation that sets Enterprise A's share of the cost of remediating XYZ site at 6 percent.*] Enterprise A has accrued its best estimate of its obligation with respect to the site at December 31, 199X, [*which is $10 million and which is included in long-term liabilities and is expected to be disbursed over the next ten years. If certain of the PRPs are ultimately not able to fund their allocated shares or the EPA insists on a more expensive remediation approach,*] Enterprise A could incur additional obligations of up to $7 million. It is reasonably possible that Enterprise A's recorded estimate of its obligation may change in the near term.

With respect to the environmental obligation discussed above, the site was acquired in 1982, and, in connection with that acquisition, the former owner partially indemnified Enterprise A for environmental impacts occurring prior to the acquisition. [*Based on existing documentation indicating the years in which the business shipped wastes to XYZ and the terms of the indemnification in the acquisition agreement,*] Enterprise A [*believes it is probable that it will recover from the prior owners 50 percent of its allocated remediation costs for XYZ and, accordingly,*] has recorded a receivable of $5 million at December 31, 199X.

Probable But Not Reasonably Estimable Losses

.165 An entity often is able to determine early in the remediation process that it is probable it has an obligation, even though the determination of a reasonable estimate of the total cost of that obligation may take additional time (for example, due to the necessity of organizing a PRP group, studying and evaluating the site, or negotiating the scope of the remediation required with the regulatory authorities and other constituencies). In situations in which a probable obligation exists, FASB Statement No. 5 and Interpretation No. 14 require that the best estimate of the loss be recorded or, if the reasonable estimate of the loss is a range and there is no best estimate within the range, that the minimum amount in the range be recorded. However, it may be that there is no best estimate and the minimum amount in the range of the overall liability is not a material amount.

.166 Even though an entity may not be able to establish a reasonable estimate of a material loss or a range of reasonably estimable material loss exposure that must be recorded, in many cases it can determine early in the investigation whether the costs of environmental remediation, in fact, may be material (that is, the upper end of the range of the reasonable estimate of the loss is material). If an entity's probable but not reasonably estimable environmental remediation obligations may be material, the financial statements should disclose the nature of the probable contingency, that is, a description of the remediation obligation, and the fact that a reasonable estimate cannot currently be made. Entities also are encouraged, but not required, to disclose the estimated time frame for resolution of the uncertainty as to the amount of the loss.

.167 An illustration of disclosure of a probable but not yet reasonably estimable environmental remediation loss contingency follows (information that is italicized and enclosed in brackets is not required):

Enterprise A has been notified by the U.S. Environmental Protection Agency (EPA) that it is a potentially responsible party (PRP) with respect to environmental impacts [*identified at the XYZ site in Sometown, USA. Several meetings have been held with the EPA and the other identified PRPs, and a remedial investigation has recently commenced.*] Although a loss is probable, it is not possible at this time to reasonably estimate the amount of any obligation for remediation [*of XYZ site*] that would be material to Enterprise A's financial statements [*because the extent of environmental impact, allocation among the PRPs, remediation alternatives (which could involve no or minimal efforts), and concurrence of the regulatory authorities have not yet advanced to the stage where a reasonable estimate of any loss that would be material to the enterprise can be made*]. [*A reasonable estimate of a material obligation, if any, is expected to be possible in 199X.*]

Unasserted Claims

.168 Whether notification by regulatory authorities in relation to particular environmental laws and regulations constitutes the assertion of a claim is a matter of legal determination. If an entity concludes that it has no current legal obligation to remediate a situation of probable or possible environmental impact, then in accordance with paragraph 10 of FASB Statement No. 5, no disclosure is required. Similarly, future actions of an entity, when they occur, may create a legal obligation to perform environmental remediation; however, no obligation exists currently (for example, if the obligation arises only when and if an entity ceases to operate a facility).[17] However, if an entity is required by existing laws and regulations to report the release of hazardous substances and to begin a remediation study or if assertion of a claim is deemed probable, the matter would represent a loss contingency subject to the disclosure provisions of Statement No. 5, paragraph 10, regardless of a lack of involvement by a regulatory agency.

Other Considerations

.169 For SEC registrants, other financial statement disclosure considerations related to environmental loss exposures are set forth in the SEC's SAB No. 92, Topic 5-Y, Question 5 (see reprint of SAB No. 92 in appendix A [paragraph .173]). Also, Question 7 of the SAB discusses disclosures for site-restoration costs or other environmental exit costs.

Environmental Remediation Costs Recognized Currently

.170 Entities are encouraged but not required to disclose the amount of environmental remediation costs recognized in the income statement in the following detail:

- The amount recognized for environmental remediation loss contingencies in each period
- The amount of any recovery from third parties that is credited to environmental remediation costs in each period

[17] This SOP does not provide guidance on accounting for pollution control costs with respect to current operations or on accounting for costs of future site restoration or closure that are required upon the cessation of operations or sale of facilities.

- The income statement caption in which environmental remediation costs and credits are included

Conclusions on Loss Contingencies and Other Matters

.171 Financial statements may include a *contingency conclusion* that addresses the estimated total unrecognized exposure to environmental remediation and other loss contingencies. Such contingency conclusions may state, for example, that "management believes that the outcome of these uncertainties should not have (or "may have") a material adverse effect on the financial condition, cash flows, or operating results of the enterprise." Alternatively, the disclosure may indicate that the adverse effect could be material to a particular financial statement or to results and cash flows of a quarterly or annual reporting period. Although potentially useful information, these conclusions are not a substitute for the required disclosures of this SOP and of FASB Statement No. 5, such as their requirement to disclose the amounts of material reasonably possible additional losses or to state that such an estimate cannot be made. Also, the assertion that the outcome should not have a material adverse effect must be supportable. If the entity is unable to estimate the maximum end of the range of possible outcomes, it may be difficult to support an assertion that the outcome should not have a material adverse effect.

.172 Entities may wish to provide a description of the general applicability and impact of environmental laws and regulations upon their business and how the existence of such laws and regulations may give rise to loss contingencies for future environmental remediation. Such disclosures often acknowledge the uncertainty of the effect of possible future changes to environmental laws and their application, and they are frequently made on an aggregated basis, considering the entity's total exposures for all its environmental sites.

.173

Appendix A

Current Authoritative Literature

FASB Statement No. 5, *Accounting for Contingencies,* and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss—An Interpretation of FASB Statement No. 5*

A-1. FASB Statement No. 5, *Accounting for Contingencies,* states in paragraph 8 that—

> An estimated loss from a loss contingency [*paragraph reference omitted*] shall be accrued by a charge to income [*footnote omitted*] if both of the following conditions are met:
>
> *a.* Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
>
> *b.* The amount of loss can be reasonably estimated.

A-2. Although environmental remediation liabilities is not one of the examples discussed in FASB Statement No. 5, environmental remediation liabilities are loss contingencies, and the discussion in paragraphs 33 through 39 of "litigation, claims, and assessments" can be useful in understanding the requirements of FASB Statement No. 5 as they relate to environmental remediation liabilities.

A-3. FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss,* points out in paragraph 2 that the condition in FASB Statement No. 5 that "the amount of loss can be reasonably estimated" does not delay accrual of a loss until only a single amount can be reasonably estimated.

A-4. Paragraph 3 of the Interpretation provides the following guidance concerning accrual of loss contingencies when the reasonable estimate of the loss is a range of amounts.

- When some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount (the best estimate) shall be accrued.
- When no amount within the range is a better estimate than any other amount (within the range), however, the minimum amount in the range shall be accrued.

A-5. Paragraphs 9 and 10 of FASB Statement No. 5 state the following.

> 9. Disclosure of the nature of an accrual [*footnote omitted*] made pursuant to the provisions of paragraph 8, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.
>
> 10. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility

that a loss or an additional loss may have been incurred.[6] The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

[6] For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 8(a) but that is not accrued because the amount of the loss can not be reasonably estimated (paragraph 8(b)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8(a)—namely, those contingencies for which there is a *reasonable possibility* that a loss may have been incurred even though information may not indicate that it is *probable* that an asset has been impaired or a liability has been incurred at the date of the financial statements.

The disclosure requirements of FASB Statement No. 5 are emphasized in FASB Interpretation No. 14.

FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*

A-6. FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts,* defines a *right of setoff* as

> a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. [*footnote omitted*] A right of setoff exists when all of the following conditions are met:
>
> *a.* Each of *two* parties owes the other determinable amounts.
>
> *b.* The reporting party has the right to set off the amount owed with the amount owed by the other party.
>
> *c.* The reporting party intends to set off.
>
> *d.* The right of setoff is enforceable at law.
>
> A debtor having a valid right of setoff may offset the related asset and liability and report the net amount. [*footnote omitted*]

APB Opinion 20, *Accounting Changes*

A-7. APB Opinion No. 20, *Accounting Changes,* states in paragraph 31 that

> the effect of a change in accounting estimate should be accounted for in (*a*) the period of change if the change affects that period only or (*b*) the period of change and future periods if the change affects both. A change in an estimate should not be accounted for by restating amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

A-8. APB Opinion No. 20, paragraph 32, states in part:

> A change in accounting estimate that is recognized in whole or in part by a change in accounting principle should be reported as a change in an estimate because the cumulative effect attributable to the change in accounting principle cannot be separated from the current or future effects of the change in estimate . . . .

A-9. APB Opinion No. 20, paragraph 33, also requires or recommends, depending on the estimates involved, disclosure of the effect of significant revisions of estimates if the effect is material.

AICPA SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*

A-10. SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* [section 10,640], requires disclosure regarding an estimate when known information available prior to issuance of the financial statements indicates that *both* of the following criteria are met:

- It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.
- The effect of the change would be material to the financial statements.

A-11. The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a material change in the estimate will occur in the near term. If the estimate involves a loss contingency covered by FASB Statement No. 5, the disclosure should also include an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to material change is encouraged but not required.

EITF Issue 93-5, *Accounting for Environmental Liabilities*

A-12. The guidance in FASB EITF Issue 93-5, *Accounting for Environmental Liabilities,* has been incorporated into this SOP. Therefore, EITF Issue 93-5 is not reproduced herein.

EITF Issue 90-8, *Capitalization of Costs to Treat Environmental Contamination*

A-13. EITF Issue 90-8, *Capitalization of Costs to Treat Environmental Contamination,* addresses whether "environmental contamination treatment costs" should be capitalized or charged to expense. Issue 90-8 is reprinted below in its entirety.

Dates Discussed: May 31, 1990; July 12, 1990

Reference: FASB Concepts Statement No. 6, *Elements of Financial Statements*

ISSUE

A company incurs costs to remove, contain, neutralize, or prevent existing or future environmental contamination (environmental contamination treatment costs). These costs may be incurred voluntarily or as required by law. They may include a wide range of expenditures, including costs of removal of contamination, such as that caused by leakage from underground storage tanks, costs to acquire tangible property, such as air pollution control equipment, costs of environmental studies, and costs of fines levied under environmental laws.

This Issue does not address (1) when to recognize liabilities related to environmental contamination treatment costs, (2) the measurement of those liabilities, or (3) whether environmental contamination treatment costs that are charged to expense should be reported as an unusual or extraordinary item.

The issue is whether environmental contamination treatment costs should be capitalized or charged to expense.

EITF DISCUSSION

The Task Force reached a consensus that, in general, environmental contamination treatment costs should be charged to expense. Those costs may be capitalized if recoverable but only if any one of the following criteria is met:

1. The costs extend the life, increase the capacity, or improve the safety or efficiency of property owned by the company. For purposes of this criterion, the condition of that property after the costs are incurred must be improved as compared with the condition of that property when originally constructed or acquired, if later.

2. The costs mitigate or prevent environmental contamination that has yet to occur and that otherwise may result from future operations or activities. In addition, the costs improve the property compared with its condition when constructed or acquired, if later.

3. The costs are incurred in preparing for sale that property currently held for sale.

The Task Force also discussed the implication of that consensus on the consensus previously reached on Issue No. 89-13, "Accounting for the Cost of Asbestos Removal." The Task Force affirmed its earlier consensus, noting that capitalization of asbestos treatment costs could be justified under the first criterion.

Exhibit 90-8A provides examples of the application of this consensus.

STATUS

No further EITF discussion is planned.

Capitalization of Costs to Treat Environmental Contamination

Exhibit 90-8A

EXAMPLES OF THE APPLICATION OF THE CONSENSUS ON EITF ISSUE 90-8

Environmental Contamination, Treatments	*Evaluation of Criteria*
1. Tanker Oil Spill:	
A. Clean up waterway and beachfront	1. Costs to clean up the waterway and beachfront are not eligible for consideration under the first criterion because the oil company does not own the property. 2. The cleanup of the waterway and beachfront does not mitigate or prevent a future oil spill from future operations. 3. The waterway and beachfront are not owned assets and, therefore, the third criterion does not apply. *Conclusion:* Costs incurred for cleanup and restoration in connection with the oil spill should be charged to expense.[1]
B. Reinforce tanker's hull to reduce risk of future spill	1. Reinforcing the hull improves the tanker's safety compared to when the tanker was originally constructed or acquired. 2. Reinforcing the hull mitigates the risk that the tanker will experience a similar oil spill during future operations and improves the tanker's safety compared to when the tanker was originally constructed or acquired. *Conclusion:* The costs incurred in connection with reinforcing the tanker's hull may be capitalized under either the first or second criterion.
2. Rusty Chemical Storage Tank:	
A. Remove rust that developed during ownership	1. Removing the rust has not improved the tank compared with its condition when built or acquired. 2. Removing the rust has mitigated the possibility of future leaks. However, removing the rust has not improved the tank compared with its condition when built or acquired.

[1] This consensus does not require that tangible assets acquired to clean a particular spill be charged to expense immediately. Rather, to the extent that those tangible assets have future uses, they may be capitalized and depreciated over their remaining useful lives.

Environmental Contamination, Treatments	*Evaluation of Criteria*
	Conclusion: Rust removal costs should be expensed unless the tank is currently held for sale and the costs were incurred to prepare the tank for sale.
B. Apply rust prevention chemicals	1. The application of rust prevention chemicals has improved the tank's condition compared with its condition when built or acquired. 2. Rust prevention chemicals mitigate the possibility that future rust will cause leaks and also improve the tank's condition compared with its condition when built or acquired. *Conclusion:* The costs of applying the rust prevention chemicals may be capitalized under either the first or second criterion.
3. Air Pollution Caused by Manufacturing Activities:	
A. Acquire and install pollution control equipment	1. The pollution control equipment improves the safety of the plant compared with its condition when built or acquired. 2. The pollution control equipment mitigates or prevents air pollution that has yet to occur but that may otherwise result from future operation of the plant and improves the safety of the plant compared with its condition when built or acquired. *Conclusion:* Costs associated with acquisition and installation of the pollution control equipment may be capitalized under either the first or second criterion.
B. Pay fines for violations of the Clean Air Act	1. Payment of fines does not extend the plant's life, increase its capacity, or improve its efficiency or safety. 2. Payment of fines does not mitigate or prevent pollution that has yet to occur but that may otherwise result from future operation of the plant. *Conclusion:* Fines paid in connection with violations of the Clean Air Act should be charged to expense. Even if the plant is currently held for sale, the fines should be charged to expense because the costs would not have been incurred to prepare the plant for sale.
4. Lead Pipes in Office Building Contaminate Drinking Water:	
A. Remove lead pipes and replace with copper pipes	1. Removing the lead pipes has improved the safety of the

Environmental Contamination, Treatments	*Evaluation of Criteria*
	building's water system compared with its condition when the water system was built or acquired. 2. By removing the lead pipes, the building's owner eliminated an existing environmental problem and prevented any further contamination from that lead. However, by removing the existing pipes, the building's owner has not mitigated or prevented environmental problems yet to occur, if any, from future operation of the building. *Conclusion:* Costs to remove the lead pipes and install copper pipes may be capitalized under the first criterion. The book value of the lead pipes should be charged to expense when removed.
5. Soil Contamination Caused by an Operating Garbage Dump:	
A. Refine soil on dump property	1. The life of a garbage dump is not extended by refining its soil. Further, the condition of the soil after refining will not be improved over its condition when the garbage dump was constructed or acquired. Removal of the toxic waste restores the soil to its original uncontaminated condition. 2. Removal of toxic waste from the soil addresses an existing environmental concern. It also prevents that waste from leaching in the future. However, removing the waste does not mitigate or prevent future operations from creating future toxic waste. The risk will continue regardless of how much of the existing soil is refined. *Conclusion:* Soil refinement costs should be charged to expense unless the garbage dump is currently held for sale and the costs were incurred to prepare the garbage dump for sale.
B. Install liner	1. The liner does not extend the useful life or improve the efficiency or capacity of the garbage dump. However, the liner has improved the garbage dump's safety compared to when the dump was constructed or acquired. 2. The liner addresses an existing and potential future problem. In this example, the garbage dump contains toxic waste from past operations and will likely generate

Environmental Contamination, Treatments	*Evaluation of Criteria*
	toxic waste during future operations. The liner partly addresses the existing environmental problem by preventing future leaching of existing toxic waste into the soil. The liner also mitigates or prevents leaching of toxic waste that may result from garbage dumping in a future period and has improved the garbage dump's safety compared to when the dump was constructed or acquired. *Conclusion:* The liner may be capitalized under either the first or second criterion.
6. Water Well Contamination Caused by Chemicals That Leaked into Wells Containing Water That Will Be Used in Future Beer Production:	
A. Neutralize water in wells	1. The treatment does not extend the life of the wells, increase their capacity, or improve efficiency. The condition of the water is not safer after the treatment compared to when the wells were initially acquired. 2. By neutralizing the water, the possibility of future contamination of the wells from future operations has not been mitigated or prevented. *Conclusion:* Costs incurred to neutralize well water should be charged to expense unless the wells were held for sale and the costs were incurred to prepare the wells for sale.
B. Install water filters	1. The water filters improve the safety of the wells compared with their uncontaminated state when built or acquired. 2. The water filters address future problems that may result from future operations. Since the water filters are effective in filtering environmental contamination, they mitigate the effect of spilling new contaminants into the wells during future operations. In addition, the water filters represent an improvement compared with the wells' original condition without water filters. *Conclusion:* The water filtering system may be capitalized under either the first or the second criterion.
7. Underground Gasoline Storage Tanks Leak and Contaminate the Company's Property:	

Environmental Contamination, Treatments	*Evaluation of Criteria*
A. Refine soil	1. Soil refinement does not extend the useful life, increase the capacity, or improve the efficiency or safety of the land relative to its unpolluted state when acquired. 2. By refining the contaminated soil, the oil company has addressed an existing problem. However, the company has not mitigated or prevented future leaks during future operations. *Conclusion:* Soil refining costs should be charged to expense unless the property is currently held for sale and the costs were incurred to prepare the property for sale.
B. Encase tanks so as to prevent future leaks from contaminating surrounding soil	1. In some cases, encasement may increase the life of the tanks because of their increased resistance to corrosion, leaking, etc. In other situations, the treatment does not increase the life of the tanks. However, the encasement has improved the tanks' safety compared with their condition when built or acquired. 2. Encasement has mitigated or prevented future leakage and soil contamination that might otherwise result from future operations. In addition, the encasement has improved the tanks' safety compared with their condition when built or acquired. *Conclusion:* The cost of encasement may be capitalized under either the first or the second criterion.
8. Air in Office Building Contaminated with Asbestos Fibers:	
A. Remove asbestos	1. Removal of the asbestos improves the building's safety over its original condition since the environmental contamination (asbestos) existed when the building was constructed or acquired. 2. By removing the asbestos, the building's owner has eliminated an existing environmental problem and has prevented any further contamination from that asbestos. However, by removing the existing asbestos, the building's owner has not mitigated or prevented new environmental problems, if any, that might result from future operation of the building. *Conclusion:* Asbestos removal costs may be capitalized as a betterment under the first criterion.

EITF Issue 89-13, *Accounting for the Cost of Asbestos Removal*

A-14. EITF Issue 89-13, *Accounting for the Cost of Asbestos Removal,* is reprinted below in its entirety.

Date Discussed: October 26, 1989

References: FASB Concepts Statement No. 6, *Elements of Financial Statements*

APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*

AICPA Accounting Interpretation 1, *Illustration of the Application of APB Opinion No. 30*

ISSUE

Various federal, state, and local laws require removal or containment of "dangerous asbestos" in buildings and regulate the manner in which the asbestos is removed or contained. A property owner incurs costs to remove or contain ("treat") asbestos in compliance with those laws.

The issues are:

1. Whether the costs incurred to treat asbestos when a property with a *known* asbestos problem is acquired should be capitalized or charged to expense
2. Whether the costs incurred to treat asbestos in an existing property should be capitalized or charged to expense
3. If it is deemed appropriate to charge asbestos treatment costs to expense, whether they should be reported as an extraordinary item

EITF DISCUSSION

The Task Force reached a consensus on the first issue that costs incurred to treat asbestos within a reasonable time period after a property with a known asbestos problem is acquired should be capitalized as part of the cost of the acquired property subject to an impairment test for that property.

The Task Force reached a consensus on the second issue that costs incurred to treat asbestos may be capitalized as a betterment subject to an impairment test for that property. When costs are incurred in anticipation of a sale of property, they should be deferred and recognized in the period of the sale to the extent that those costs can be recovered from the estimated sales price.

The Task Force reached a consensus on the third issue that asbestos treatment costs that are charged to expense are not extraordinary items under Opinion 30.

The SEC Observer noted that regardless of whether asbestos treatment costs are capitalized or charged to expense, SEC registrants should disclose significant exposure for asbestos treatment costs in "Management's Discussion and Analysis."

STATUS

No further EITF discussion is planned. A related issue was discussed in Issue No. 90-8, "Capitalization of Costs to Treat Environmental Contamination." The Task Force affirmed the consensus above, noting that capitalization of asbestos treatment costs could be justified under the consensus in Issue 90-8.

SEC Staff Accounting Bulletin No. 92, *Accounting and Disclosures Relating to Loss Contingencies*

A-15. For SEC registrants, SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies,* provides additional accounting, display, and disclosure guidance. SAB No. 92 is reproduced below.

STAFF ACCOUNTING BULLETIN NO. 92

The staff hereby adds Section Y to Topic 5 of the Staff Accounting Bulletin Series. Topic 5-Y provides guidance regarding the accounting and disclosures relating to loss contingencies. In addition, the staff hereby adds Question 7 to Topic 2-A and adds Section F to Topic 10. Question 7 of Topic 2-A discusses loss contingencies assumed in a business combination accounted for as a purchase. Topic 10-F discusses the presentation by utility companies of liabilities for environmental costs.

TOPIC 5: MISCELLANEOUS ACCOUNTING

* * * * *

Y. Accounting and disclosures relating to loss contingencies.

Facts: A registrant believes it may be obligated to pay material amounts as a result of product or environmental liability. These amounts may relate to, for example, damages attributed to the registrant's products or processes, clean-up of hazardous wastes, reclamation costs, fines, and litigation costs. The registrant may seek to recover a portion or all of these amounts by filing a claim against an insurance carrier or other third parties.

Paragraph 8 of *Statement of Financial Accounting Standards No. 5,* "Accounting for Contingencies," ("SFAS 5") states that an estimated loss from a loss contingency shall be accrued by a charge to income if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. The Emerging Issues Task Force ("EITF") of the Financial Accounting Standards Board reached a consensus on EITF Issue 93-5, "Accounting for Environmental Liabilities," that an environmental liability should be evaluated independently from any potential claim for recovery. Under that consensus, any loss arising from the recognition of an environmental liability should be reduced by a potential claim for recovery only when that claim is probable[1] of realization. The EITF also reached a consensus that discounting an environmental liability for a specific clean-up site to reflect the time value of money is appropriate only if the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable for that site. Further, any asset that is recognized relating to a claim for recovery of a liability that is recognized on a discounted basis also should be discounted to reflect the time value of money.

Because uncertainty regarding the alternative methods of presenting in the balance sheet the amounts recognized as contingent liabilities and claims for recovery from third parties was not resolved by the EITF and current disclosure practices remain diverse, the staff is publishing its interpretation of the current accounting literature and disclosure requirements to serve as guidance for public companies. The AICPA's Accounting Standards Executive Committee has appointed a task force to address environmental concerns. The staff encourages efforts by the profession to develop comprehensive guidance applicable to the accounting and financial statement disclosures relating to environmental matters.

Question 1: Does the staff believe that it is appropriate to offset in the balance sheet a claim for recovery that is probable of realization against a probable contingent liability, that is, report the two as a single net amount on the face of the balance sheet?

Interpretive Response: Not ordinarily. The staff believes that separate presentation of the gross liability and related claim for recovery in the balance sheet most fairly presents the potential consequences of the contingent claim on the company's resources and is the preferable method of display. Recent reports of litigation over insurance policies' coverage of product and environmental liabilities and financial failures in the insurance industry indicate that there are significant uncertainties regarding both the timing and the ultimate realization of claims made to recover amounts from insurance carriers and other third parties. The risks and uncertainties associated with a registrant's contingent liability are separate and distinct from those associated with its claim for recovery from third parties.

Separate presentation of the gross liability and the claim for recovery is consistent with the recent consensus of the EITF, which concluded that the amounts of the contingent liability and any claim for recovery should be estimated and evaluated independently. Furthermore, accounting guidance generally proscribes the offsetting of assets and liabilities except where a right of setoff exists.[2] This general proscription was strengthened by the recent issuance of *Financial Accounting Standards Board Interpretation No. 39,* "Offsetting of Amounts Relating to Certain Contracts," ("FIN 39"), which is effective for financial statements issued for periods beginning after December 15, 1993. The guidance in that interpretation indicates that the prohibition on setoff in the balance sheet should be applied more comprehensively than previously may have been the practice.

It is the staff's view that presentation of liabilities net of claims for recovery will not be appropriate after the provisions of FIN 39 are required to be applied in financial statements. In the interim, registrants should ensure that notes to the financial statements include information necessary to an understanding of the material uncertainties affecting both the measurement of the liability and the realization of recoveries. The staff believes these disclosures should include the gross amount of any claims for recovery that are netted against the liability.

Question 2: If a registrant is jointly and severally liable with respect to a contaminated site but there is a reasonable basis for apportionment of costs among responsible parties, must the registrant recognize a liability with respect to costs apportioned to other responsible parties?

Interpretive Response: No. However, if it is probable that other responsible parties will not fully pay costs apportioned to them, the liability that is recognized by the registrant should include the registrant's best estimate, before consideration of potential recoveries from other parties, of the additional costs that the registrant expects to pay. Discussion of uncertainties affecting the registrant's ultimate obligation may be necessary if, for example, the solvency of one or more parties is in doubt or responsibility for the site is disputed by a party. A note to the financial statements should describe any additional loss that is reasonably possible.

Question 3: Estimates and assumptions regarding the extent of environmental or product liability, methods of remedy, and amounts of related costs frequently prove to be different from the ultimate outcome. How do these uncertainties affect the recognition and measurement of the liability?

Interpretive Response: The measurement of the liability should be based on currently available facts, existing technology, and presently enacted laws and regulations, and should take into consideration the likely effects of inflation and other societal and economic factors. Notwithstanding significant uncertainties, management may not delay recognition of a contingent liability until only a single amount can be reasonably estimated. If management is able to determine that the amount of the liability is likely to fall within a range and no amount within that range can be determined to be the better estimate, the registrant should recognize the minimum amount of the range pursuant to *Financial Accounting Standards Board Interpretation No. 14,* "Reasonable Estimation of the Amount of a Loss" ("FIN 14"). The staff believes that recognition of a loss equal to the lower limit of the range is necessary even if the upper limit of the range is uncertain.

In measuring its environmental liability, a registrant should consider available evidence including the registrant's prior experience in remediation of contaminated sites, other companies' clean-up experience, and data released by the Environmental Protection Agency or other organizations. Information necessary to support a reasonable estimate or range of loss may be available prior to the performance of any detailed remediation study. Even in situations in which the registrant has not determined the specific strategy for remediation, estimates of the costs associated with the various alternative remediation strategies considered for a site may be available or reasonably estimable. While the range of costs associated with the alternatives may be broad, the minimum clean-up cost is unlikely to be zero. As additional information becomes available, changes in estimates of the liability should be reported in the period that those changes occur in accordance with paragraphs 31–33 of *Accounting Principles Board Opinion No. 20,* "Accounting Changes."

Question 4: Assuming that the registrant's estimate of an environmental or product liability meets the conditions set forth in the consensus on EITF Issue 93-5 for recognition on a discounted basis, what discount rate should be applied?

Interpretive Response: The staff believes that the rate used to discount the cash payments should be the rate that will produce an amount at which the environmental or product liability could be settled in an arm's-length transaction with a third party. If that rate is not readily determinable, the discount rate used to discount the cash payments should not exceed the interest rate on monetary assets that are essentially risk free[3] and have maturities comparable to that of the environmental or product liability.

If the liability is recognized on a discounted basis to reflect the time value of money, the notes to the financial statements should, at a minimum, include disclosures of the discount rate used, the expected aggregate undiscounted amount, expected payments for each of the five succeeding years and the aggregate amount thereafter, and a reconciliation of the expected aggregate undiscounted amount to amounts recognized in the statements of financial position. Material changes in the expected aggregate amount since the prior balance sheet date, other than those resulting from pay-down of the obligation, should be explained.

Question 5: What financial statement disclosures should be furnished with respect to recorded and unrecorded product or environmental liabilities?

Interpretive Response: Paragraphs 9 and 10 of SFAS 5 identify disclosures regarding loss contingencies that generally are furnished in notes to financial statements. The staff believes that product and environmental liabilities typically are of such significance that detailed disclosures regarding the judgments and assumptions underlying the recognition and measurements of the liabilities are necessary to prevent the financial statements from being misleading and to inform readers fully regarding the range of reasonably possible outcomes that could have a material effect on the registrant's financial condition, results of operations, or liquidity. Examples of disclosures that may be necessary include:

- Circumstances affecting the reliability and precision of loss estimates.
- The extent to which unasserted claims are reflected in any accrual or may affect the magnitude of the contingency.
- Uncertainties with respect to joint and several liability that may affect the magnitude of the contingency, including disclosure of the aggregate expected cost to remediate particular sites that are individually material if the likelihood of contribution by the other significant parties has not been established.
- Disclosure of the nature and terms of cost-sharing arrangements with other potentially responsible parties.
- The extent to which disclosed but unrecognized contingent losses are expected to be recoverable through insurance, indemnification arrangements, or other sources, with disclosure of any material limitations of that recovery.
- Uncertainties regarding the legal sufficiency of insurance claims or solvency of insurance carriers.[4]
- The time frame over which the accrued or presently unrecognized amounts may be paid out.
- Material components of the accruals and significant assumptions underlying estimates.

Registrants are cautioned that a statement that the contingency is not expected to be material does not satisfy the requirements of SFAS 5 if there is at least a reasonable possibility that a loss exceeding amounts already recognized may have been incurred and the amount of that additional loss would be material to a decision to buy or sell the registrant's securities. In that case, the registrant must either (*a*) disclose the estimated additional loss, or range of loss, that is reasonably possible, or (*b*) state that such an estimate cannot be made.

Question 6: What disclosures regarding loss contingencies may be necessary outside the financial statements?

Interpretive Response: Registrants should consider the requirements of Items 101 (Description of Business), 103 (Legal Proceedings), and 303 (Management's Discussion and Analysis) of Regulations S-K and S-B. The Commission has issued two interpretive releases that provide additional guidance with respect to these items.[5] In a 1989 interpretive release, the Commission noted that the availability of insurance, indemnification, or contribution may be relevant in determining whether the criteria for disclosure have been met with respect to a contingency.[6] The registrant's assessment in this regard should include consideration of facts such as the periods in which claims for recovery may be realized, the likelihood that the claims may be contested, and the financial condition of third parties from which recovery is expected.

Disclosures made pursuant to the guidance identified in the preceding paragraph should be sufficiently specific to enable a reader to understand the scope of the contingencies affecting the registrant. For example, a registrant's discussion of historical and anticipated environmental expenditures should, to the extent material, describe separately (*a*) recurring costs associated with managing hazardous substances and pollution in on-going operations, (*b*) capital expenditures to limit or monitor hazardous substances or pollutants, (*c*) mandated expenditures to remediate previously contaminated sites, and (*d*) other infrequent or nonrecurring clean-up expenditures that can be anticipated but which are not required in the present circumstances. Disaggregated disclosure that describes accrued and reasonably likely losses with respect to particular environmental sites that are individually material may be necessary for a full understanding of these contingencies. Also, if management's investigation of potential liability and remediation cost is at different stages with respect to individual sites, the consequences of this with respect to amounts accrued and disclosed should be discussed.

Examples of specific disclosures typically relevant to an understanding of historical and anticipated product liability costs include the nature of personal injury or property damages alleged by claimants, aggregate settlement costs by type of claim, and related costs of administering and litigating claims. Disaggregated disclosure that describes accrued and reasonably likely losses with respect to particular claims may be necessary if they are individually material. If the contingency involves a large number of relatively small individual claims of a similar type, such as personal injury from exposure to asbestos, disclosure of the number of claims filed for each period presented, the number of claims dismissed, settled, or otherwise resolved for each period, and the average settlement amount per claim may be necessary. Disclosures should address historical and expected trends in these amounts and their reasonably likely effects on operating results and liquidity.

Question 7: What disclosures should be furnished with respect to site restoration costs or other environmental exit costs?

Interpretive Response: The staff believes that material liabilities for site restoration, post-closure, and monitoring commitments, or other exit costs that may occur on the sale, disposal, or abandonment of a property should be disclosed in the notes to the financial statements. Appropriate disclosures generally would include the nature of the costs involved, the total anticipated cost, the total costs accrued to date, the balance sheet classification of accrued amounts, and the range or amount of reasonably possible additional losses.

If an asset held for sale or development will require remediation to be performed by the registrant prior to development, sale, or as a condition of sale, a note to the financial statements should describe how the necessary expenditures are considered in the assessment of the asset's net realizable value. Additionally, if the registrant may be liable for remediation of environmental damage relating to assets or businesses previously disposed, disclosure should be made in the financial statements unless the likelihood of a material unfavorable outcome of that contingency is remote. The registrant's accounting policy with respect to such costs should be disclosed in accordance with *Accounting Principle Board Opinion No. 22,* "Disclosure of Accounting Policies."

Question 8: A registrant expects to incur site restoration costs, post-closure and monitoring costs, or other environmental exit costs at the end of the useful life of the asset. Would the staff object to the registrant's proposal to accrue the exit costs over the useful life of the asset?

Interpretive Response: No. This is an established accounting practice in some industries. In other industries, the staff will raise no objection to that accounting provided that the criteria in paragraph 8 of SFAS 5 are met. The staff acknowledges that in some circumstances the use of the asset in operations gives rise to growing exit costs that represent a probable liability. The accrual of the liability should be recognized as an expense in accordance with the consensus on EITF Issue 90-8, "Capitalization of Costs to Treat Environmental Contamination." See interpretive responses to questions 7 and 8 for guidance on appropriate disclosures.

TOPIC 2: BUSINESS COMBINATIONS

* * * * *

A: Purchase Method

7. Loss contingencies assumed in a business combination.

Facts: A registrant acquires a business enterprise in a transaction accounted for by the purchase method. In connection with the acquisition, the acquiring company assumes certain contingent liabilities of the acquired company.

Question: How should the acquiring company account for and disclose contingent liabilities that have been assumed in a business combination?

Interpretive Response: In accordance with *Accounting Principles Board Opinion No. 16,* "Business Combinations," the acquiring company should allocate the cost of an acquired company to the assets acquired and liabilities assumed based on their fair values at the date of acquisition. With respect to contingencies for which a fair value is not determinable at the date of acquisition, the guidance of *Statement of Financial Accounting Standards No. 5,* "Accounting for Contingencies" and *Financial Accounting Standards Board Interpretation No. 14,* "Reasonable Estimation of the Amount of a Loss" should be applied. If the registrant is awaiting additional information that it has arranged to obtain for the measurement of a contingency during the allocation period specified by *Statement of Financial Accounting Standards No. 38,* "Accounting for Preacquisition Contingencies of Purchased Enterprises," the staff believes that the registrant should disclose that the purchase price allocation is preliminary. In that circumstance, the registrant should describe the nature of the contingency and furnish other available information that will enable a reader to understand its potential effects on the final allocation and on post-acquisition operating results. Management's Discussion and Analysis should include appropriate disclosure regarding any unrecognized preacquisition contingency and its reasonably likely effects on operating results, liquidity, and financial condition.

The staff believes that the allocation period should not extend beyond the minimum reasonable period necessary to gather the information that the registrant has arranged to obtain for purposes of the estimate. Since an allocation period usually should not exceed one year, registrants believing that they will require a longer period are encouraged to discuss their circumstances with the staff. If it is unlikely that the liability can be estimated on the basis of information known to be obtainable at the time of the initial purchase price allocation, the allocation period should not be extended with respect to that liability. An adjustment to the contingent liability after the expiration of the allocation period would be recognized as an element of net income.

TOPIC 10: UTILITY COMPANIES

* * * * *

F. Presentation of Liabilities for Environmental Costs

Facts: A public utility company determines that it is obligated to pay material amounts as a result of an environmental liability. These amounts may relate to, for example, damages attributed to clean-up of hazardous wastes, reclamation costs, fines, and litigation costs.

Question 1: May a rate-regulated enterprise present on its balance sheet the amount of its estimated liability for environmental costs net of probable future revenue resulting from the inclusion of such costs in allowable costs for rate-making purposes?

Interpretive Response: No. *Statement of Financial Accounting Standards No. 71,* "Accounting for the Effects of Certain Types of Regulation," ("SFAS 71") specifies the conditions under which rate actions of a regulator can provide reasonable assurance of the existence of an asset. The staff believes that environmental costs meeting the criteria of paragraph 9[7] of SFAS 71 should be presented on the balance sheet as an asset and should not be offset against the liability. Contingent recoveries through rates that do not meet the criteria of paragraph 9 should not be recognized either as an asset or as a reduction of the probable liability.

Question 2: May a rate-regulated enterprise delay recognition of a probable and estimable liability for environmental costs which it has incurred at the date of the latest balance sheet until the regulator's deliberations have proceeded to a point enabling management to determine whether this cost is likely to be included in allowable costs for rate-making purposes?

Interpretive Response: No. *Statement of Financial Accounting Standards No. 5,* "Accounting for Contingencies," states that an estimated loss from a loss contingency shall be accrued by a charge to income if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. The staff believes that actions of a regulator can affect whether an incurred cost is capitalized or expensed pursuant to SFAS 71, but the regulator's actions cannot affect the timing of the recognition of the liability.

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[1] Paragraph 3 of SFAS 5 defines probable as "likely to occur."

[2] Paragraph 7 of Accounting Principles Board Opinion No. 10, "Omnibus Opinion." Also, FASB Technical Bulletin 88-2, "Definition of a Right of Setoff."

[3] As described in paragraph 4(a) of *Statement of Financial Accounting Standards No. 76*, "Extinguishment of Debt."

[4] The staff believes there is a rebuttable presumption that no asset should be recognized for a claim for recovery from a party that is asserting that it is not liable to indemnify the registrant. Registrants that overcome that presumption should disclose the amount of recorded recoveries that are being contested and discuss the reasons for concluding that the amount is probable of recovery.

[5] See Securities Act Release No. 6130 (September 27, 1979) and Financial Reporting Release No. 36 (May 18, 1989).

[6] See, for example, footnote 30 of Financial Reporting Release No. 36 (footnote 17 of Section 501.02 of the Codification of Financial Reporting Policies).

[7] Paragraph 9 of SFAS 71 requires a rate-regulated enterprise to capitalize all or part of an incurred cost that would otherwise be charged to expense if it is probable that future revenue will be provided to recover the previously incurred cost from inclusion of the costs in allowable costs for rate-making purposes.

GASB Literature

A-16. Although this SOP does not include state and local governmental entities in its scope,[18] guidance issued by the GASB may be relevant to some reporting entities applying this SOP.

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[18] Under the provisions of Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting,* paragraph 7, proprietary activities may apply *all* FASB Statements and Interpretations issued after November 30, 1989, *except for* those that conflict with or contradict GASB pronouncements. Paragraph 33 of the Basis For Conclusions of that Statement explains that, for proprietary activities that apply paragraph 7, an AICPA SOP or Industry Audit and Accounting Guide that does not include governmental entities in its scope but that has been cleared by the FASB would be considered category (b) guidance under SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, issued by the Auditing Standards Board (ASB) of the AICPA.

A-17. GASB Statement No. 18, *Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs*, which is effective for financial statements for periods beginning after June 15, 1993, applies to state and local governmental entities that are required by federal, state, or local laws or regulations to incur closure and postclosure care costs on landfills.

A-18. Under GASB Statement No. 18, the estimated total current cost of a landfill closure and postclosure care includes the following (measured in terms of current dollars):

- Cost of equipment expected to be installed and facilities expected to be constructed near or after the date the landfill stops accepting solid waste and during the postclosure period.
- Cost of the final cover (capping) expected to be applied near or after the date the landfill stops accepting solid waste.
- Cost of monitoring and maintaining the expected usable landfill area during the postclosure period.

A-19. A portion of the estimated total current cost of a landfill closure and postclosure care is required to be recognized as an expense and as a liability in each period the landfill accepts solid waste, and recognition is to be completed by the time the landfill stops accepting waste. The cumulative effect of changes in the estimate of the current cost of landfill closure and postclosure care (including the impact of inflation) is recognized in the period of the change.

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Appendix B

Remediation Liability Case Study

B-1. *The following case study illustrates the application of the recognition and measurement guidance provided in this SOP; it does not illustrate all disclosure requirements set forth in this SOP. The case study is not intended to be used to evaluate financial statements issued prior to the effective date of this SOP.*

Typical Superfund Off-Site Scenario

Prior to 1980, the XYZ Manufacturing Company contracted with a state-licensed waste hauling contractor to remove specified, nonhazardous solid and liquid industrial waste from one of its plants for disposal off-site at a state-licensed disposal facility. A purchase order was let, and the work was performed. The contractor complied with all applicable laws and regulations, and monthly reports were filed with appropriate state environmental agencies.

1986

In 1986, the company received an information request from the United States Environmental Protection Agency (EPA) pursuant to section 104 of the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA). The information request stated that the EPA believed that hazardous substances at a site, now listed by the EPA on its National Priorities List (NPL), were generated at XYZ's plant. XYZ was named as a potentially responsible party (PRP) and was directed by the EPA, under penalty of law, to search its records exhaustively and answer a series of questions possibly implicating it directly to the site, or indirectly by its having used one or more transporters the EPA said it was also investigating.

XYZ searched its records as directed and determined late in 1986 that it had, in fact, contributed hazardous substances to the site. XYZ could not, however, determine how significant the hazardous substances it had sent to the site were in relation to the total population of hazardous substances at the site. The minimum remediation cost, including a minimum amount of legal fees, that XYZ was able to estimate was not material to its financial statements. XYZ was able, however, to determine that it was reasonably possible that its ultimate liability could be material.

1987

The EPA identified a number of waste generators, transporters, and site owner/operators as likely PRPs. The identified PRPs were invited to a meeting at which government lawyers requested that one or more of the PRPs voluntarily perform a remedial investigation/feasibility study (RI/FS) to evaluate existing site conditions (including a public health and ecological risk assessment) and to develop a proposed array of remedial alternatives from which the EPA would select a remedy and demand that it be implemented. Standardized EPA terms and conditions, stipulated penalty provisions, and indeterminate scope of work elements inhibited voluntary agreement among the PRPs, and so a consent decree was not achieved.

1988

The EPA asserted the existence of "imminent and substantial endangerment" at the site early in 1988 under section 106 of CERCLA, and it issued a unilateral administrative order to the PRP with the deepest pockets—XYZ—to undertake the RI/FS.

Because treble damages are authorized under section 106 of CERCLA, XYZ agreed to conduct the RI/FS specified in the order and demanded that other identified PRPs participate in the effort. XYZ initially estimated the cost that would be incurred to perform the RI/FS to be between $1 million and $2 million. Based on the limited information that was available about the site, information that XYZ had about its contribution to the site, and the number and financial condition of other PRPs, XYZ initially estimated that its ultimate share of this cost would prove to be in the range of 20 percent to 50 percent. XYZ also estimated that it would incur legal costs related to the remediation effort of $200,000 to $2 million in addition to any legal costs that might be incurred by any PRP group that might be formed. No amounts within any of these ranges were considered to be better estimates than any other amounts within any of these ranges. Because of a lack of information about the type and extent of the remediation effort that could be required, no range of cost of the overall remediation effort could be developed at this time.

Under threat of a contribution lawsuit by XYZ, a PRP group was formed late in 1988. The PRP group had three objectives: (1) to implement the requirements of the unilateral administrative order in the most cost-effective and scientifically valid way, (2) to raise money and allocate costs among the PRPs willing to perform the work based on the types and relative quantities of wastes shipped to the site or another agreed-upon formula, and (3) to recover costs from nonparticipating PRPs, if possible.

1989

Because of the lack of a good data base of factual information upon which to make sound allocation decisions agreeable to all, outside arbitration was utilized in 1989 to allocate "fair share" costs among participating PRPs. The arbitrator preliminarily apportioned 65 percent of the costs for the site to the four participating PRPs, as follows:

XYZ	20%
PRP No. 2	20
PRP No. 3	15
PRP No. 4	10
	65%
Orphan share	25
Recalcitrant share	10
	100%

Twenty-five percent of the site was determined to be the "orphan share," for which no PRP could be identified. Ten percent was attributed to two recalcitrant (nonparticipating) PRPs, and there was insufficient information to overcome the presumption that costs will be allocated only among the participating PRPs.

XYZ gained some understanding of the other participating PRPs' financial condition and believed each of them was able and likely to pay its full share of the costs of the RI/FS. XYZ was concerned, however, about the ability of PRP No. 3 to pay its full share of the cost of the overall remediation effort.

Based on the amount already spent on legal costs and the results of PRP organization efforts, XYZ determined that $350,000 was the best estimate of its separate legal costs. The estimate of the costs that will be incurred to perform the RI/FS, which now included group administration costs, now stood at $1.2 million to $2.2 million.

1991

The RI/FS was substantially completed in 1991. No changes were made to the PRP allocation percentages as a result of the RI/FS completion. The PRP group's initial estimate of the cost of implementing the remedy expected to be required by the EPA was $25 million to $30 million. No amount within this range was considered to be a better estimate than any other amount within the range. This estimate included estimates of the cost of all elements of the remediation effort, including common legal, engineering, construction, monitoring, operation and maintenance costs (including postremediation monitoring for a period of thirty years), and so forth.

XYZ believed that PRP No. 2 and PRP No. 4 could and would pay their full shares of the cost of the remediation effort. PRP No. 3, however, indicated that, because of its deteriorating financial position, it would likely be unable to pay more than two-thirds of its 15 percent share and none of its allocated amount attributed to the orphan and recalcitrant shares, or 10 percent of those costs. XYZ shared PRP No. 3's views about PRP No. 3's ability to pay.

1992

Three years after site studies began, the EPA and its outside contractors evaluated the reports submitted under the terms of the unilateral administrative order. A record of decision (ROD) was issued by the EPA on September 30, 1992, in which remedial actions based on the RI/FS were selected and cost estimates were presented. The PRPs were requested to voluntarily implement the ROD and again sign up to the terms demanded by the government. No preenforcement federal court review is permitted, even if the remedy specified in the ROD is scientifically flawed, unattainable by available, proven technology, non-cost-effective, or open-ended. The PRPs had the following choices: perform the remedy specified in the ROD voluntarily, or refuse to do work, in which case the EPA would either issue another unilateral administrative order or perform the work using its contractor procurement systems and sue the PRPs for cost recovery. The PRPs agreed to perform the remedy specified in the ROD and entered into a consent judgment.

Note: The law requires the EPA to review the ROD and remedy within five years of its implementation by the PRPs. If the objectives of the ROD have not been attained, the EPA may make additional demands on the PRPs. If one or more PRPs believe they have paid a disproportionate share of the costs, they may track down other PRPs and sue them in a contribution action. Although requests for reimbursement from Superfund can also be made for allocations attributed to unidentified or unknown parties (the orphan share) under certain conditions, this is not usually allowed by terms and conditions of consent order settlements with EPA.

Discussion of Case

FASB Statement No. 5, *Accounting for Contingencies,* requires accrual of a loss contingency when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Receipt in 1986 of an information request did not establish that a liability was probable because, notwithstanding the EPA's interest in XYZ's connection, if any, to the site, it had not been established that XYZ was in fact associated with the site. As noted in chapter 5 of the SOP, however, "receipt of notification that an entity may be a PRP compels the entity to action."

When XYZ determined late in 1986 that it had, in fact, contributed hazardous substances to the site, the liability became probable. The criteria for recognition had not yet been met, however, because XYZ did not have sufficient information to reasonably estimate a minimum amount in the range of its liability that would be material to its financial statements. Disclosure of the nature of the contingency and a statement that an estimate of the loss or range of loss cannot be made was required under FASB Statement No. 5.

During 1987, little additional information that would aid XYZ in making an estimate of the loss or range of loss became available. Therefore, the accounting and disclosure for the contingent loss related to the remediation liability remained the same.

In 1988, when XYZ agreed to perform an RI/FS in accordance with the EPA's unilateral administrative order and the PRP group was formed, XYZ should have recorded a liability of $400,000, computed as follows:

XYZ's estimated share of the minimum amount in the range of the estimated cost of the RI/FS [*20 percent of $1,000,000*]	$200,000
XYZ's minimum estimate of its legal costs	200,000
	$400,000

Because other PRPs had agreed during 1988 to participate in the RI/FS effort, they are considered to be participating PRPs. Neither the fact that the unilateral administrative order named only XYZ nor the fact that a preliminary cost-sharing formula had not yet been determined by the arbitrator should have required XYZ to accrue more than its estimated allocable share of the minimum estimated liability.

Although no recognition benchmarks were achieved in 1989 or 1990, XYZ should have refined its estimate of its liability as additional significant information became available. For example, in 1989, when the preliminary cost-sharing formula was developed by the arbitrator and the estimate of the cost of the RI/FS was revised, XYZ should have refined its estimate of its share of the cost of the RI/FS and adjusted its liability to $719,231, less any amounts already expended. $719,231 is computed as follows:

XYZ's allocable share of the minimum amount in the range of the estimated cost of the RI/FS [*20 percent of $1.2 million*]	$240,000
XYZ's pro rata share of amounts allocable to other parties but that are not expected to be paid by those other parties [*20/65 of 35 percent of $1.2 million*]	129,231
XYZ's estimated legal costs	350,000
	$719,231

By the time the feasibility study was substantially completed in 1991, XYZ should have adjusted its liability to reflect its estimated share of the minimum amount of the overall remediation liability. Based on the facts presented, this amount should be $9,350,000, less any amounts already expended. $9,350,000 is computed as follows:

20% of $25 million	$5,000,000
20/65 of 35 percent of $25 million	2,692,308
20/50 of amount allocable to PRP No. 3 that is not expected to be paid by PRP No. 3 [*20/50 of 5 percent of $25 million plus 20/50 of 15/65 of 35 percent of $25 million*]	1,307,692
Estimated legal costs	350,000
	$9,350,000

The estimate of the environmental remediation liability should be further refined when the ROD is issued in 1992 and at various other points when additional information becomes available.

The measurement of the remediation liability should not have been discounted at any point during the period under discussion because the amount of the obligation and the amount and timing of cash payments were not fixed or reliably determinable.

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Appendix C

Auditing Environmental Remediation Liabilities

This section presents the recommendations of the Environmental Issues Task Force of the Auditing Standards Board regarding the application of generally accepted auditing standards to the audit of an entity's financial statements as it relates to environmental remediation liabilities. Members of the AICPA's Auditing Standards Board have found this guidance to be consistent with existing auditing standards. AICPA members should be prepared to justify departures from this guidance.

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Introduction and Scope

C-1. The accounting and disclosure issues related to environmental remediation liabilities are complex. The exposure to such liabilities and the controls implemented by entities to identify and evaluate these liabilities vary from entity to entity. Estimates of environmental remediation liabilities usually are predicated on subjective information and numerous judgments about how matters will be resolved in the future. Such matters generally increase audit risk in an audit of financial statements in accordance with generally accepted auditing standards (GAAS).

C-2. Management is responsible for establishing and maintaining controls that will enable it to identify, evaluate, and account for litigation, claims, and assessments and to reflect them in the financial statements in conformity with GAAP. FASB Statement No. 5, *Accounting for Contingencies,* requires accrual of a liability when (*a*) information available prior to issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements, and (*b*) the amount of the loss can be reasonably estimated. FASB Statement No. 5 also requires certain disclosures about contingencies. Chapters 5 to 7 of this SOP provide guidance on applying FASB Statement No. 5 to matters involving environmental remediation liabilities.

C-3. The guidance in this section focuses on planning, performing, and reporting on an audit of financial statements in accordance with GAAS as it relates to auditing environmental remediation liabilities arising from Superfund laws, the corrective action provisions of the Resource Conservation and Recovery Act of 1976 (RCRA), and other analogous federal, state, and non-United States laws and regulations. The guidance is not intended to apply to other types of environmental engagements, such as engagements to report on compliance with environmental laws and regulations as performed under Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation.* However, certain aspects of this guidance may be useful in such engagements. This appendix does not provide guidance on auditing the liabilities of insurance companies for unpaid claims or auditing asset impairment.

Audit Planning and Objectives

Understanding the Business

C-4. Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision*, presents guidance on planning the audit of an entity's financial statements. Planning involves the development of an overall strategy for the expected conduct of an audit. SAS No. 22 recognizes that the nature, timing, and extent of the planning will vary with the size and complexity of the entity whose financial statements are being audited and with the auditor's experience with the entity and knowledge of the entity's business. As part of the planning process, the auditor should obtain an understanding of the accounting and disclosure requirements for environmental remediation liabilities, which are set forth in chapters 5 to 7 of this SOP. As stated in paragraphs 6 to 8 of SAS No. 22, the auditor should obtain a level of knowledge about matters related to the nature of the entity's business, its organization, and its operating characteristics that will enable the auditor to plan and perform the audit in accordance with GAAS. Examples of such matters that pertain to environmental remediation liabilities include the following:

- The industry or industries in which the entity operates
- The types of products or services provided by the entity
- The number and characteristics of the entity's locations
- Applicable governmental regulations
- Production and distribution processes

Knowledge about such matters ordinarily is obtained through experience with the entity or its industry and inquiry of entity personnel. Inquiries about environmental remediation liabilities might be directed to accounting, finance, operations, environmental, compliance, or legal personnel. Other useful sources of information about environmental remediation liabilities may include industry publications, financial statements, and other publicly available information from entities in the same industry, and information available from regulatory agencies.

C-5. Questions that might be asked of entity personnel to obtain an understanding of potential environmental remediation liabilities to which an entity may be exposed include the following:

- What controls are in place to identify potential environmental remediation liabilities or related contingencies affecting the entity?
- Has the entity been designated as a PRP by the EPA under the Superfund laws or by state regulatory agencies under analogous state laws?
- If the entity has been designated as a PRP, are there any pending civil or criminal investigations or actions?
- Have regulatory authorities or environmental consultants issued any reports about the entity, such as site assessments or environmental impact studies?
- Are landfills or underground storage tanks used to store or dispose of environmentally hazardous substances?
- Is the entity required to have environmental permits, such as hazardous waste transporter permits or hazardous waste treatment, storage, and disposal permits?
- For property sold, abandoned, purchased, or closed, are there any requirements for site cleanup or for future removal and site restoration?
- Have there been any violations of environmental laws, such as the Superfund laws and the corrective action provisions of RCRA?

It also may be helpful when planning the audit of environmental remediation liabilities to review minutes of meetings of the board of directors (or committees) and reports related to such matters prepared by the entity's internal auditors, compliance officers, or other individuals responsible for such matters.

C-6. Depending on the extent of the entity's exposure to environmental remediation liabilities, the auditor may decide to involve personnel knowledgeable about such matters in the audit and to use the work of a specialist.

Audit Objectives

C-7. It is management's responsibility to develop appropriate estimates of environmental remediation liabilities for use in the preparation of the financial statements. It is the auditor's responsibility to evaluate the reasonableness of those estimates in forming his or her opinion on the financial statements taken as a whole. Most of the auditor's work in forming his or her opinion consists of obtaining and evaluating evidential matter concerning assertions in the financial statements. Assertions are representations by management that are embodied in the financial statement components. With respect to environmental remediation liabilities, the relevant financial statement assertions and the related objectives of the auditor are shown in the following table:

Assertions	*Objective*
Completeness and valuation	To determine whether all environmental remediation liabilities that should be presented in the financial statements are identified and reflected in the financial statements in conformity with GAAP
Presentation and disclosure	To determine whether environmental remediation liabilities and contingencies are classified, described, and disclosed in the financial statements in conformity with GAAP

The auditor assesses inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures that will be performed to achieve these objectives.

Assessing Audit Risk

C-8. Once the auditor has obtained an understanding of the potential environmental remediation liabilities to which the entity may be exposed, he or she should make preliminary judgments about materiality and should assess audit risk. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, provides guidance to the auditor on assessing audit risk and materiality when planning and performing an audit of an entity's financial statements. Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Audit risk is composed of inherent risk, control risk, and detection risk.

C-9. *Inherent Risk.* SAS No. 47 defines inherent risk as the susceptibility of an assertion to a material misstatement, assuming there are no related internal controls. In assessing inherent risk for assertions about environmental remediation liabilities, the auditor should consider the knowledge he or she has obtained about the industry in which the entity operates. Certain industries, by nature, tend to have a significant risk of exposure to environmental remediation liabilities. Examples of such industries include chemicals, oil and gas, pharmaceuticals, mining, and utilities. However, an entity need not operate in one of these industries to be exposed to environmental remediation liabilities. Examples of other industries with potential exposure to environmental remediation liabilities are real estate, banking, insurance, and health care. Certain research and development activities (including those engaged in by some not-for-profit entities) also may be subject to significant exposures.

C-10. Certain transactions, such as past acquisitions involving real property (including acquisitions by a creditor pursuant to default by a debtor), may expose an entity to environmental remediation liabilities. Under the Superfund laws, current and former owners of land may be responsible for clean-up costs. Situations such as the following may indicate the existence of potential environmental remediation liabilities:

- Past or current ownership of property on which hazardous substances are being or were disposed of
- Recent purchases of property at prices that appear to be significantly below market
- Sales of contaminated land under arrangements whereby the seller retains responsibility for clean-up pursuant to indemnification clauses
- Aborted real estate sales transactions
- Sales of businesses involving the retention of real property by the seller

C-11. When assessing inherent risk, the auditor should recognize that estimates of environmental remediation liabilities are affected by factors that management cannot control, such as the actions of regulators and the recommendations and opinions of technical and engineering experts. For this reason, the evaluation of environmental remediation liabilities usually involves considerable analysis and subjective estimation by management and the assistance of third parties such as attorneys and environmental engineers.

C-12. *Control Risk.* SAS No. 47 defines control risk as the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, identifies the components of internal control and explains how an independent auditor should consider internal control in planning and performing an audit. An entity's internal control consists of five components: control environment, risk assessment, control activities, information and communication, and monitoring. For an entity with potential exposure to environmental remediation liabilities, the auditor's understanding of the entity's internal control generally should extend to controls designed to help management identify and evaluate environmental remediation liabilities and loss contingencies. The level of sophistication of an entity's internal control as it relates to environmental remediation matters varies from entity to entity. Relevant factors that an entity might consider when designing its internal control include such matters as the extent of exposure to which the entity is subject, the geographical diversity of the entity, and the remediation activities undertaken or expected to be required. Some entities have specially designed systems for data collection and quantification, and expert personnel involved in the evaluation and oversight of remediation activities. Other entities have less formal means of gathering information and may rely on outside parties to assist management in its evaluation and oversight of remediation activities.

C-13. SAS No. 55 also provides guidance on assessing control risk. The auditor may decide to perform tests of controls, to the extent deemed appropriate in the circumstances, to determine whether control risk may be assessed at less than the maximum level. In other cases, the auditor may assess control risk at the maximum level for all or a portion of the financial statement assertions related to environmental remediation liabilities because the auditor believes that the controls are unlikely to be effective or because evaluating the effectiveness of the controls would be inefficient. The auditor's assessment of inherent risk and control risk, as discussed above, forms the basis for his or her decisions about the nature, timing, and extent of substantive audit procedures to be performed.

Substantive Audit Procedures

C-14. Substantive audit procedures are designed to obtain sufficient competent evidential matter related to the audit objectives. The auditor's substantive tests of environmental remediation liabilities generally consist of testing the accounting estimates recorded by management, making inquiries of legal counsel or identified specialists, and obtaining representations from management.

C-15. SAS No. 57, *Auditing Accounting Estimates,* provides guidance to the auditor on obtaining and evaluating sufficient competent evidential matter to support financial statement assertions that are based on significant accounting estimates. When evaluating the reasonableness of the estimates of environmental remediation liabilities, the auditor should first understand how management developed the estimates. Based on that understanding, the auditor should use one or a combination of the following approaches set forth in SAS No. 57 to audit the estimate.

a. Review and test the process used by management to develop the estimate.

b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.

c. Review subsequent events or transactions occurring prior to the completion of fieldwork.

When auditing environmental remediation liabilities, approaches *a* and *b*, or a combination thereof, usually will be most effective. Approach *c*, taken alone, normally will not be effective because remediation costs are expended over a long period of time, usually extending well beyond the completion of fieldwork.

C-16. The auditor should select the approach or approaches based on his or her judgment as to the degree of evidential matter necessary in the circumstances, including consideration of the approach or approaches expected to be most efficient. Because of the complexity involved in developing estimates of environmental remediation liabilities, including the possible need to use the work of a specialist, approach *a* normally will be most efficient.

Reviewing and Testing the Process Used by Management to Develop the Estimate

C-17. The auditor may evaluate the reasonableness of estimates of environmental remediation liabilities by reviewing the process used by management to develop the estimate and by performing procedures to test it. This approach often is the most appropriate when the estimates are developed by or based on the work of an environmental specialist.

C-18. SAS No. 57 identifies the following as procedures the auditor may consider performing when using this approach:

a. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation. Some of the more common controls over the preparation of estimates of environmental remediation liabilities that might be considered by the auditor include—

- The nature and extent of monitoring by senior management or the board of directors of the entity's consideration of environmental remediation liabilities.
- The nature and extent of procedures in place for assessing compliance with applicable environmental laws and regulations and for evaluating possible violations.
- The nature and extent of procedures in place for involving appropriate operating, financial, legal, and compliance personnel in monitoring the entity's environmental remediation liabilities, and in developing the estimates.
- The information systems used by the entity to compile and access data about the entity's waste generation, emissions, and other environmental impacts.
- The entity's use of environmental specialists, including its procedures for determining whether the specialists have the requisite skill or knowledge regarding environmental remediation matters, knowledge of the entity's business, and understanding of the available methodologies for calculating environmental remediation cost estimates.
- The procedures in place for verifying that data about the nature, destinations, and volumes of hazardous substances or wastes are appropriately collected, classified, and summarized.
- The procedures in place for assessing the appropriateness of industry or other external sources of data used in developing assumptions (for example, information provided by other PRPs, regulatory authorities, and industry associations) and, where applicable, for substantiating such information.

b. Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose, based on information gathered in other audit tests. Sources of data and factors used may include—

- Internal company records, such as payroll records for employees who devote significant time directly to environmental remediation efforts.
- Information from published sources about socioeconomic trends or other factors that might affect environmental remediation liabilities, such as inflation rates, judicial decisions, and enacted changes in legislation affecting remediation methods or definitions of hazardous substances.

c. Consider whether there are additional key factors or alternative assumptions about the factors. Key factors that might be considered include—

- Information about environmental remediation liabilities included in the response to the inquiry of the entity's lawyer.
- Studies or reports by environmental consultants.
- Reports, notices, or correspondence issued by regulatory authorities.

d. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data. Assumptions that might be evaluated include—

- Allocations of remediation responsibilities (and consequently the attendant liabilities) among PRPs.
- Remediation technologies and expected time frames.
- Postclosure monitoring requirements.

e. Analyze historical data used in developing the assumptions to assess whether the data are comparable and consistent with data of the period under audit, and consider whether the data are sufficiently reliable for this purpose. Factors to consider include—

- Whether the entity's current process for estimating environmental remediation liabilities has resulted in reasonably accurate, appropriate estimates in prior periods, and the extent to which current data indicate changes from prior experience.
- Whether changes in the entity's business have been factored into the estimate.
- Relationships between estimates of liabilities for one location and estimates or actual costs incurred for similar locations.

f. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.

g. Review available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the entity, as well as consider their relationship to the assumptions. Consider the following, for example:

- Practices concerning the resolution of environmental contingencies that may have a significant effect on the entity's ultimate environmental remediation liability (for example, a practice of vigorously contesting remediation plans proposed by regulators as opposed to a practice of tacitly accepting those plans)
- Plans to sell, dispose of, or abandon specific facilities
- Financial statements or other information used by management to assess participating PRPs' abilities to pay their allocable shares of the estimated environmental remediation liability

h. Consider using the work of a specialist regarding certain assumptions.

i. Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.

Developing an Independent Expectation of the Estimate

C-19. The auditor may decide to develop an independent expectation of the estimate of environmental remediation liabilities generally by using the work of an environmental specialist. For example, the auditor might use this approach if management has not engaged or employed an environmental specialist, or to assess the reasonableness of, or the effects of alternative key factors and assumptions on, an estimate prepared by a specialist engaged or employed by management.

Using the Work of a Specialist

C-20. Because of the complexity of environmental remediation activities and the difficulties involved in developing estimates of environmental remediation liabilities, management often will engage or employ a specialist to perform this work. Examples of such specialists are remediation technologies specialists, responsibility allocation specialists, claims specialists, environmental engineers, and environmental attorneys.

C-21. Specialists might be involved in one or more stages of the process of developing estimates of environmental remediation liabilities, including—

- Identifying situations for which remediation is required.
- Designing or recommending a remedial action plan for the entity.
- Gathering and analyzing data on which to base the estimates of remediation costs (for example, performing a baseline risk assessment).
- Providing information to management that will enable management to estimate the entity's environmental remediation liability and develop the related financial statement disclosures.

C-22. As noted previously, the process of estimating environmental remediation liabilities usually is complex and involves many subjective judgments. Consequently, the auditor may decide to use the work of a specialist to evaluate financial statement assertions about environmental remediation liabilities. SAS No. 73, *Using the Work of a Specialist*, provides guidance to the auditor who uses the work of a specialist in performing an audit.

C-23. *Qualifications and Work of a Specialist.* SAS No. 73 also provides guidance on matters the auditor should consider when evaluating the professional qualifications of a specialist to determine whether the specialist possesses the necessary skill or knowledge in a particular field. The specialist's level of skill or knowledge should be commensurate with the nature and complexity of the entity's environmental remediation liabilities that the specialist has been asked to address. Matters that might be relevant in evaluating the professional qualifications of a specialist include—

- Knowledge of various remediation technologies, including their acceptability, strengths, weaknesses, and applicability.
- Knowledge of environmental remediation issues that are likely to affect the entity, including legal, regulatory, industry, and social developments.
- Technical or educational background related to environmental remediation matters.

- Work experience related to environmental remediation matters.

C-24. The auditor should obtain an understanding of the nature of the work performed or to be performed by the specialist. That understanding should include—

- The objectives and scope of the specialist's work, for example, whether the specialist is engaged to perform a baseline risk assessment or a feasibility study.
- The specialist's relationship to the entity, if any.
- The methods and assumptions used by the specialist, including, for example, a comparison of the methods and assumptions used by the specialist with those used by management or other specialists, or with those used in the preceding period.
- The appropriateness of using the specialist's work for the intended purpose. In some cases, the auditor may decide it is necessary to contact the specialist to determine whether the specialist is aware that his or her work will be used for evaluating assertions in the financial statements.
- The form and content of the specialist's findings, for example, the extent of detail included or to be included in the report.

Reports issued by environmental specialists are not standard in their form or content and do not always clearly express the underlying assumptions or methods used by the specialist. Communication with the specialist in these circumstances may assist the auditor in obtaining the necessary understanding.

C-25. *The Specialist's Relationship to the Entity.* If a specialist is employed by an entity, or otherwise has a relationship that might directly or indirectly influence the findings of the specialist, the auditor should assess the risk that the specialist's objectivity might be impaired. Factors that the auditor might consider when determining whether the specialist's objectivity might be impaired include the auditor's prior experience with the specialist, discussions with the specialist and management, and additional information about the specific nature and significance of the relationship. If the auditor concludes that the specialist's objectivity might be impaired, the auditor should perform additional procedures with respect to the specialist's work, for example, engaging another specialist to review some or all of the related specialist's work.

C-26. *Using the Findings of the Specialist.* The specialist is responsible for the appropriateness and reasonableness of the methods and assumptions used and for their application. However, the auditor should (*a*) obtain an understanding of the methods and assumptions used by the specialist, (*b*) make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and (*c*) evaluate whether the specialist's findings support the related financial statement assertions.

C-27. If the auditor concludes that the specialist's findings are unreasonable, the auditor should apply additional procedures that may include obtaining the opinion of another specialist.

Auditing Potential Recoveries

C-28. Potential claims for recovery from insurers, PRPs other than participating PRPs, prior property owners, and governmental or third-party funds should be evaluated separately from the environmental remediation liability. To evaluate whether the recovery of a potential claim is probable, correspondence or communication with others such as the insurer, PRPs other than participating PRPs, or legal counsel generally is necessary. Requests for confirmation of recoverable amounts from such parties should be carefully designed to ensure that the parties fully understand what is being requested. Also, because confirmations do not necessarily provide sufficient evidence regarding the realizability of such amounts, the auditor may need to obtain other evidence to evaluate the realizability of recorded recoverable amounts. As noted in paragraph .141 of this SOP, if a claim is the subject of litigation, a rebuttable presumption exists that realization of the claim is not probable. SAS No. 67, *The Confirmation Process*, provides guidance to the auditor about the confirmation process in audits performed in accordance with GAAS.

Inquiries of a Client's Lawyer

C-29. The auditor should consider requesting information about environmental remediation liabilities and loss contingencies in the letter of inquiry sent to the entity's counsel because such matters frequently involve litigation. The letter of inquiry of a client's lawyer should include a list prepared by management (or a request by management that the lawyer prepare a list) that describes each of the matters the lawyer is currently handling and the expected outcomes of those matters. SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, provides guidance on the procedures an auditor should consider performing to identify litigation, claims, and assessments and to satisfy himself or herself as to the financial reporting and disclosure of such matters.

Client Representations

C-30. The auditor should consider obtaining written representations from management about estimates and disclosures of environmental remediation liabilities and loss contingencies affecting the financial statements, including specific representations as to the adequacy of such disclosures and the expected outcomes of uncertainties. SAS No. 19, *Client Representations,* provides guidance to the auditor about representations to be obtained from management as part of an audit.

Assessing Disclosures

C-31. Guidelines for disclosure related to environmental remediation liabilities and loss contingencies are presented in chapter 7 of this SOP. SAS No. 32, *Adequacy of Disclosure in Financial Statements,* requires the auditor to assess the adequacy of disclosures of material matters in the financial statements in connection with rendering an opinion on the presentation of financial statements in conformity with GAAP. In the context of environmental remediation loss contingencies, the auditor should evaluate management's assessment of the likelihood of loss and ability to reasonably estimate the potential loss. If disclosure is required, the auditor should assess the adequacy of the disclosures, including any conclusions expressed by management regarding the expected outcome of such contingencies, based on evidence obtained, as applicable, from the following:

- Operating, environmental, legal, and financial management personnel
- Specialists

- Other audit tests

Evaluating Audit Test Results

C-32. The auditor should evaluate the results of tests of the environmental remediation liabilities and related disclosures in the context of the entity's financial statements taken as a whole. Other auditing literature that provides guidance on evaluating the results of audit tests includes SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* which provides guidance on the evaluation of audit test results, and paragraph 29 of SAS No. 47, which provides additional guidance on the auditor's responsibility for evaluating the reasonableness of estimates in relationship to the financial statements taken as a whole.

Reporting

C-33. Departures from GAAP or scope limitations related to environmental remediation liabilities or loss contingencies may require modification of the auditor's standard report on an entity's financial statements. SAS No. 58, *Reports on Audited Financial Statements,* provides guidance to the auditor on reporting when there is a GAAP departure or a scope limitation.

Departures From GAAP

C-34. Departures from GAAP involving environmental remediation liabilities or loss contingencies generally involve (1) inadequate disclosures, (2) the application of inappropriate accounting principles, or (3) unreasonable accounting estimates. The auditor should determine whether the presentation and disclosure of an environmental remediation liability or the disclosure of an uncertainty involving an environmental remediation loss contingency complies with the guidance in chapter 7 of this SOP. The auditor should also assess the appropriateness of the accounting policies used and the reasonableness of the estimates. Chapters 5 and 6 of this SOP present the accounting principles for the recognition and measurement of environmental remediation liabilities. If the auditor concludes that the financial statements are not fairly presented in all material respects because the accounting principles followed are inappropriate or misapplied, the disclosures are inadequate, or management's estimates are unreasonable, the auditor should express a qualified or adverse opinion.

Scope Limitations

C-35. The auditor should consider whether he or she has obtained sufficient competent evidential matter to support management's assertions about environmental remediation liabilities and loss contingencies and their presentation and disclosure in the financial statements. The auditor should distinguish between situations involving uncertainties and those involving scope limitations. An uncertainty exists if resolution of the environmental remediation loss contingency is expected to occur at a future date at which time conclusive evidential matter concerning the outcome of the uncertainty is expected to become available. However, if sufficient evidential matter currently exists or did exist but is not available to the auditor because of restrictions imposed by management, inadequate recordkeeping, or other conditions that prevent the auditor from gaining access to the information, a limitation on the scope of the auditor's work may exist sufficient to cause the auditor to qualify or disclaim an opinion because of a scope limitation.

Making Reference to a Specialist

C-36. Use of specialists is common in the determination and development of financial statement estimates of environmental remediation liabilities and disclosures related to environmental remediation loss contingencies. SAS No. 73 provides the auditor with guidance on considering the effect of the specialist's work on the auditor's report. That guidance precludes the auditor from referring to the work of a specialist in the auditor's report, because such reference might be interpreted as a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. However, the guidance permits the auditor to refer to the specialist in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for a departure from an unqualified opinion.

Accounting Changes

C-37. As indicated in paragraph .102 of this SOP, the effect of initially applying the provisions of this SOP may have elements of a change in accounting principle that are inseparable from a change in accounting estimate; accordingly, the effect shall be reported as a change in accounting estimate. If the initial application of the accounting guidance in this SOP has a material effect on the comparability of the financial statements, an explanatory paragraph should be added to the auditor's report pursuant to paragraph 12 of SAS No. 1, section 420, *Consistency of Application of Generally Accepted Accounting Principles.*

Communication With Audit Committees

C-38. SAS No. 61, *Communication With Audit Committees,* provides the auditor with guidance on the types of matters related to the scope and results of the audit that should be reported to the audit committee or those of equivalent authority and responsibility. Such matters include management judgments and accounting estimates. The auditor should determine whether the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates, such as those for environmental remediation liabilities, and the basis for the auditor's conclusions regarding the reasonableness of the estimates.

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Appendix D

Response to Comments Received

D-1. An exposure draft of a proposed SOP, *Environmental Remediation Liabilities (Including Auditing Guidance),* was issued for public comment on June 30, 1995. More than seventy comment letters were received in response to the exposure draft.

D-2. The majority of the comments related to the measurement of environmental remediation liabilities. A significant number of commentators also expressed concerns about a lack of symmetry in the measurement of the remediation liability and of any probable recoveries, about the proposed SOP's scope, and about the proposed transition provisions and effective date of the SOP. Some commentators also suggested that, because environmental remediation liabilities is a broad topic, it should be addressed by the FASB rather than the Accounting Standards Executive Committee (AcSEC).

D-3. These comments and AcSEC's responses to them are discussed below.

Scope

D-4. The exposure draft excluded from its scope accounting for remediation actions that are undertaken at the sole discretion of management and that are not induced by the threat of litigation or assertion of a claim or an assessment. A number of commentators recommended expanding the scope to include such actions, with the majority of them recommending that the SOP specifically permit or require the recording of a liability for voluntary remediation programs when management intends to undertake such programs.

D-5. AcSEC continues to believe that such remediation actions should be outside the scope of this SOP. AcSEC believes that addressing the issues would require a far broader project than this SOP was intended to be. Such a broader project would possibly need to be undertaken by the FASB rather than AcSEC since it might require reconsideration of the liability-recognition model established by FASB Statement No. 5, *Accounting for Contingencies.* Moreover, AcSEC believes this SOP, with its relatively narrow scope, will produce significant improvements in practice that should not be delayed unnecessarily.

Measurement of the Liability

D-6. The exposure draft provided that the measurement of the liability should include the following:

a. Incremental direct costs of the remediation effort

b. Costs of compensation and benefits for employees to the extent an employee is expected to devote time directly to the remediation effort

The exposure draft defined the remediation effort to include, among other things, the costs of defending against assertions of liability for remediation.

D-7. Many commentators stated that payroll and payroll-related costs, including the costs of in-house legal counsel, should be treated as period costs rather than being included in the measurement of the environmental remediation liability. Among the reasons cited were the following.

- Because environmental-affairs, technical, and legal personnel who devote time to the remediation effort would be employed by an entity even in the absence of an obligation to remediate a particular site, devoting a portion of their time to a particular site does not represent a sacrifice of economic benefits.
- Salaries and related costs that are not inventoriable generally are treated as period costs; such costs generally are not accrued as part of other kinds of liabilities.
- The cost of estimating and tracking this element of the accrual would be burdensome.
- Whether such costs should be included in the measurement of the liability should be considered by the FASB because of its implications to areas beyond environmental liabilities.

D-8. In addition, many commentators said that the cost of defending against assertions of liability, regardless of whether the defense is to be performed by in-house counsel or outside counsel, should be treated as a period cost. Among the reasons cited were the following.

- Costs of defending against assertions of liability are discretionary and, therefore, do not have one of the essential characteristics of a liability set forth in FASB Concepts Statement No. 6, *Elements of Financial Statements.*
- Such costs may be incurred before it can be determined whether a remediation liability exists.
- The guidance inevitably would be analogized to other kinds of liabilities. Accordingly, it would represent a *de facto* Interpretation of FASB Statement No. 5 that should be exposed and debated as such.

D-9. AcSEC believes that devoting the time of employees to a particular activity, by definition, represents a sacrifice of economic resources. AcSEC acknowledges that, in most situations, compensation and benefits for employees who are not involved with production of inventory are treated as a period cost. AcSEC believes, however, that the measurement of an environmental remediation liability should be based on the cost that will be incurred to extinguish the liability and that the measurement should not vary significantly merely because an entity chooses to satisfy elements of the liability using employees rather than outside contractors. The need to include internal costs in the measurement of a liability is addressed explicitly in various items of authoritative literature. FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* states in footnote 15, "If significant, the internal and external costs directly associated with administering the postretirement benefit plan also should be accrued as a component of assumed per capita claims costs." FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* states in paragraph 20, "A liability for all costs expected to be incurred in connection with the settlement of unpaid claims (claim adjustment expenses) shall be accrued when the related liability for unpaid claims is accrued. . . . Claim adjustment expenses also include other costs that cannot be associated with specific claims but are related to claims paid or in the process of settlement, such as internal costs of the claims function." SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* [section 10,330], states in paragraph 87 [section 10,330.87] that a provision for anticipated losses on contracts should include all costs of the type allocable to contracts under paragraph 72 of that SOP [section 10,330.72]. Paragraph 72 of SOP 81-1 [section 10,330.72] states that such costs include all direct costs, such as material, labor, and subcontracting costs, and the following indirect costs: the costs of indirect labor, contract supervision, tools and equipment, supplies, quality control and inspection, insurance, repairs and maintenance, depreciation and amortization, and, in some circumstances, support costs, such as central preparation and processing of payrolls.

D-10. Finally, AcSEC considered accounting literature that provides that certain internal cost be deferred or capitalized rather than treated as a period expense. FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* provides that direct loan-origination costs of a completed loan are to be offset against loan-origination fees and any excess deferred. Direct loan-origination costs include incremental direct costs incurred in transactions with independent third parties and certain costs directly related to specified activities performed by the lender. The costs directly related to those activities include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent for the origination of the loan.

D-11. AcSEC was concerned, however, that the requirement to include in the measurement of the environmental remediation liability the costs of compensation and benefits for all employees who are expected to devote time to the remediation effort would create an unjustified record keeping burden on reporting entities. Accordingly, the approach used in the SOP limited the inclusion of nonincremental direct costs to the costs of compensation and benefits for those employees who are expected to devote a *significant amount* of time directly to the remediation effort. AcSEC believes this approach will produce sound and useful reported information at a reasonable cost. As discussed in the SOP, the remediation effort does not include routine environmental compliance matters and costs involved with potential recoveries. Also, indirect internal costs such as administrative and occupancy costs are not included in the measurement of the environmental remediation liability.

D-12. AcSEC believes the cost associated with including the appropriate compensation and benefit costs in the measurement of the liability will not be excessive. In this regard, AcSEC notes that in many cases periodic adjustment of the liability could be performed by reestimating this component of the liability and that this SOP does not impose an obligation to use formal procedures such as time sheets for the development of the liability and to track the actual expenditures.

D-13. AcSEC acknowledges that the treatment of costs to defend against assertions of this and other kinds of liability is diverse: Some include such costs in the measurement of a liability for a loss contingency under FASB Statement No. 5, while the majority of practice treats litigation costs as period costs. AcSEC believes that any authoritative guidance on the treatment of such costs should be developed as a broad issue with appropriate due process. AcSEC, therefore, concluded not to provide guidance on inclusion of the cost of defense against assertions of liability in the measurement of the environmental remediation liability. Costs to defend against assertions of liability in the context of environmental remediation liabilities involve determining whether an entity is responsible for participating in a remediation process. Legal costs involved with determining (*a*) the extent of remedial actions that are required, (*b*) the type of remedial actions to be used, and (*c*) the allocation of costs among PRPs are not part of the cost to defend against assertions of liability and are to be included in the measurement of the environmental remediation liability.

D-14. The exposure draft provided that current measurements of the liability ". . . should be based on remediation technology that exists currently." Certain commentators agreed with this conclusion. In their opinions, the nature of the remediation effort was sufficiently different from liabilities for closure or removal of long-lived assets that a difference in anticipating changes in technology was justified.

D-15. Some commentators concluded that differences between the guidance in the exposure draft concerning anticipation of advances in technology and the FASB's tentative conclusions concerning anticipation of advances in technology in its project on accounting for certain liabilities related to closure or removal of long-lived assets (formerly nuclear decommissioning) should be resolved. These commentators did not always express a preference.

D-16. The majority of commentators suggested that to ignore advances in technology is unrealistic and recommended that changes in technology that are reasonable and that can be supported should be allowed to be considered in determining the remediation liability. FASB Statement No. 106 was cited as an example of authoritative literature that permits consideration of anticipated changes in technology.

D-17. AcSEC acknowledges that, by restricting remediation technologies to those currently available, realistic developments in technology that could substantially reduce the ultimate obligation would be ignored. This approach would be inconsistent with the objective of reporting, in the financial statements, a liability that represents the most likely amount to be paid. Further, AcSEC agrees that the FASB's approach in Statement No. 106 to estimating postemployment health care costs demonstrates the acceptability of anticipating realistic changes in technology when estimating future costs that are affected significantly by technological advances.

D-18. AcSEC believes that information regarding expected advances in remediation technologies is considered routinely by environmental engineers and consultants as they evaluate the effectiveness and cost of alternative remediation strategies. AcSEC acknowledges the inherent uncertainty involved in anticipating developments in technology but concluded that acceptable constraints would be placed on this uncertainty by requiring that advances be considered only to the extent that the entity has a reasonable basis to expect that a remediation technology will be approved. Further, this uncertainty becomes resolved at such time as a record of decision is issued since, at that stage in the process, the remediation technology to be used is defined. Accordingly, AcSEC modified its original position to require that the estimated liability be measured based on the technology that is expected to be approved to remediate the site.

D-19. Paragraph .131 of the SOP states: "In situations in which it is not practicable to estimate inflation and such other factors [productivity improvements] because of uncertainty about the timing of expenditures, a current-cost estimate would be the minimum in the range of the liability to be recorded until such time as these cost effects can be reasonably estimated." That guidance is different from the guidance proposed in the FASB's May 31, 1996, exposure draft of a Proposed Statement of Financial Accounting Standards, *Accounting for Certain Liabilities Related to Closure or Removal of Long-Lived Assets,* which provides that, in determining the estimated future cash outflows that will be required to satisfy closure or removal obligations, current-cost estimates should be adjusted for inflation in all cases. AcSEC believes the difference is justified, because the degree of timing uncertainty that exists concerning some environmental remediation liabilities is significantly greater than the degree of timing uncertainty that typically exists concerning closure or removal liabilities.

D-20. For example, an entity may know that a remedial action for which it has a liability could begin within, say, one year of the reporting date. The entity may also know that, for reasons such as disagreements among potentially responsible parties over their relative responsibility for the site and the methodology to be used at the site, it is equally likely that remedial action will not begin for five, or perhaps ten, years. In such circumstances, consideration of the effects of inflation and of productivity improvements in the measurement of the liability would require an arbitrary assumption about when the remedial action will begin, which would diminish the reliability of the measurement and the usefulness of the reported information.

D-21. Although timing uncertainties also often exist in closure situations (concerning the end of the useful life of a long-lived asset, which is when cash outflows for closure or removal of a long-lived asset would occur), those uncertainties tend to concern periods that are more distant from the measurement date. This factor mitigates the effects of such uncertainties.

D-22. AcSEC believes that, in the context of environmental remediation liabilities, using a current cost estimate until there is a basis for estimating productivity improvements and the timing of the satisfaction of the liability will result in reported information that has the characteristics of usefulness and reliability.

D-23. Uncertainties are pervasive in the measurement of environmental remediation liabilities, and the SOP's approach to addressing those uncertainties is to require reporting entities to recognize their best estimate at the particular point in time (or, if no best estimate can be made, the minimum estimate) of their share of the liability and to refine their estimate as events in the remediation process occur. The guidance provided in this SOP—that an undiscounted current cost estimate would be the minimum in the range of the liability to be recognized until such time as a better estimate can be made—is consistent with that approach.

Measurement of Probable Recoveries

D-24. The exposure draft required discounting of recovery assets in all circumstances. Many commentators expressed concerns that that guidance, in combination with the SOP's guidance concerning discounting of liabilities, produced counterintuitive results when applied, for example, to fully insured liabilities. AcSEC agreed with commentators that the measurement of some recovery assets should be symmetrical with the measurement of the related liability. AcSEC noted that, in FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* the FASB provided for the measurement of reinsurance receivables on a basis symmetrical to that of the liability. Accordingly, AcSEC concluded that probable recoveries should be measured at their undiscounted amounts if (*a*) the liability is not discounted and (*b*) the timing of the recovery is dependent on the timing of the payment of the liability. This second criterion—dependency of the timing of the recovery on the timing of the payment of the liability—would usually be met, for example, if an insurance company agrees, in accordance with the terms of an insurance contract, to reimburse the reporting entity for all or a percentage of the remediation costs incurred by the reporting entity as the reporting entity expends money to satisfy its obligation, whereas the criterion likely would not be met, for example, in a lump-sum buyout by an insurance company of contested coverage.

Relationship of the Guidance in This SOP to FASB Statement No. 121

D-25. This SOP addresses the recognition of environmental remediation liabilities and explicitly does not address the recognition of asset impairment. FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,* provides guidance on the recognition and measurement of impairment of long-lived assets. Under FASB Statement No. 121, an entity determines whether a long-lived asset is impaired by comparing the expected future cash flows (undiscounted and without interest charges) from the use and eventual disposition of the asset to the asset's carrying amount. If the asset is determined to be impaired, the impairment loss is measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset.

D-26. FASB Statement No. 121 does not address explicitly cash flows related to environmental remediation that may be associated with a long-lived asset. The EITF reached a consensus in Issue No. 95-23, *The Treatment of Certain Site Restoration/Environmental Exit Costs When Testing a Long-Lived Asset for Impairment,* that future cash flows for environmental exit costs that are associated with a long-lived asset and that have been recognized as a liability should be excluded from the undiscounted expected future cash flows used to test the asset for recoverability under Statement No. 121. However, EITF Issue No. 95-23 relates only to environmental exit costs that may be incurred if a long-lived asset is sold, is abandoned, or ceases operations. It does not address the appropriate treatment of cash outflows to satisfy the environmental remediation liabilities that are the subject of this SOP when an asset would continue operating. AcSEC believes guidance should be developed to address the recognition test under FASB Statement No. 121 and the measurement of impairment under the Statement when an environmental remediation liability associated with a long-lived asset has been recognized pursuant to this SOP. The guidance should avoid consideration of the effect of the environmental remediation obligation twice.

Disclosures

D-27. A number of commentators said the disclosures that are encouraged, but not required, by the SOP should be mandatory. Those commentators believe that the encouraged disclosures provide valuable, or even essential, information to users of the financial statements.

D-28. AcSEC believes the encouraged disclosures will enhance the usefulness of financial statements as tools for decision making. AcSEC recognizes, however, that the FASB is undertaking a project on disclosure effectiveness and decided that it would be inappropriate to impose new disclosure requirements concerning environmental remediation liabilities at this time. Accordingly, the SOP imposes no disclosure requirements that go beyond the requirements of existing authoritative literature.

Transition

D-29. A number of commentators said that the effect of initially applying the SOP should be reported in a manner similar to the cumulative effect of a change in accounting principle. A number of those commentators believe the SOP's guidance on what elements should be included in the accrual; on estimation of the liability in the strict, joint and several, and retroactive legal scheme of environmental remediation liabilities; and on accrual of estimates of components of the overall liability before the overall liability can be reasonably estimated constitute significant new guidance that would result in a change in the application of an accounting principle and should be accounted for as such. Some of those commentators believe that, although in individual cases the effect of applying the SOP would have elements of a change in the application of an accounting principle and of a change in an accounting estimate, the entire change should be reported as a change in accounting principle because that is the predominant characteristic of the change. AcSEC rejected those arguments because treating the effect of initially applying the SOP as a change in accounting principle would directly contradict APB Opinion No. 20, *Accounting Changes,* paragraph 32, which states in part:

> A change in accounting estimate that is recognized in whole or in part by a change in accounting principle should be reported as a change in an estimate because the cumulative effect attributable to the change in accounting principle cannot be separated from the current or future effects of the change in estimate.

Coordination With the FASB

D-30. A number of commentators expressed the view that, because the accounting and reporting issues embraced by the scope of this SOP are of such a broad nature, the FASB rather than AcSEC should address them. AcSEC notes that it coordinates its efforts with the FASB throughout the process of developing an SOP. This coordination begins when AcSEC sends a prospectus that describes a possible project to the FASB. That prospectus is discussed at a public board meeting and, if no more than two FASB members object to having AcSEC take on the project, the project can proceed.

D-31. The criteria considered by the FASB in clearing AcSEC's prospectuses include the following:

- The project does not conflict with current or proposed accounting requirements, unless it is a limited circumstance that is adequately justified.
- The project will result in an improvement in practice.
- The AICPA has demonstrated a need for the project.
- The benefits of any SOP are expected to outweigh the costs of applying it.

D-32. All AcSEC meetings are open to the public, and an FASB representative generally attends all AcSEC meetings. The FASB also clears AcSEC exposure drafts and final SOPs at public board meetings before their promulgation. In connection with clearing the final SOP, the FASB is provided with copies of all comment letters received by AcSEC.

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Appendix E

Acronyms

ARAR	Applicable or relevant and appropriate requirement
BACT	Best available control technology
CERCLA	Comprehensive Environmental Response, Compensation and Liability Act (Also referred to as Superfund, together with SARA)
CERCLIS	Comprehensive Environmental Response, Compensation and Liability Information System
DMR	Discharge monitoring report
EPCRA	Emergency Planning and Community Right-to-Know Act (also referred to as SARA title III)
LAER	Lowest achievable emission rate
MSDS	Material safety data sheet
NAAQS	National ambient air quality standards
NPDES	Nation Pollutant Discharge Elimination System
NPL	National Priorities List
NSPS	New source performance standards
POTW	Publicly owned treatment works
PRAP	Proposed remedial action plan
PRP	Potentially responsible party
PSD	Prevention of significant deterioration
RCRA	Resource Conservation and Recovery Act
RFA	RCRA facility assessment
RFI	RCRA facility investigation
RI/FS	Remedial investigation/feasibility study
ROD	Record of Decision
SARA	Superfund Amendments and Reauthorization Act of 1986 (together with CERCLA, also referred to as Superfund)
SWMU	Solid waste management unit
TSCA	Toxic Substances Control Act
TSDF	Treatment, storage, or disposal facility
UST	Underground storage tank

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Glossary

Administrative record. Related to Superfund and EPCRA: all documents containing information the government uses to select response actions and impose administrative sanctions relating to CERCLA and Title III of SARA, the Emergency Planning and Community Right-to-Know Act. This paper trail includes correspondence, the RI/FS, the Record of Decision, and public comments. SARA appears to limit judicial review of the adequacy of a response action to the administrative record.

Applicable or Relevant and Appropriate Requirements (ARARs). ARARs include the federal standards and more stringent state standards that are legally applicable or relevant and appropriate under the circumstances. ARARs include cleanup standards, standards of control, and other environmental protection requirements, criteria, or limitations. RCRA has frequently been used as an ARAR for remediation of Superfund sites.

Baseline risk assessment. Related to Superfund and RCRA: the qualitative and quantitative evaluation performed in an effort to define the risk posed to human health, the environment, or both by the presence or potential presence, use, or both of specific pollutants. Baseline risk assessments are performed as part of the RI/FS process under Superfund and as part of the RCRA facility investigation in RCRA corrective actions.

Closure. Related to RCRA: the process in which the owner-operator of a hazardous waste management unit discontinues active operation of the unit by treating, removing from the site, or disposing of on site all hazardous wastes in accordance with an EPA- or state-approved plan. Included, for example, are the process of emptying, cleaning, and removing or filling underground storage tanks (USTs) and the capping of a landfill. Closure entails specific financial guarantees and technical tasks that are included in a closure plan and must be implemented.

Comprehensive Environmental Response, Compensation, and Liability Information System (CERCLIS) or CERCLA Information System. A database maintained by the U.S. EPA and the states that lists sites where releases have either been addressed or need to be addressed. CERCLIS consists of three inventories: CERCLIS Removal Inventory, CERCLIS Remedial Inventory, and CERCLIS Enforcement Inventory. Within the three inventories are inactive and active release sites. Inactive release sites are those sites where no further action is needed. Active release sites are those sites that may have an ongoing response action; that may not yet have been addressed by the EPA, but are scheduled for future action; or that may have been addressed and are targeted for further investigation of environmental impacts.

Consent decree. A legal document, approved by a judge, that formalizes an agreement reached between the EPA and potentially responsible parties (PRPs) through which PRPs will conduct all or part of a remedial action at a Superfund site; cease or correct actions or processes that are polluting the environment; or otherwise comply with regulations where PRPs' failure to comply caused the EPA to initiate regulatory enforcement actions. The consent decree describes the actions PRPs will take and may be subject to a public comment period.

Containment. Measures taken to prevent the migration of, or exposure of humans or the environment to, hazardous substances. Containment includes, for example, the construction of dikes, trenches, ditches, fences, underground barrier walls, surface caps, and groundwater pumping facilities as well as monitoring to ensure the integrity of the containment system.

Corrective action. Related to RCRA: action to remedy releases from hazardous waste management units, or any other sources of releases at or from a TSDF.

Disposal. Related to CERCLA and RCRA: under RCRA, the discharge, deposit, injection, dumping, spilling, leaking, or placing of any solid waste or hazardous waste into or on any land or water so that such solid waste or hazardous waste or any constituent thereof may enter the environment or be emitted into the air or discharged into any waters, including groundwaters. Similarly under CERCLA with regard to hazardous substances.

Hazardous substance. Related to Superfund: the definition of hazardous *substance* in CERCLA is broader than the definition of hazardous *wastes* under RCRA. Under CERCLA, a hazardous substance is any element, compound, mixture, solution, or substance that, when released to the environment, may present substantial danger to the public health or welfare or to the environment. It also includes (1) specifically designated substances; (2) toxic pollutants under the Federal Water Pollution Control Act; (3) hazardous wastes having the characteristics identified under or listed pursuant to RCRA (excluding any waste suspended from regulation under the Solid Waste Disposal Act by Congress); (4) hazardous air pollutants under the Clean Air Act; and (5) any imminently hazardous chemical substance or mixture for which the government has taken action under section 7 of the Toxic Substances Control Act. Petroleum (including crude oil not otherwise specifically listed or designated as a hazardous substance under any of the above laws), natural gas, natural gas liquids, liquefied natural gas, or synthetic gas useable for fuel (or mixtures of natural gas and such synthetic gas) are excluded.

Hazardous waste. Related to RCRA: a waste, or combination of wastes, that because of its quantity, concentration, toxicity, corrosiveness, mutagenicity or inflammability, or physical, chemical, or infectious characteristics may (1) cause, or significantly contribute to, an increase in mortality or an increase in serious irreversible, or incapacitating reversible illness; or (2) pose a substantial present or potential hazard to human health or the environment when improperly treated, stored, transported, or disposed of, or otherwise managed. Technically, those wastes that are regulated under RCRA 40 CFR Part 261.

Hazardous waste constituent. A constituent that caused the waste to be listed as a hazardous waste under 40 CFR Part 261 Subpart D.

National Priorities List (NPL). The EPA's list of the most serious uncontrolled or abandoned hazardous waste sites identified for possible long-term remedial action under Superfund. The list is based primarily on the score a site receives from the Hazard Ranking System. The EPA is required to update the NPL at least once a year.

Orphan share. Equitable share of liability for response or remediation costs attributed to orphan-share PRPs, or the amount by which the equitable share of liability for response or remediation costs attributable to other parties exceeds the amount for which those parties have settled their liability.

Orphan-share PRP. An identified PRP that cannot be located or that is insolvent.

Orphan site. A Superfund site where all identified potentially responsible parties no longer exist or are insolvent.

Participating PRP. A party to a Superfund site that has acknowledged potential involvement with respect to the site. Also referred to as a *player*.

Potentially responsible party (PRP). Any individual, legal entity, or government—including owners, operators, transporters, or generators—potentially responsible for, or contributing to, the environmental impacts at a Superfund site. The EPA has the authority to require PRPs, through administrative and legal actions, to remediate such sites.

Recalcitrant PRP. A party whose liability with respect to a Superfund site is substantiated by evidence, but that refuses to acknowledge potential involvement with respect to the site. Also referred to as a *nonparticipating PRP*.

Release. Related to Superfund: any spilling, leaking, pumping, pouring, emitting, emptying, discharging, injecting, escaping, leaching, dumping, or disposing into the environment. Includes the abandonment or discarding of barrels, containers, and other closed receptacles containing any hazardous substance, pollutant, or contaminant. The law provides for several exclusions. Release also means the substantial threat of release.

Remedial action, remediation. Related to Superfund: generally long-term actions taken to (*a*) investigate, alleviate, or eliminate the effects of a release of a hazardous substance into the environment; (*b*) investigate, alleviate, or eliminate a threat of the release of an existing hazardous substance that could potentially harm human health or the environment; or (*c*) restore natural resources. Also used in this SOP to refer to corrective action under RCRA.

Remedial investigation/feasibility study (RI/FS). Extensive technical studies conducted by the government or by the PRPs to investigate the scope of site impacts (RI) and determine the remedial alternatives (FS) that, consistent with the National Contingency Plan, may be implemented at a Superfund site. Government-funded RI/FSs do not recommend a specific alternative for implementation. RI/FSs conducted by PRPs usually do recommend and technically support a remedial alternative. An RI/FS may include a variety of on- and off-site activities, such as monitoring, sampling, and analysis.

Removal, removal action. Under CERCLA, generally short-term actions taken to respond promptly to an urgent need. The cleanup or removal of released hazardous substances from the environment; actions in response to the threat of release; actions that may be necessary to monitor, assess, and evaluate the release or threat; disposal of removed material; or other actions needed to prevent, minimize, or mitigate damage to public health or welfare or to the environment. Removal also includes, without being limited to, security fencing or other measures to limit access; provision of alternative water supplies; temporary evacuation and housing of threatened individuals not otherwise provided for; and any emergency assistance provided under the Disaster Relief Act.

Response action. Related to Superfund: a broad term encompassing removal, remediation, and containment actions, as well as precleanup and enforcement-related activities.

Solid waste management unit (SWMU). Related to RCRA: any discernible waste management unit from which hazardous constituents may migrate, irrespective of whether the unit was intended for the management of solid or hazardous wastes. The types of units considered SWMUs are landfills, surface impoundments, waste piles, land treatment units, incinerators, injection wells, tanks, container storage areas, waste-water treatment systems, and transfer stations. In addition, areas associated with production processes at facilities that have been affected by routine, systematic, and deliberate releases of wastes (which may include abandoned or discarded products), or hazardous constituents from wastes, are considered SWMUs.

Treatment, storage, or disposal facility (TSDF). Related to RCRA: with some exceptions, any facility that treats hazardous wastes; any facility that stores hazardous wastes, except generators who store their own wastes for less than 90 days for subsequent transport off-site; or any facility that serves to receive hazardous waste and disposes of it.

Unilateral administrative order. Order issued unilaterally by the EPA under section 106(a) of CERCLA to PRPs, or to non-PRPs such as adjacent landowners, requiring them to take a response action. Unilateral administrative orders contain findings of fact and conclusions of law, and they specify the work to be performed and the EPA's right to take over the work in the event of noncompliance, inadequate performance, or an emergency. A unilateral administrative order does not allocate conduct required by the order between individual PRPs; however, the EPA may issue carve-out orders requiring individual PRPs to perform specific actions. Also referred to as a "section 106 order."

Unknown PRP. A party that has liability with respect to a Superfund site, but that has not yet been identified as a potentially responsible party by the U.S. EPA or by an analogous state agency.

Unproven PRP. A party that has been identified as a potentially responsible party for a Superfund site by the U.S. Environmental Protection Agency or by an analogous state agency, but that does not acknowledge potential involvement with respect to the site because no evidence has been presented linking the party to the site. Also referred to as a *hiding-in-the-weeds PRP.*

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[The next page is 80,301.]

Section 10,690

Statement of Position 97-1 Accounting by Participating Mortgage Loan Borrowers

May 9, 1997

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Scope

.01 This Statement of Position (SOP) establishes the borrower's accounting for a participating mortgage loan if the lender is entitled to participate in appreciation in the market value of the mortgaged real estate project, the results of operations of the mortgaged real estate project, or in both. This SOP applies to all borrowers in participating mortgage loan arrangements.

.02 This SOP does not apply to participating leases, debt convertible at the option of the lender into equity ownership of the property, or participating loans resulting from troubled debt restructurings.[1] It also does not apply to creditors in participating mortgage loan arrangements.

Background

.03 Through the 1960s, most loans collateralized by real estate projects had fixed interest rates and long-term payment periods with full amortization of principal. Thereafter, loans with variable features, such as adjustable interest rates and variable payments, began to emerge. The desire for instruments

[1] Accounting for leases is addressed in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 13, *Accounting for Leases.* Accounting for debt convertible at the option of the lender into equity ownership of the property is addressed in Accounting Principles Board (APB) Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants.* Participating loans originating from troubled debt restructurings should be accounted for in conformity with FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings.*

in which the return to the lenders was tied more closely to the performance of the property led to the introduction of participating mortgage loans.

.04 Participating mortgage loans and nonparticipating mortgage loans share the following characteristics:

- Debtor-creditor relationships between those who provide initial cash outlays and hold the mortgages, and those who are obligated to make subsequent payments to the mortgage holders
- Real estate collateral
- Periodic fixed-rate or floating-rate interest payments
- Fixed maturity dates for stated principal amounts

.05 However, unlike a nonparticipating mortgage loan arrangement, in a participating mortgage loan, the lender participates in appreciation in the market value of the mortgaged real estate project or the results of operations of the mortgaged real estate project, or in both. The terms and economics of participating mortgage loan agreements vary by agreement. The terms and economics of one agreement may create a circumstance in which any participation payment is remote. In another agreement, the terms and economics may transfer many of the risks and rewards of property ownership.

.06 A lender may be entitled to participate in appreciation in the market value of a project either upon the sale of the project, at a deemed sale date, or at the maturity or refinancing of the loan. In agreements in which lenders participate in results of operations, the definition of the results of operations may vary among agreements. Examples of these definitions include but are not limited to revenue, income, or cash flows before or after debt service.

.07 The participation terms of a participating mortgage loan agreement usually are negotiated concurrently with the other terms of the underlying mortgage loan. A borrower agrees to participation rights generally because of market conditions, or in exchange for concessions granted by the lender on some other term(s) of the loan, such as a lower interest rate or a higher loan-to-value ratio.

.08 The lender's participation reduces the borrower's potential realization of operating results or gain on the sale of the real estate. However, the participation also may reduce the following:

- The contract interest the borrower is required to pay
- The risk that the borrower will be unable to pay interest at the stated or floating rate in the loan agreement and, consequently, the risk that the borrower will default on the loan and need to sell the property
- The amount of capital the borrower has at risk, because the loan-to-value ratio normally is higher

Further, the obligation to pay the lender a share of the property appreciation does not increase the current exposure of the borrower to loss in its investment, because the participation payments are made only if the market value of the property appreciates.

.09 In FASB Emerging Issues Task Force (EITF) Issue No. 86-28, *Accounting Implications of Indexed Debt Instruments,* the EITF considered indexed debt instruments, including participating mortgage obligations. The consensus indicates that the borrower's obligation under a participating mortgage to pay the lender a share of unrealized property appreciation should be recognized as a liability immediately when the property appreciates. A consensus was not reached, however, on how to account for the corresponding charge.

In order to enhance consistency in practice, this SOP provides additional guidance that specifically addresses the borrower's accounting for participating mortgage loans.

Conclusions

At Origination

.10 If the lender is entitled to participate in appreciation in the market value of the mortgaged real estate project, the borrower should determine the fair value of the participation feature at the inception of the loan. The borrower should recognize a participation liability for that amount, with a corresponding debit to a debt discount account. The debt discount should be amortized by the interest method, using the effective interest rate.

Interest Expense

.11 Interest expense on participating mortgage loans consists of the following three components:

a. Amounts designated in the mortgage agreement as interest

b. Amounts related to the lender's participation in results of operations

c. Amortization of debt discount related to the lender's participation in the market value appreciation of the mortgaged real estate project

Amounts Designated in the Mortgage Agreement as Interest

.12 Amounts designated in the mortgage agreement as interest should be charged to income in the period that the interest is incurred. If the loan's stated interest rate varies based on changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate, or the United States Treasury bill weekly average rate), the calculation of the interest should be based on the factor (the index or the rate) as it changes over the life of the loan.

Amounts Related to the Lender's Participation in the Results of the Operations of the Mortgaged Real Estate Project

.13 Amounts due to a lender pursuant to the lender's participation in the real estate project's results of operations (as defined in the participating mortgage loan agreement) should be charged to interest expense in the borrower's corresponding financial reporting period, with a corresponding credit to the participation liability.

Amounts Related to the Lender's Participation in the Market Value Appreciation of the Mortgaged Real Estate Project

.14 As discussed in paragraph .10 of this SOP, if the lender is entitled to participate in appreciation in the market value of the mortgaged real estate project, at the inception of the loan the borrower should establish a participation liability equal to the fair value of the participation feature. The corresponding debit should be to a debt-discount account and should be amortized by the interest method over the life of the loan, using the effective interest rate. This amortization should be included in interest expense.[2]

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[2] Interest recognized pursuant to this SOP is subject to the requirements of FASB Statement No. 34, *Capitalization of Interest Costs.* Once capitalized, amounts should not be adjusted for the effects of reversals of appreciation.

Accounting for a Participation in Appreciation Subsequent to Inception of the Loan

.15 At the end of each reporting period, the balance of the participation liability should be adjusted to equal the current fair value of the participation feature. The corresponding debit or credit should be to the related debt-discount account. The revised debt discount should be amortized prospectively, using the effective interest rate.

Extinguishment of Participating Mortgage Loans

.16 If the participating mortgage loan is extinguished prior to its due date, the difference between the recorded amount of the debt (including the unamortized debt discount and the participation liability) and the amount exchanged to extinguish the debt is a debt extinguishment gain or loss that should be reported as required by FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*.* [Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 145.]

Disclosures

.17 The borrower's financial statements should disclose the following:

- The aggregate amount of participating mortgage obligations at the balance-sheet date, with separate disclosure of the aggregate participation liabilities and related debt discounts
- Terms of the participations by the lender in either the appreciation in the market value of the mortgaged real estate project or the results of operations of the mortgaged real estate project, or both

Effective Date and Transition

.18 This SOP is effective for financial statements issued for fiscal years beginning after June 30, 1997, and for financial statements for interim periods in such years. The effect of the initial application of the provisions of this SOP should be reported as a cumulative effect of a change in accounting principle. Presentation of pro forma effects of retroactive application is not required. Restatement of previously issued annual financial statements is not permitted.

.19 Early adoption is encouraged but not required. If a decision is made to adopt the provisions of this SOP in a fiscal year beginning on or before June 30, 1997, and the decision is made in other than the first interim period of the fiscal year, financial statements for previous interim periods of that year should be restated.

.20 For participating loans with variable interest rates, the cumulative effect of adoption should be calculated using the interest rate in effect at incep-

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* FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*, supersedes FASB Statement No. 4, *Reporting Gains and Losses From Extinguishment of Debt*. FASB Statement No. 145 eliminated the requirement to classify all gains and losses associated with extinguishment of debt as extraordinary items. However, the rescission of FASB Statement No. 4 does not preclude gains or losses from extinguishment of debt that meet the criteria of APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, from being classified as extraordinary items. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 145.]

tion of the participating mortgage loan. The initial interest rate should be treated as a fixed rate for purposes of this calculation.

The provisions of this Statement of Position need not be applied to immaterial items.

Basis for Conclusions

At Origination

.21 In a participating mortgage loan arrangement, the lender generally grants certain concessions to the borrower in return for the right to participate in either the appreciation in the market value of the mortgaged real estate project or the operations of the mortgaged real estate project, or in both. A common concession is granting an interest rate lower than that which would have been included in a comparable nonparticipating mortgage loan. Another common concession is a higher loan-to-value ratio than would be allowed at the same interest rate in a loan that does not include the participation in appreciation. AcSEC believes that in participating loan arrangements, the borrower has received something of value (the lower interest rate) in exchange for something of value (the participation feature) and that such exchanges should be given accounting recognition.

.22 Paragraph 11 of Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*, states that "If cash and some other rights or privileges are exchanged for a note, the value of the rights or privileges should be given accounting recognition as described in paragraph 7." The participation feature included in the loan represents such a right. The participation feature has a market value separate from the loan agreement itself. In order to eliminate the participation feature while retaining the other terms of the mortgage loan, the borrower would be required to make a payment to the lender equal to the market value of the participation feature.

.23 The proposed accounting in the exposure draft that preceded this SOP would have required that borrowers record the loan at inception without allocating any of the proceeds to a liability related to the participation feature. AcSEC had been concerned about the ability to separately price the rights to participate in appreciation in value. AcSEC was informed by several respondents, however, that borrowers do have the ability to price these participation features separately. AcSEC, therefore, modified its original position to require that a separate liability for the participation in appreciation be recognized at inception and that liability should be measured at the fair value of the participation feature.

.24 Also, because of the participation feature, the stated rate of interest on the loan is less than the market rate of interest. AcSEC believes that, in accordance with paragraph 7 of APB Opinion 21, a discount, equal in amount to the fair value of the participation feature, should be established for this difference. That discount should be amortized over the life of the loan.

.25 Although AcSEC notes that a participation in the operations of a mortgaged property can be valued similarly, AcSEC believes that the cost of monitoring and updating the information needed to record and review the ongoing estimate of such a liability would exceed the benefits to be gained by reporting the liability. Consequently, AcSEC concluded that amounts due to a lender pursuant to a participation in operations of the mortgaged real estate should be included in interest expense in the borrower's corresponding financial reporting period.

Interest Expense

.26 Paragraph 15 of APB Opinion 21 requires that the difference between the present value and the face amount of a note be treated as a discount or premium and be amortized over the life of the note in such a way as to result in a constant rate of interest when applied to the carrying amount at the beginning of any given period. Consequently, AcSEC concluded that requiring amortization of the debt discount using the interest method is consistent with paragraph 15 of APB Opinion 21.

.27 Additionally, as discussed in paragraph .25 of this SOP, AcSEC believes that the cost of monitoring and updating the information needed to record and review the fair value of a lender's participation in operations would exceed the benefits to be gained by adjusting the liability. Consequently, AcSEC concluded that amounts due to a lender pursuant to a participation in operations of the mortgaged real estate should be treated as interest expense in the borrower's corresponding financial reporting period and that they should be accounted for in a manner consistent with the accounting for amounts designated in the mortgage loan agreement as interest.

Accounting for a Participation in Appreciation Subsequent to Inception of the Loan

.28 This SOP requires adjustment of the participation liability at each reporting date to its fair value. The exposure draft would have required the borrower to estimate at each balance sheet date the value on which the participation payment would have been based. For example, if the borrower would have been required to make a payment to the lender pursuant to the participation feature if the property were sold at the balance sheet date, the borrower would have been required to recognize a participation liability at the financial statement date equal to the estimated amount of the payment.

.29 Each period, the participation liability would have been debited or credited, if necessary, to adjust the balance in the account to the amount that would have been paid to the lender if the property were sold at its then-estimated market value or if the mortgage loan matured or was refinanced at that date. The corresponding debit or credit would have been made to the related debt-discount account. When applying the interest method, the borrower would have been required to recalculate the effective interest rate to reflect the changes in expected future payments (exclusive of payments related to participations in operations) assuming that (*a*) the expected future payment pursuant to the participation feature was to be paid on the due date of the loan and (*b*) the recalculated expected future payment amount was known at the inception of the loan. The debt discount related to the participation liability would have been adjusted to the amount that would have existed had the new effective interest rate been applied since the origination of the participating mortgage loan. In addition, a corresponding charge or credit to interest expense for this cumulative interest adjustment would have been required.

.30 Several respondents to the exposure draft commented that the proposed accounting in the exposure draft was unnecessarily complex and would have been costly and burdensome to apply. These respondents also commented that the proposed annual cumulative catch-up adjustment would lead to volatility of earnings. These respondents stated that changes in residual-value estimates and their effect on interest rates were more analogous to modifications of interest rates of debt instruments, which are accounted for prospectively. AcSEC considered these comments and agreed that the accounting should be simplified.

.31 This SOP does not require that the borrower's entire debt obligation (including the participation feature) be recorded at fair value. The underlying debt obligation should be recorded at amortized cost, while the participation feature should be recorded at fair value. AcSEC notes that recording debt obligations at fair value is not common practice. Therefore, AcSEC concluded that the underlying debt obligation should continue to be recorded on an amortized cost basis.

.32 However, AcSEC believes that the amortized cost basis is not meaningful with respect to the participation feature. AcSEC believes that because the fair value of the participation feature represents the best estimate of the amount at which it could be settled, the participation feature should be recorded at its fair value.

.33 AcSEC believes that requiring recognition in the current period of the entire amount of the change in the fair value of the participation feature would result in unnecessary volatility. AcSEC notes that the impact of factors that affect effective yields (for example, changes in interest rates) is commonly recognized prospectively. Therefore, AcSEC concluded that changes in the fair value of the participation feature should be amortized into income prospectively as adjustments to the effective yield.

.34 AcSEC believes that this approach results in relevant and reliable reported information about the obligation, that it is broadly consistent with existing practices in accounting for liabilities, and that it alleviates respondents' concerns about complexity and costliness.

.35 Other methods considered and rejected by AcSEC included (*a*) offsetting changes in the participation liability by changing the reported amount of the related asset, (*b*) requiring disclosure, but not recognition, of the lender's share in the appreciation, and (*c*) requiring adjustment of the participation liability balance to the amount that would have been paid to the lender if the property were sold at its estimated market value at the reporting date.

Increasing the Reported Amount of the Asset

.36 AcSEC considered a method under which any change to the participation liability would have been offset by changes in the reported amount of the related asset. This method was proposed by several respondents to the exposure draft. These respondents noted that the change in value of the asset was the underlying and directly offsetting source of the change in the participation liability. They commented that it was troubling that the determination of the property's value is considered reliable enough to recognize and measure a potential obligation and a charge to operations in accordance with FASB Statement No. 5, *Accounting for Contingencies,* but is not reliable enough to recognize an increase in the value of the asset. AcSEC concluded that to use an asset to account for changes in the value of the property would be inconsistent with the historical cost model of accounting. Furthermore, AcSEC believes that amounts due pursuant to participation features represent additional interest on the participating mortgages. Therefore, AcSEC believes that the amount should be recognized as interest expense over the life of the loan. If the change in the participation liability had been offset by changing the reported amount of the related asset, that change would have been recognized through depreciation over the remaining depreciable life of the asset, which only coincidentally would match the remaining life of the loan.

Disclosure

.37 Several respondents to the exposure draft recommended that AcSEC require only disclosure of the lender's share of the appreciation in value of the property or properties. This position appeared to be linked to disagreement with the accounting proposed in the exposure draft. These respondents opposed recording a lender's share of the appreciation in value without recognizing a corresponding increase in the value of the asset. AcSEC considered these comments but notes that disclosure is not a substitute for recognition in financial statements for items that meet recognition criteria.

Disclosures

.38 AcSEC believes that the disclosures required by this SOP are necessary to provide users with adequate information related to the financial position of borrowers in participating mortgage loan arrangements. AcSEC believes that, given the susceptibility of real estate to fluctuations in value, requiring disclosure of the terms of the participations provides users of financial statements with information that is helpful in assessing the risks facing participating mortgage loan borrowers.

Transition

.39 AcSEC believes that the adoption of this SOP constitutes a change in accounting principle for which the advantages of retroactive treatment in prior-period financial statements do not outweigh the disadvantages, as discussed in paragraphs 27 to 30 of APB Opinion 20, *Accounting Changes*. Accordingly, AcSEC concluded that the effect of initial application of this SOP should be reported as a cumulative effect of a change in accounting principle.

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Appendix

Illustration of a Participation in Appreciation

A-1. Assume that on January 1, 19X1, Borrower Co. purchased a property for $10 million. On that date, Borrower paid $1 million cash and entered into a participating mortgage loan agreement with Lender Co. in the amount of $9 million.

A-2. The loan agreement has the following terms:

- Fifteen-year term
- Interest-only periodic payments, principal to be repaid at end of term
- Five-percent stated interest rate
- Twenty-percent participation in appreciation in the value of the property above $10 million, payable at maturity (or earlier if the asset is sold or the loan is refinanced)

A-3. Assumptions related to the fair value of the participation feature are as follows:

Date	*Fair Value*	*Estimated Payment*	*Years in Future*
1/1/X1	$25,055	$300,000	15
12/31/X1	40,063	320,000	14
12/31/X2	54,122	333,000	13

A-4. Based on the preceding assumptions, Borrower Co. should make the following journal entries for this participating mortgage loan.

a. On January 1, 19X1, the following journal entries should be recorded:

Cash	$ 9,000,000	
Loan discount	25,055	
Mortgage loan payable		9,000,000
Participation liability		25,055

To record participating debt and estimate of participation liability (based on fair value of participation feature).

Property	$10,000,000	
Cash		10,000,000

To record purchase of property.

b. By the end of 19X1, entries to record interest expense and amortization of discount throughout the year would have taken the following form:

Interest expense	$ 451,159	
Interest payable		450,000
Loan discount		1,159

To record interest expense and amortization of debt discount using the interest method and an effective rate of 5.03 percent (rounded).

Loan discount	$ 15,008	
Participation liability		15,008

To adjust balance of participation liability to fair value at end of period. The adjustment is calculated as follows:

Fair value at 12/31/X1	$ 40,063
Fair value at 1/1/X1	25,055
Adjustment	$ 15,008

Note: For purposes of this illustration, the fair value of the participation feature at 12/31/X1 is based on a revised estimate of the equity participation that would be payable in fourteen years of $320,000.

c. At the end of 19X2, entries to record interest expense and amortization of discount throughout the year would have taken the following form:

Interest expense	$451,979	
Interest payable		450,000
Loan discount		1,979

To record interest expense and amortization of debt discount, using the interest method and an effective rate of 5.04 percent (rounded).

Loan discount	$ 14,059	
Participation liability		14,059

To adjust recorded participation liability of $40,063 to fair value at 12/31/X2 of $54,122.

Accounting Standards Executive Committee (1995–1996)

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Section 10,700

Statement of Position 97-2
Software Revenue Recognition

October 27, 1997

NOTE

Statements of Position (SOPs) on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA SOPs that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this SOP if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the SOP should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

An effective date provision of this SOP has been deferred by SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2*, Software Revenue Recognition. This SOP is effective March 31, 1998. If an enterprise had applied SOP 97-2 in an earlier period for financial statements or information already issued prior to the promulgation of this SOP, amounts reported in those financial statements or as part of that information may be restated to reflect the deferral of the effective date of the second sentence of paragraphs 10, 37, 41, and 57 of SOP 97-2 and the related examples noted in paragraph .03 of this SOP.

SOP 97-2 is amended by SOP 98-9, *Modification of SOP-97-2*, Software Revenue Recognition, *With Respect to Certain Transactions*. The provisions of this SOP that extend the deferral of the application of certain passages of SOP 97-2 are effective December 15, 1998. All other provisions of this SOP are effective for transactions entered into in fiscal years beginning after March 15, 1999. Earlier adoption is permitted as of the beginning of fiscal years or interior periods for which financial statements or information has not been issued. Retroactive application of the provisions of this SOP is prohibited.

Introduction

.01 Statement of Position (SOP) 91-1, *Software Revenue Recognition*, was issued in 1991 to provide guidance on applying generally accepted accounting principles to software transactions and to narrow the range of revenue recognition practices that were in use before its issuance. Since the issuance of SOP 91-1, practice issues have been identified that the AICPA's Accounting Standards Executive Committee (AcSEC) believes are not addressed adequately in SOP 91-1. In addition, AcSEC believes some of the guidance in SOP 91-1 should be reconsidered. This SOP supersedes SOP 91-1.

Scope

.02 This SOP provides guidance on when revenue should be recognized and in what amounts for **licensing**, selling, leasing, or otherwise marketing computer software.[1] It should be applied to those activities by all entities that earn such revenue. It does not apply, however, to revenue earned on products or services containing software that is incidental[2] to the products or services as a whole.

.03 In connection with the licensing of an existing product, a vendor might offer a small discount (for example, a coupon or other form of offer for five percent off) on additional licenses of the licensed product or other products that exist at the time of the offer but are not part of the arrangement. Such marketing and promotional activities are not unique to software and are not included in the scope of this SOP.[3]

Relationship to Other Pronouncements

.04 If a lease of software includes property, plant, or equipment, the revenue attributable to the property, plant, or equipment should be accounted for in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 13, *Accounting for Leases*, and any revenue attributable to the software, including **postcontract customer support (PCS)**, should be accounted for separately in conformity with the guidance set forth in this SOP. However, in conformity with paragraph .02, if the property, plant, or equipment contains software that is incidental to the property, plant, or equipment as a whole, the software should not be accounted for separately.

.05 A number of the requirements of this SOP are similar to or overlap those in certain pronouncements of the Accounting Principles Board (APB) or the FASB, such as FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*. This SOP does not alter the requirements of any APB Opinion or FASB pronouncement.

Conclusions

.06 The following conclusions should be read in conjunction with the *Basis for Conclusions* section, beginning with paragraph .93 of this SOP, and the examples in appendix A, *Examples of the Application of Certain Provisions of this SOP* [paragraph .146].

Basic Principles

.07 Software arrangements range from those that provide a license for a single software product to those that, in addition to the **delivery** of software or a software system, require significant production, modification, or customization of software. If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the entire arrangement should be accounted for in conformity with Accounting

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[1] Terms defined in the glossary are set in **boldface** type the first time they appear in this SOP.

[2] Indicators of whether software is incidental to a product as a whole include (but are not limited to) (*a*) whether the software is a significant focus of the marketing effort or is sold separately, (*b*) whether the vendor is providing postcontract customer support, and (*c*) whether the vendor incurs significant costs that are within the scope of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*. An example of the applicability of this SOP to revenue earned on products containing software is included in appendix A [paragraph .146].

[3] As discussed in paragraph .09, arrangements may include multiple elements. If the discount or other concessions in an arrangement are more than insignificant, a presumption is created that an additional element(s) (as defined in paragraph .09) is being offered in the arrangement.

Research Bulletin (ARB) No. 45, *Long-Term Construction-Type Contracts*, using the relevant guidance herein, and in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* [section 10,330].[4]

.08 If the arrangement does not require significant production, modification, or customization of software, revenue should be recognized when all of the following criteria are met.

- Persuasive evidence of an arrangement exists.
- Delivery has occurred.
- The vendor's fee is fixed or determinable.
- Collectibility is probable.[5]

.09 Software arrangements may provide licenses for multiple software deliverables (for example, software products, **upgrades/enhancements**, PCS, or services), which are termed multiple *elements*. A number of the elements may be described in the arrangement as being deliverable only on a **when-and-if-available** basis. When-and-if-available deliverables should be considered in determining whether an arrangement includes multiple elements. Accordingly, the requirements of this SOP with respect to arrangements that consist of multiple elements should be applied to all additional products and services specified in the arrangement, including those described as being deliverable only on a when-and-if-available basis.

.10 If an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated within the contract for each element. Vendor-specific objective evidence of fair value is limited to the following:

- The price charged when the same element is sold separately
- For an element not yet being sold separately, the price established by management having the relevant authority; it must be probable that the price, once established, will not change before the separate introduction of the element into the marketplace

The amount allocated to undelivered elements is not subject to later adjustment.[6] However, if it becomes probable that the amount allocated to an undelivered element will result in a loss on that element of the arrangement, the loss should be recognized pursuant to FASB Statement No. 5, *Accounting for Contingencies*. When a vendor's pricing is based on multiple factors such as the number of products and the number of users, the amount allocated to the same element when sold separately must consider all the factors of the vendor's pricing structure.

.11 If a discount is offered in a multiple-element arrangement, a proportionate amount of that discount should be applied to each element included in the arrangement based on each element's fair value without regard to the discount. However, as discussed in paragraph .37, no portion of the discount should be allocated to any upgrade rights. Moreover, to the extent that a discount exists, the residual method described in paragraph .12 attributes that

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[4] If a software arrangement includes services that meet the criteria discussed in paragraph .65 of this SOP, those services should be accounted for separately.

[5] The term *probable* is used in this SOP with the same definition as used in FASB Statement No. 5, *Accounting for Contingencies*.

[6] This does not apply to changes in the estimated percentage of customers not expected to exercise an upgrade right. See paragraph .37.

discount entirely to the delivered elements. [As amended, effective for transactions entered into in fiscal years beginning after March 15, 1999, by Statement of Position 98-9.]

.12 If sufficient vendor-specific objective evidence does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement should be deferred until the earlier of the point at which (*a*) such sufficient vendor-specific objective evidence does exist or (*b*) all elements of the arrangement have been delivered. The following exceptions to this guidance are provided.

- If the only undelivered element is PCS, the entire fee should be recognized ratably (see paragraphs .56 through .62).
- If the only undelivered element is services that do not involve significant production, modification, or customization of software (for example, training or installation), the entire fee should be recognized over the period during which the services are expected to be performed (see paragraphs .63 through .71).
- If the arrangement is in substance a subscription, the entire fee should be recognized ratably (see paragraphs .48 and .49).
- If the fee is based on the number of copies, the arrangement should be accounted for in conformity with paragraphs .43 through .47.
- There may be instances in which there is vendor-specific objective evidence of the fair values of *all* undelivered elements in an arrangement but vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement. In such instances, the fee should be recognized using the residual method, provided that (*a*) all other applicable revenue recognition criteria in this SOP are met and (*b*) the fair value of all of the undelivered elements is less than the arrangement fee. Under the residual method, the arrangement fee is recognized as follows: (*a*) the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is deferred and (*b*) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

[As amended, effective for transactions entered into in fiscal years beginning after March 15, 1999, by Statement of Position 98-9.]

.13 The portion of the fee allocated to an element should be recognized as revenue when the criteria in paragraph .08 of this SOP are met with respect to the element. In applying those criteria, the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of the delivered element, because the **customer** would not have the full use of the delivered element.

.14 No portion of the fee (including amounts otherwise allocated to delivered elements) meets the criterion of collectibility if the portion of the fee allocable to delivered elements is subject to forfeiture, refund, or other concession if any of the undelivered elements are not delivered. In order for the revenue related to an arrangement to be considered not subject to forfeiture, refund, or other concession, management must intend not to provide refunds or concessions that are not required under the provisions of the arrangement. All available evidence should be considered to determine whether the evidence persuasively indicates that the revenue is not subject to forfeiture, refund, or other concession. Although no single item of evidence may be persuasive, the following additional items should be considered:

- Acknowledgment in the arrangement of products not currently available or not to be delivered currently
- Separate prices stipulated in the arrangement for each deliverable element
- Default and damage provisions as defined in the arrangement
- Enforceable payment obligations and due dates for the delivered elements that are not dependent on the delivery of the future deliverable elements, coupled with the intent of the vendor to enforce rights of payment
- Installation and use of the delivered software
- Support services, such as telephone support, related to the delivered software being provided currently by the vendor

Regardless of the preceding, the vendor's historical pattern of making refunds or other concessions that were not required under the original provisions (contractual or other) of other arrangements should be considered more persuasive than terms included in the arrangement that indicate that no concessions are required.

Evidence of an Arrangement

.15 Practice varies with respect to the use of written contracts. Although a number of sectors of the industry rely upon signed contracts to document arrangements, other sectors of the industry that license software (notably the packaged software sector) do not.

.16 If the vendor operates in a manner that does not rely on signed contracts to document the elements and obligations of an arrangement, the vendor should have other forms of evidence to document the transaction (for example, a purchase order from a third party or on-line authorization). If the vendor has a customary business practice of utilizing written contracts, evidence of the arrangement is provided only by a contract signed by both parties.

.17 Even if all other requirements set forth in this SOP for the recognition of revenue are met (including delivery), revenue should not be recognized on any element of the arrangement unless persuasive evidence of an arrangement exists.

Delivery

.18 The second criterion in paragraph .08 for revenue recognition is delivery. The principle of not recognizing revenue before delivery applies whether the customer is a **user** or a **reseller**. Except for arrangements in which the fee is a function of the number of copies, delivery is considered to have occurred upon the transfer of the product master or, if the product master is not to be delivered, upon the transfer of the first copy. For software that is delivered electronically, the delivery criterion of paragraph .08 is considered to have been met when the customer either (*a*) takes possession of the software via a download (that is, when the customer takes possession of the electronic data on its hardware), or (*b*) has been provided with access codes that allow the customer to take immediate possession of the software on its hardware pursuant to an agreement or purchase order for the software. In such cases, revenue should be recognized if the other criteria of paragraph .08 have been satisfied.

.19 Paragraphs .20 through .25 provide guidance on determining whether delivery is considered to have occurred in certain kinds of software transactions.

Customer Acceptance

.20 After delivery, if uncertainty exists about customer acceptance of the software, license revenue should not be recognized until acceptance occurs.

Determining Delivery—Multiple Copies of Software Products Versus Multiple Licenses

.21 Arrangements to use multiple copies of a software product under **site licenses** with users and to market multiple copies of a software product under similar arrangements with resellers should be distinguished from arrangements to use or market multiple single licenses of the same software.

- In the former kind of arrangement, duplication is incidental to the arrangement and the delivery criterion is met upon the delivery of the first copy or product master. The vendor may be obligated to furnish up to a specified number of copies of the software, but only if the copies are requested by the user. The licensing fee is payable even if no additional copies are requested by the user or reseller. If the other criteria in this SOP for revenue recognition are met, revenue should be recognized upon delivery of the first copy or product master. The estimated costs of duplication should be accrued at that time.
- In the latter kind of arrangement, the licensing fee is a function of the number of copies delivered to, made by, or deployed by the user or reseller. Delivery occurs and revenue should be recognized as the copies are made by the user or sold by the reseller if the other criteria in this SOP for revenue recognition are met.

Delivery Other Than to the Customer

.22 Delivery should not be considered complete unless the destination to which the software is shipped is the customer's place of business or another site specified by the customer. In addition, if a customer specifies an intermediate site but a substantial portion of the fee is not payable until the delivery by the vendor to another site specified by the customer, revenue should not be recognized until the delivery is made to that other site.

Delivery Agents

.23 Vendors may engage agents, often referred to as fulfillment houses, to either duplicate and deliver or only deliver software products to customers. Revenue from transactions involving delivery agents should be recognized when the software is delivered to the customer. Transferring the fulfillment obligation to an agent of the vendor does not relieve the vendor of the responsibility for delivery. This is the case even if the vendor has no direct involvement in the actual delivery of the software product to the customer.

Authorization Codes

.24 In a number of software arrangements, vendors use **authorization codes**, commonly referred to as *keys*, to permit customer access to software that otherwise would be restricted. Keys are used in a variety of ways and may serve different purposes. For example, permanent keys may be used to control access to the software, or additional permanent keys may be necessary for the duplication of the software. Temporary keys may be used for the same purposes and also may be used to enhance the vendor's ability to collect payment or to control the use of software for demonstration purposes.

.25 In software arrangements involving the use of keys, delivery of a key is not necessarily required to satisfy the vendor's delivery responsibility. The software vendor should recognize revenue on delivery of the software if all other requirements for revenue recognition under this SOP and all of the following conditions are met.

- The customer has licensed the software and the vendor has delivered a version of the software that is fully functional except for the permanent key or the additional keys (if additional keys are used to control the reproduction of the software).
- The customer's obligation to pay for the software and the terms of payment, including the timing of payment, are not contingent on delivery of the permanent key or additional keys (if additional keys are used to control the reproduction of the software).
- The vendor will enforce and does not have a history of failing to enforce its right to collect payment under the terms of the original arrangement.

In addition, if a temporary key is used to enhance the vendor's ability to collect payment, the delivery of additional keys, whether temporary or permanent, is not required to satisfy the vendor's delivery responsibility if (*a*) the above conditions are met and (*b*) the use of a temporary key in such circumstances is a customary practice of the vendor. Selective issuance of temporary keys might indicate that collectibility is not probable or that the software is being used only for demonstration purposes.

Fixed or Determinable Fees and Collectibility

.26 The other prerequisites in paragraph .08 for revenue recognition are that (*a*) the vendor's fee is fixed or determinable and (*b*) collectibility is probable. A software licensing fee is not fixed or determinable if the amount is based on the number of units distributed or copied, or the expected number of users of the product. Revenue recognition for variable-pricing arrangements is discussed in paragraphs .43 through .47 of this SOP. Additionally, if an arrangement includes (*a*) rights of return or (*b*) rights to refunds without return of the software, FASB Statement No. 48 requires that conditions that must be met in order for the vendor to recognize revenue include that the amount of future returns or refunds can be reasonably estimated.

Factors That Affect the Determination of Whether a Fee is Fixed or Determinable and Collectible

.27 A number of arrangements that call for fixed or determinable payments, including minimum royalties or license fees from resellers, specify a payment period that is short in relation to the period during which the customer is expected to use or market the related products. Other arrangements have payment terms that extend over a substantial portion of the period during which the customer is expected to use or market the related products. Because a product's continuing value may be reduced due to the subsequent introduction of enhanced products by the vendor or its competitors, the possibility that the vendor still may provide a refund or concession to a creditworthy customer to liquidate outstanding amounts due under the original terms of the arrangement increases as payment terms become longer.

.28 For the reason cited in paragraph .27 *any* extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable. Further, if payment of a significant portion of the software licensing fee is not due until after expiration of the license or more than twelve months after delivery, the licensing fee should be *presumed* not to be fixed or determinable. However, this presumption may be overcome by evidence that the vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions. In such a situation, a vendor should consider such fees fixed or determinable and should recognize revenue upon delivery of the software, provided all other conditions for revenue recognition in this SOP have been satisfied.

.29 If it cannot be concluded that a fee is fixed or determinable at the outset of an arrangement, revenue should be recognized as payments from customers become due (assuming all other conditions for revenue recognition in this SOP have been satisfied).

.30 For reseller arrangements, the following factors also should be considered in evaluating whether the fixed or determinable fee and collectibility criteria for revenue recognition are met.

- Business practices, the reseller's operating history, competitive pressures, informal communications, or other factors indicate that payment is substantially contingent on the reseller's success in distributing individual units of the product.[7]
- Resellers are new, undercapitalized, or in financial difficulty and may not demonstrate an ability to honor a commitment to make fixed or determinable payments until they collect cash from their customers.
- Uncertainties about the potential number of copies to be sold by the reseller may indicate that the amount of future returns cannot be reasonably estimated on delivery; examples of such factors include the newness of the product or marketing channel, competitive products, or dependence on the market potential of another product offered (or anticipated to be offered) by the reseller.
- Distribution arrangements with resellers require the vendor to rebate or credit a portion of the original fee if the vendor subsequently reduces its price for a product and the reseller still has rights with respect to that product (sometimes referred to as price protection). If a vendor is unable to reasonably estimate future price changes in light of competitive conditions, or if significant uncertainties exist about the vendor's ability to maintain its price, the arrangement fee is not fixed or determinable. In such circumstances, revenue from the arrangement should be deferred until the vendor is able to reasonably estimate the effects of future price changes and the other conditions of this SOP have been satisfied.

.31 *Customer Cancellation Privileges.* Fees from licenses cancelable by customers are neither fixed nor determinable until the cancellation privileges lapse. Fees from licenses with cancellation privileges expiring ratably over the license period are considered to become determinable ratably over the license period as the cancellation privileges lapse. In applying the provisions of this paragraph, obligations related to warranties for defective software, including warranties that are routine, short-term, and relatively minor, should be accounted for in conformity with FASB Statement No. 5. Additionally, short-term rights of return, such as thirty-day money-back guarantees, should not be considered cancellation privileges; the related returns should be accounted for in conformity with FASB Statement No. 48.

.32 *Fiscal Funding Clauses.* Fiscal funding clauses sometimes are found in software license arrangements in which the licensees are governmental units. Such clauses generally provide that the license is cancelable if the legislature or funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the licensing arrangement.

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[7] Contractual arrangements under which the reseller is obligated to pay only as and if sales are made to users should be accounted for as consignments.

.33 Consistent with FASB Technical Bulletin No. 79-10, *Fiscal Funding Clauses in Lease Agreements*, a software licensing arrangement with a governmental unit containing a fiscal funding clause should be evaluated to determine whether the uncertainty of a possible license arrangement cancellation is a remote contingency.[8] If the likelihood is assessed as remote, the software licensing arrangement should be considered noncancelable. Such an assessment should include the factors discussed in paragraphs .27 and .28 of this SOP. If the likelihood is assessed as other than remote, the license should be considered cancelable, thus precluding revenue recognition. A fiscal funding clause with a customer other than a governmental unit that is required to include such a clause creates a contingency that precludes revenue recognition until the requirements of the clause and all other provisions of this SOP have been satisfied.

Multiple-Element Arrangements

.34 As discussed in paragraph .09, multiple-element arrangements to which contract accounting does not apply may include customer rights to any combination of additional software deliverables, services, or PCS. If contract accounting does not apply, individual elements in such arrangements should be accounted for in accordance with paragraphs .08 through .14. Paragraphs .35 through .73 provide guidance on the application of those paragraphs to multiple-element arrangements.

Additional Software Deliverables and Rights to Exchange or Return Software

.35 As part of a multiple-element arrangement, a vendor may agree to deliver software currently and to deliver additional software in the future. The additional deliverables may include upgrades/enhancements or additional software products. Additionally, a vendor may provide the customer with the right to exchange or return software, including the right to transfer software from one hardware **platform** or operating system to one or more other platforms or operating systems (a **platform-transfer right**).

.36 *Upgrades/enhancements.* As part of a multiple-element arrangement, a vendor may agree to deliver software currently and provide the customer with an **upgrade right** for a specified upgrade/enhancement. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor's established practice. (Rights to receive *unspecified* upgrades/enhancements on a when-and-if-available basis are PCS, as it has been redefined in this SOP.) The upgrade right should be accounted for as a separate element in accordance with paragraphs .08 through .14. Guidance on the application of those paragraphs to multiple-element software arrangements that include upgrade rights is given in paragraphs .37 and .38.

.37 If a multiple-element arrangement includes an upgrade right, the fee should be allocated between the elements based on vendor-specific objective evidence of fair value. The fee allocated to the upgrade right is the price for the upgrade/enhancement that would be charged to existing users of the software product being updated. If the upgrade right is included in a multiple-element arrangement on which a discount has been offered (see paragraph .11), no portion of the discount should be allocated to the upgrade right. If sufficient vendor-specific evidence exists to reasonably estimate the percentage of customers that are not expected to exercise the upgrade right, the fee allocated to

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[8] The evaluation of whether the level of uncertainty of possible cancellation is remote should be consistent with FASB Statement No. 5, which defines *remote* as relating to conditions in which "the chance of the future event or events occurring is slight."

the upgrade right should be reduced to reflect that percentage. This estimated percentage should be reviewed periodically. The effect of any change in that percentage should be accounted for as a change in accounting estimate.

.38 The amount of the fee allocated to the upgrade right should be recognized as revenue when the conditions in paragraphs .08 through .14 are met. If sufficient vendor-specific objective evidence does not exist for the allocation of the fee to the upgrade right, revenue from the arrangement should be deferred until the earlier of the point at which (*a*) such sufficient vendor-specific objective evidence does exist or (*b*) all elements of the arrangement have been delivered.

.39 *Additional Software Products.* As part of a multiple-element arrangement, a vendor may agree to deliver software currently and deliver specified additional software products in the future. The rights to these additional products may be included either in the terms of a PCS arrangement or in a separate agreement. Even if the rights to the additional software products are included in a PCS arrangement, the revenue allocable to the additional software products should be accounted for separately from the PCS arrangement as an element of a multiple-element arrangement.

.40 Multiple-element arrangements that include rights to undelivered additional software products that are not subscriptions (see paragraphs .48 and .49) should be accounted for in accordance with paragraphs .08 through .14 of this SOP. Guidance on the application of those paragraphs to such arrangements is provided in paragraphs .41 through .47 below.

.41 The fee from the arrangement should be allocated among the products based on vendor-specific objective evidence of fair value. The allocation should be based on the relative sales prices (determined pursuant to paragraphs .10 and .11 of this SOP) of the products. If vendor-specific objective evidence of fair value does not exist, paragraph .12 of this SOP requires that all revenue from the arrangement be deferred until the earlier of the point at which (*a*) such sufficient vendor-specific objective evidence does exist or (*b*) all elements of the arrangement have been delivered. The fee allocated to the additional software products should not be reduced by the percentage of any customers that are not expected to exercise the right to receive additional software products.

.42 If the arrangement is based on a price per product (not a price per copy), the portion of the fee allocated to a product should be recognized as revenue when the product is delivered, assuming all other provisions of paragraphs .08 through .14 of this SOP are met.

.43 Some **fixed fee** license or reseller arrangements provide customers with the right to reproduce or obtain copies at a specified price per copy (rather than per product) of two or more software products up to the total amount of the fixed fee. A number of the products covered by the arrangement may not be deliverable or specified at the inception of the arrangement. Although the price per copy is fixed at the inception of the arrangement, an allocation of the arrangement fee to the individual products generally cannot be made, because the total revenue allocable to each software product is unknown and depends on the choices to be made by the customer and, sometimes, future development activity while the arrangement is in effect. Nevertheless, as discussed in paragraph .46 of this SOP, in certain situations, revenue can be allocated to the products that are undeliverable or not specified at the inception of the arrangement.

.44 In arrangements in which no allocation can be made, until the first copy or product master of each product covered by the arrangement has been delivered to the customer assuming the provisions of paragraphs .08 through .14 of this SOP are met, revenue should be recognized as copies of delivered products either (*a*) are reproduced by the customer or (*b*) are furnished to the customer if the vendor is duplicating the software. Once the vendor has delivered the product master or the first copy of all products covered by the arrangement, any licensing fees not previously recognized should be recognized. (At that point, only duplication of the software is required to satisfy the vendor's delivery requirement. As discussed in paragraph .21 of this SOP, duplication of the software is incidental to the arrangement, and delivery is deemed to have occurred upon delivery of the product master or first copy.) When the arrangement terminates, the vendor should recognize any licensing fees not previously recognized.

.45 The revenue from the kind of arrangements discussed in paragraph .44 should not be recognized fully until at least one of the following conditions is met.

- Delivery is complete for all products covered by the arrangement.
- The aggregate revenue attributable to all copies of the software products delivered is equal to the fixed fee, provided that the vendor is not obligated to deliver additional software products under the arrangement.

.46 Nevertheless, certain arrangements that include products that are not deliverable at the inception impose a maximum number of copies of the undeliverable product(s) to which the customer is entitled. In such arrangements, a portion of the arrangement fee should be allocated to the undeliverable product(s). This allocation should be made assuming that the customer will elect to receive the maximum number of copies of the undeliverable product(s).

.47 The revenue allocated to the delivered products should be recognized when the product master or first copy is delivered. If, during the term of the arrangement, the customer reproduces or receives enough copies of these delivered products so that revenue allocable to the delivered products exceeds the revenue previously recognized, such additional revenue should be recognized as the copies are reproduced or delivered. The revenue allocated to the undeliverable product(s) should be reduced by a corresponding amount.

.48 As part of a multiple-element arrangement with a user, a vendor may agree to deliver software currently and to deliver *unspecified* additional software products in the future (including unspecified platform transfer rights that do not qualify for exchange accounting as described in paragraphs .50 through .55). For example, the vendor may agree to deliver all new products to be introduced in a family of products over the next two years. These arrangements are similar to arrangements that include PCS in that future deliverables are unspecified. Nevertheless, they are distinguished from arrangements that include PCS because the future deliverables are products, not unspecified upgrades/enhancements.

.49 The software elements of the kinds of arrangements discussed in paragraph .48 should be accounted for as subscriptions. No allocation of revenue should be made among any of the software products, and all software product-related revenue from the arrangement should be recognized ratably over the term of the arrangement beginning with delivery of the first product. If the term of the arrangement is not stated, the revenue should be recognized ratably over the estimated economic life of the products covered by the arrangement, beginning with delivery of the first product. An intent on the part of the vendor not to develop new products during the term of the arrangement does not relieve the vendor of the requirement to recognize revenue ratably over the term of the arrangement, beginning with the delivery of the first product.

.50 *Rights to Exchange or Return Software.* As part of an arrangement, a software vendor may provide the customer with the right to return software or to exchange software for products with no more than minimal differences in price, functionality, or features. The accounting for returns is significantly different from the accounting for exchanges. Although it is sometimes difficult to determine whether a transaction is a return or exchange of software, the fact that the software is not returned physically does not preclude accounting for the transaction as either an exchange or as a return. If the software is not returned physically and the customer contractually is entitled to continue to use the previously delivered software, the arrangement should be accounted for in the manner prescribed in the section herein entitled "Additional Software Products" (see paragraphs .39 through .49). If the software is not returned physically and the customer contractually is not entitled to continue to use the previously delivered software, the transaction should be accounted for either as a return or as an exchange, as discussed in the following paragraphs.

.51 If the rights discussed in the previous paragraph are offered to users (but not resellers), the exchanges are analogous to "exchanges by ultimate customers of one item for another of the same kind, quality, and price . . . [that] are not considered returns" described in footnote 3 of FASB Statement No. 48. Conversely, exchanges by users of software products for dissimilar software products or for similar software products with more than minimal differences in price, functionality, or features are considered returns, and revenue related to arrangements that provide users with the rights to make such exchanges should be accounted for in conformity with FASB Statement No. 48. If the other product(s) is not available at the time the initial product is delivered, there should be persuasive evidence that demonstrates there will be no more than minimal differences in price, features, or functionality among the products in order for the right to qualify as a right to exchange. Additionally, if the vendor expects to incur a significant amount of development costs related to the other product, the other product should be considered to have more than a minimal difference in functionality.

.52 As part of a multiple-element arrangement, a vendor may grant a user a platform-transfer right. Depending on the circumstances, the exercise of a platform-transfer right may represent an exchange, a return, or additional software products for accounting purposes. If the customer contractually is entitled to continue to use the software that was delivered originally (in addition to the software that is to be delivered for the new platform), the platform transfer right should be accounted for in the manner prescribed in the section herein entitled "Additional Software Products" (see paragraphs .39 through .49).

.53 If, as part of a multiple-element arrangement, a vendor offers a user (not a reseller) a platform-transfer right, and the provisions of paragraphs .08 through .14 of this SOP are met, the revenue from the software license should be recognized upon the initial delivery of the software, and the exercise of the platform-transfer right should be treated as an exchange, if the platform-transfer right—

- Is for the same product (see paragraph .54)
- Does not increase the number of copies or concurrent users of the software product available under the license arrangement.

.54 Products are considered to be the same product if there are no more than minimal differences among them in price, features, and functions, and if they are marketed as the same product, even though there may be differences arising from environmental variables such as operating systems, databases, user interfaces, and platform scales. Indicators of "marketed as the same product" include (*a*) the same product name (although version numbers may differ) and (*b*) a focus on the same features and functions.

.55 As part of their standard sales terms or as a matter of practice, vendors may grant resellers the rights to exchange unsold software for other software (including software that runs on a different hardware platform or operating system). Because the reseller is not the ultimate customer (see paragraph .51), such exchanges, including those referred to as stock balancing arrangements, should be accounted for as returns. Arrangements that grant rights to make such exchanges should be accounted for in conformity with FASB Statement No. 48, even if the vendors require the resellers to purchase additional software to exercise the exchange rights.

Postcontract Customer Support

.56 Software arrangements may include the right to PCS. PCS includes the right to receive PCS services or *unspecified* upgrades/enhancements, or both, offered to users or resellers. A vendor may develop historical patterns of regularly providing all customers or certain kinds of customers with the services or unspecified upgrades/enhancements normally associated with PCS, or may anticipate doing so, even though there is no written contractual obligation or the stipulated PCS term commences at some date after delivery. In those situations, an implied PCS arrangement exists that commences upon product delivery. For purposes of applying the guidance in this SOP, PCS includes a vendor's expected performance based on such patterns, even if performance is entirely at the vendor's discretion and not pursuant to a formal agreement.

.57 If a multiple-element software arrangement includes explicit or implicit rights to PCS, the total fees from the arrangement should be allocated among the elements based on vendor-specific objective evidence of fair value, in conformity with paragraph .10. The fair value of the PCS should be determined by reference to the price the customer will be required to pay when it is sold separately (that is, the renewal rate). The portion of the fee allocated to PCS should be recognized as revenue ratably over the term of the PCS arrangement, because the PCS services are assumed to be provided ratably. However, revenue should be recognized over the period of the PCS arrangement in proportion to the amounts expected to be charged to expense for the PCS services rendered during the period if—

- Sufficient vendor-specific historical evidence exists demonstrating that costs to provide PCS are incurred on other than a straight-line basis. In making this determination, the vendor should take into consideration allocated portions of cost accounted for as research and development (R&D) costs and the amortization of costs related to the upgrade-enhancement capitalized in conformity with FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*. Such costs should be considered as part of the costs to provide PCS.
- The vendor believes that it is probable that the costs incurred in performing under the current arrangement will follow a similar pattern.

Because the timing, frequency, and significance of unspecified upgrades/enhancements can vary considerably, the point at which unspecified upgrades/

enhancements are expected to be delivered should not be used to support income recognition on other than a straight-line basis.

.58 If sufficient vendor-specific objective evidence does not exist to allocate the fee to the separate elements and the only undelivered element is PCS, the entire arrangement fee should be recognized ratably over (*a*) the contractual PCS period (for those arrangements with explicit rights to PCS) or (*b*) the period during which PCS is expected to be provided (for those arrangements with implicit rights to PCS).

.59 PCS revenue may be recognized together with the initial licensing fee on delivery of the software if all of the following conditions are met.

a. The PCS fee is included with the initial licensing fee.

b. The PCS included with the initial license is for one year or less.

c. The estimated cost of providing PCS during the arrangement is insignificant.

d. Unspecified upgrades/enhancements offered during PCS arrangements historically have been and are expected to continue to be minimal and infrequent.

If PCS revenue is recognized upon the delivery of the software, the vendor must accrue all estimated costs of providing the services, including upgrades/enhancements. Upgrades/enhancements are not developed solely for distribution to PCS customers; revenues are expected to be earned from providing the enhancements to other customers as well. Therefore, costs should be allocated between PCS arrangements and other licenses.

.60 A determination that unspecified upgrades/enhancements offered during the PCS arrangement are expected to be minimal and infrequent should be evidenced by the patterns of minimal and infrequent unspecified upgrades/enhancements offered in previous PCS arrangements. A conclusion that unspecified upgrades/enhancements are expected to be minimal and infrequent should not be reached simply because unspecified upgrades/enhancements have been or are expected to be offered less frequently than on an annual basis. Regardless of the vendor's history of offering unspecified upgrades/enhancements to initial licensees, PCS should be accounted for separately from the initial licensing fee if the vendor expects to offer upgrades/enhancements that are greater than minimal or more than infrequent to the users or resellers of the licensed software during the PCS arrangement.

.61 *Postdelivery Telephone Support at No Additional Charge.* Postdelivery telephone support provided to users by the vendor at no additional charge should be accounted for as PCS, in conformity with this SOP, regardless of whether the support is provided explicitly under the licensing arrangement. Although such telephone support may be offered or available for periods exceeding one year, if the vendor has established a history of providing substantially all the telephone support within one year of the licensing or sale of the software, the PCS may be considered to have a term of one year or less in applying paragraph .59, item (*b*) of this SOP. Accordingly, revenue allocable to telephone support may be recognized together with the initial licensing fee on delivery of the software if all the conditions in paragraph .59 of this SOP are met. This provision applies only to telephone support provided at no additional charge. If revenue allocable to telephone support is recognized together with the licensing fee on delivery, the vendor should accrue the estimated cost of providing that support.

.62 *PCS Granted by Resellers.* An arrangement in which a vendor grants a reseller the right to provide unspecified upgrades/enhancements to the reseller's customers is an implied PCS arrangement between the vendor and the reseller, even if the vendor does not provide direct telephone support to the reseller's customers. If sufficient vendor-specific objective evidence does not exist to allocate the fee to the software and the PCS, revenue from both the licensing arrangement and the PCS should be recognized ratably over the period during which PCS is expected to be provided.

Services

.63 Certain arrangements include both software and service elements (other than PCS-related services). The services may include training, installation, or consulting. Consulting services often include implementation support, software design or development, or the customization or modification of the licensed software.

.64 If an arrangement includes such services, a determination must be made as to whether the service element can be accounted for separately as the services are performed. Paragraph .65 discusses the criteria that must be considered in making such a determination. If the nature of the services is such that the service element does not qualify for separate accounting as a service, contract accounting must be applied to both the software and service elements included in the arrangement. Paragraphs .74 through .91 of this SOP address the application of contract accounting to software arrangements.

.65 In order to account separately for the service element of an arrangement that includes both software and services, sufficient vendor-specific objective evidence of fair value must exist to permit allocation of the revenue to the various elements of the arrangement (as discussed in paragraphs .10 and .12). Additionally, the services (*a*) must not be essential to the functionality of any other element of the transaction and (*b*) must be described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services.

.66 If an arrangement includes services that meet the criteria of paragraph .65 for separate accounting, revenue should be allocated among the service and software elements of the contract. This allocation should be based on vendor-specific objective evidence of fair values. (Fair values are not necessarily the same as any separate prices stated for the separate elements of the arrangement.) Revenue allocated to the service element should be recognized as the services are performed or, if no pattern of performance is discernible, on a straight-line basis over the period during which the services are performed.

.67 If vendor-specific objective evidence of the fair value does not exist to allocate a portion of the fee to the service element, and the only undelivered element is services that do not involve significant production, modification, or customization of the software (for example, training or installation), the entire arrangement fee should be recognized as the services are performed. If no pattern of performance is discernible, the entire arrangement fee should be recognized on a straight-line basis over the period during which the services are performed.

.68 An important factor to consider in determining whether the services are essential to the functionality of any other element is whether the software included in the arrangement is considered **core** or **off-the-shelf software**. Core software is software that a vendor uses in creating other software. It is not sold as is because customers cannot use it unless it is customized to meet system objectives or customer specifications. Off-the-shelf software is software that is marketed as a stock item that can be used by customers with little or no customization.

.69 Software should be considered off-the-shelf software if it can be added to an arrangement with insignificant changes in the underlying code and it could be used by the customer for the customer's purposes upon installation. Actual use by the customer and performance of other elements of the arrangement is not required to demonstrate that the customer could use the software off-the-shelf. If significant modifications or additions to the off-the-shelf software are necessary to meet the customer's purpose (for example, changing or making additions to the software, or because it would not be usable in its off-the-shelf form in the customer's environment), the software should be considered core software for purposes of that arrangement. If the software that is included in the arrangement is not considered to be off-the-shelf software, or if significant modifications or additions to the off-the-shelf software are necessary to meet the customer's functionality, no element of the arrangement would qualify for accounting as a service, and contract accounting should be applied to both the software and service elements of the arrangement.

.70 Factors indicating that the service element is essential to the functionality of the other elements of the arrangement, and consequently should not be accounted for separately, include the following.

- The software is not off-the-shelf software.
- The services include significant alterations to the features and functionality of the off-the-shelf software.
- Building complex interfaces is necessary for the vendor's software to be functional in the customer's environment.
- The timing of payments for the software is coincident with performance of the services.
- **Milestones** or customer-specific acceptance criteria affect the realizability of the software-license fee.

.71 Judgment is required in determining whether the obligation to provide services in addition to the delivery of software should be accounted for separately as a service element. Services that qualify for accounting as a service element of a software arrangement always are stated separately and have one or more of the following characteristics.

- The services are available from other vendors.
- The services do not carry a significant degree of risk or unique acceptance criteria.
- The software vendor is an experienced provider of the services.
- The vendor is providing primarily implementation services, such as implementation planning, loading of software, training of customer personnel, data conversion, building simple interfaces, running test data, and assisting in the development and documentation of procedures.
- Customer personnel are dedicated to participate in the services being performed.

.72 *Funded Software-Development Arrangements.* Software-development arrangements that are fully or partially funded by a party other than the vendor that is developing the software typically provide the funding party with some or all of the following benefits:

- Royalties payable to the funding party based solely on future sales of the product by the software vendor (that is, reverse royalties)
- Discounts on future purchases by the funding party of products produced under the arrangement
- A nonexclusive sublicense to the funding party, at no additional charge, for the use of any product developed (a prepaid or paid-up nonexclusive sublicense)

.73 A funded software-development arrangement within the scope of FASB Statement No. 68, *Research and Development Arrangements*, should be accounted for in conformity with that Statement. If the technological feasibility of the computer software product pursuant to the provisions of FASB Statement No. 86 has been established before the arrangement has been entered into, FASB Statement No. 68 does not apply because the arrangement is not a research and development arrangement. Accounting for costs related to funded software-development arrangements is beyond the scope of this SOP. However, if capitalization of the software-development costs commences pursuant to FASB Statement No. 86, any income from the funding party under a funded software-development arrangement should be credited first to the amount of the development costs capitalized. If the income from the funding party exceeds the amount of development costs capitalized, the excess should be deferred and credited against future amounts that subsequently qualify for capitalization. Any deferred amount remaining after the project is completed (that is, when the software is available for general release to customers and capitalization has ceased) should be credited to income.

Contract Accounting

.74 If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the service element does not meet the criteria for separate accounting set forth in paragraph .65. The entire arrangement should be accounted for in conformity with ARB No. 45, using the relevant guidance in SOP 81-1 [section 10,330]. Nevertheless, transactions that normally are accounted for as product sales should not be accounted for as long-term contracts merely to avoid the delivery requirements normally associated with product sales for revenue recognition.

.75 In applying contract accounting, the vendor must use either the percentage-of-completion method or the completed-contract method. The determination of the appropriate method should be made according to the recommendations in paragraphs 21 through 33 of SOP 81-1 [section 10,330.21 through .33].

.76 *Segmentation.* Software contracts may have discrete elements that meet the criteria for segmenting in paragraphs 39 through 42 of SOP 81-1 [section 10,330.39 through .42]. If a contract is segmented, each segment is treated as a separate profit center. Progress-to-completion for each segment should be measured in conformity with paragraphs .78 through .80 of this SOP.

.77 Some vendors of arrangements that include software combined with services or hardware or both do not identify the elements separately and do not sell them separately because of agreements with their suppliers. Other vendors who are not restricted by such agreements nevertheless bid or negotiate software and other products and services together. Arrangements that do not meet the segmentation criteria in paragraph 40 of SOP 81-1 [section 10,330.40] are prohibited from being segmented, unless the vendor has a history of providing the software and other products and services to customers under separate arrangements and the arrangement meets the criteria in paragraph 41 of SOP 81-1 [section 10,330.41].

.78 *Measuring Progress-to-Completion Under the Percentage-of-Completion Method.* Paragraph 46 of SOP 81-1 [section 10,330.46] describes the approaches to measuring progress on contracts (or segments thereof) under the percentage-of-completion method. Those approaches are grouped into input and output measures, as follows.

> Input measures are made in terms of efforts devoted to a contract. They include the methods based on costs and on efforts expended. Output measures are made in terms of results achieved. They include methods based on units produced, units delivered, contract milestones, and value added. For contracts under which separate units of output are produced, progress can be measured on the basis of units of work completed.

For software contracts, an example of an input measure is labor hours; an example of an output measure is arrangement milestones, such as the completion of specific program modules.

.79 If, as discussed in paragraph .76 of this SOP, a software contract includes a discrete element that meets the segmentation criteria of SOP 81-1 [section 10,330], the method chosen to measure progress-to-completion on the element should be the method that best approximates progress-to-completion. Progress-to-completion on separate elements of the same software arrangement may be measured by different methods. The software vendor should choose measurement methods consistently, however, so that it uses similar methods to measure progress-to-completion on similar elements.

.80 Output measures, such as value-added or arrangement milestones, may be used to measure progress-to-completion on software arrangements, but many companies use input measures because they are established more easily. As noted in paragraph 47 of SOP 81-1 [section 10,330.47], "The use of either type of measure requires the exercise of judgment and the careful tailoring of the measure to the circumstances." Further, paragraph 51 of SOP 81-1 [section 10,330.51] states that

> The acceptability of the results of input or output measures deemed to be appropriate to the circumstances should be periodically reviewed and confirmed by alternative measures that involve observation and inspection. For example, the results provided by the measure used to determine the extent of progress may be compared to the results of calculations based on physical observations by engineers, architects, or similarly qualified personnel. That type of review provides assurance somewhat similar to that provided for perpetual inventory records by periodic physical inventory counts.

.81 *Input Measures.* Input measures of progress-to-completion on arrangements are made in terms of efforts devoted to the arrangement and, for software arrangements, include methods based on costs, such as cost-to-cost measures, and on efforts expended, such as labor hours or labor dollars. Progress-to-completion is measured indirectly, based on an established or assumed relationship between units of input and productivity. A major advantage of input measures is that inputs expended are easily verifiable. A major disadvantage is that their relationship to progress-to-completion may not hold if inefficiencies exist or if the incurrence of the input at a particular point does not indicate progress-to-completion.

.82 Costs incurred should be included in measuring progress-to-completion only to the extent that they relate to contract performance. Items not specifically produced for the arrangement, such as hardware purchased from third parties or off-the-shelf software, should not be included in the measurement of progress-to-completion.

.83 Labor hours often are chosen as the basis for measuring progress-to-completion, because they closely approximate the output of labor-intensive processes and often are established more easily than output measures. Core software requires labor-intensive customization. Therefore, labor hours provide a good measure of progress-to-completion on elements of software arrangements that involve the customization of core software.

.84 If the measurement of progress-to-completion is based primarily on costs, the contribution to that progress of hardware and software that were produced specifically for the arrangement may be measurable and recognizable before delivery to the user's site. For example, efforts to install, configure, and customize the software may occur at the vendor's site. The costs of such activities are measurable and recognizable at the time the activities are performed.

.85 *Output Measures.* Progress on arrangements that call for the production of identifiable units of output can be measured in terms of the value added or milestones reached. Although progress-to-completion based on output measures is measured directly from results achieved, thus providing a better approximation of progress than is provided by input measures, output measures may be somewhat unreliable because of the difficulties associated with establishing them.

.86 In order for the value added to be verifiable, the vendor must identify elements or subcomponents of those elements. If output measures are neither known nor reasonably estimable, they should not be used to measure progress-to-completion.

.87 If value added by off-the-shelf software is to be included in the measurement of progress-to-completion, such software cannot require more than minor modifications and must be usable by the customer for the customer's purpose in the customer's environment. If more than minor modifications or additions to the off-the-shelf software are necessary to meet the functionality required under the arrangement terms, either by changing or making additions to the software, or because the software would not be usable by the customer in its off-the-shelf form for the customer's purpose in the customer's environment, it should be accounted for as core software.

.88 Value added by the customization of core software should be included in the measurement of progress-to-completion of the customization and installation at the user's site. However, if the installation and customization processes are divided into separate output modules, the value of core software associated with the customization of a module should be included in the measurement of progress-to-completion when that module is completed.

.89 Contract milestones may be based on contractual project plans. Contractual provisions generally require the performance of specific tasks with the approval or acceptance by the customer; project plans generally schedule inspections in which the project's status is reviewed and approved by management. The completion of tasks that trigger such inspections are natural milestones because they are subject to relatively independent review as an intrinsic part of the project management process.

.90 Considerations other than progress-to-completion affect the amounts that become billable at particular times under many arrangements. Accordingly, although the achievement of contract milestones may cause arrangement revenues to become billable under the arrangement, the amounts billable should be used to measure progress-to-completion only if such amounts indeed indicate such progress.

.91 The milestones that are selected to measure progress-to-completion should be part of the management review process. The percentage-of-completion designated for each milestone should be determined considering the experience of the vendor on similar projects.

Effective Date and Transition

.92 This SOP is effective for transactions entered into in fiscal years beginning after December 15, 1997. Earlier application is encouraged as of the beginning of fiscal years or interim periods for which financial statements or information have not been issued. Retroactive application of the provisions of this SOP is prohibited. [*Note:* An effective date provision of this SOP has been deferred by SOP 98-4. See section 10,740.]

The provisions of this Statement need not be applied to immaterial items.

Basis for Conclusions

Background

.93 SOP 91-1 was issued in December 1991. AcSEC understands that certain provisions of that Statement are being applied inconsistently in practice and that various practice issues have arisen that were not addressed in SOP 91-1. As a result, AcSEC added a project to its agenda in March 1993 to interpret those provisions and provide additional guidance. The key issues identified at the outset of the project related to accounting for arrangements that provided for multiple deliverables (including PCS). The project began as an amendment to SOP 91-1. However, as deliberations progressed, AcSEC determined that it would be more appropriate to supersede SOP 91-1 to (*a*) amend the provisions in question and (*b*) incorporate AcSEC's conclusions on practice issues that had not been addressed in SOP 91-1.

Basic Principles

.94 Transfers of rights to software by licenses rather than by outright sales protect vendors from the unauthorized duplication of their products. Nevertheless, the rights transferred under software licenses are substantially the same as those expected to be transferred in sales of other kinds of products. AcSEC believes the legal distinction between a license and a sale should not cause revenue recognition on software products to differ from revenue recognition on the sale of other kinds of products.

.95 Arrangements to deliver software or a software system, either alone or together with other products, may include services. AcSEC believes that if those services entail significant production, modification, or customization of the software, such software before those alterations (even if already delivered) is not the product that has been purchased by the customer. Instead, the product purchased by the customer is the software that will result from the alterations. Accordingly, AcSEC concluded that arrangements that include services that entail significant production, modification, or customization of software are construction-type or production-type contracts, and should be accounted for in conformity with ARB No. 45 and SOP 81-1 [section 10,330]. AcSEC concluded that if the services do not entail significant production, modification, or customization of software, the service element should be accounted for as a separate element.

.96 AcSEC believes that revenue generally should not be recognized until the element has been delivered. The recognition of revenue from product sales on delivery is consistent with paragraphs 83(b) and 84 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. Paragraph 83(b) provides the following guidance for recognition of revenues.

> Revenues are not recognized until earned. An entity's revenue-earning activities involve *delivering* or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. [Footnote omitted][Emphasis added]

Paragraph 84 states that in recognizing revenues and gains

> [t]he two conditions [for revenue recognition] (being realized or realizable and being earned) are usually met by the time the product or merchandise is delivered...to customers, and revenues...are commonly recognized at time of sale (usually meaning *delivery*). [Emphasis added]

.97 SOP 91-1 did not address arrangements that included software that was deliverable only when-and-if-available. Implementation questions arose as to whether when-and-if-available terms created contingencies that could be disregarded in determining whether an arrangement consists of multiple elements. AcSEC believes that because the when-and-if-available deliverables are bargained for in arrangements, they are of value to the customer. Accordingly, AcSEC concluded that when-and-if-available deliverables should be considered in determining whether an arrangement consists of multiple elements. Thus, the requirements of this SOP with respect to arrangements that consist of multiple elements should be applied to all additional products and services specified in the arrangement, including those described as being deliverable only when-and-if-available.

.98 In SOP 91-1, the accounting for vendor obligations remaining after delivery of the software was dependent upon whether the obligation was significant or insignificant. However, these determinations were not being made in a consistent manner, leading to a diversity in practice. AcSEC believes that all obligations should be accounted for and that revenue from an arrangement should be allocated to each element of the arrangement, based on vendor-specific objective evidence of the fair values of the elements. Further, AcSEC concluded that revenue related to a particular element should not be recognized until the revenue-recognition conditions in paragraphs .08 through

.14 of this SOP are met, because the earnings process related to that particular element is not considered complete until that time.

.99 In paragraph .10 of this SOP, AcSEC concluded that the revenue from an arrangement should be allocated to the separate elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated in the contract for each element. AcSEC believes that separate prices stated in a contract may not represent fair value and, accordingly, might result in an unreasonable allocation of revenue. AcSEC believes that basing the allocation on fair values is consistent with the accounting for commingled revenue. An example is the following discussion in paragraph 12 of FASB Statement No. 45, *Accounting for Franchise Fee Revenue*.

> The franchise agreement ordinarily establishes a single initial franchise fee as consideration for the franchise rights and the initial services to be performed by the franchisor. Sometimes, however, the fee also may cover tangible property, such as signs, equipment, inventory, and land and building. In those circumstances, the portion of the fee applicable to the tangible assets shall be based on the fair value of the assets.

.100 AcSEC considered allowing the use of surrogate prices such as competitor prices for similar products or industry averages to determine fair value. However, AcSEC believes that inherent differences exist between elements offered by different vendors. These inherent differences led AcSEC to conclude that only vendor-specific evidence of fair value can be considered sufficiently objective to allow the allocation of the revenue to the various elements of the arrangement.

.101 AcSEC believes that the best evidence of the fair value of an element is the price charged if that element is sold separately. Still, an arrangement may include elements that are not yet being sold separately. As discussed in the previous paragraph, because of inherent differences between the elements offered by different vendors, AcSEC concluded that companies should not use surrogate prices, such as competitor prices for similar products or industry averages, as evidence of the fair value for an element. AcSEC believes, however, that if a price for the element has been established by management having the relevant authority, such a price represents evidence of the fair value for that element. To meet the criterion of objectivity, it must be probable that the established price will not change before the introduction of the element to the marketplace. Thus, the internally established prices should be factual and not estimates. For this reason, AcSEC concluded that the allocations may not be adjusted subsequently.

.102 AcSEC is aware that the pricing structure of certain arrangements is not limited to the prices charged for the separate elements. Pricing may be based on many different factors or combinations thereof. For example, certain arrangements are priced based on a combination of (*a*) the prices of products to be licensed and (*b*) the number of users that will be granted access to the licensed products. In some of these arrangements, the vendor requires a minimum number of users.

.103 The products contained in such arrangements are not available to the customer at the prices charged in the arrangement unless the customer also pays for the minimum number of users. Therefore, the prices contained in the arrangement do not represent the prices charged for the product when sold separately. AcSEC believes that it would be inappropriate to determine the fair values of the products (as discussed in paragraph .10) without giving consideration to the impact of the user-based portion of the fee. For this reason, AcSEC concluded in paragraph .10 that when a vendor's pricing is based on multiple factors such as the number of products and the number of users, the price charged for the same element when sold separately must consider all factors of the vendor's pricing structure.

.104 Often, multiple element arrangements are sold at a discount rather than at the sum of the list prices for each element. If the amounts deferred for undelivered elements were based on list prices, the amount of revenue recognized for delivered elements would be understated. Accordingly, AcSEC concluded that relative sales prices should be used in determining the amount of revenue to be allocated to the elements of an arrangement.

.105 AcSEC believes that if an undelivered element is essential to the functionality of a delivered element, the customer does not have full use of the delivered element. Consequently, AcSEC concluded that delivery is considered not to have occurred in such situations.

.106 AcSEC believes that the earnings process with respect to delivered products is not complete if fees allocated to those products are subject to forfeiture, refund, or other concession if the vendor does not fulfill its delivery responsibilities. AcSEC believes that the potential concessions indicate the customer would not have licensed the delivered products without also licensing the undelivered products. Accordingly, AcSEC concluded that in order to recognize revenue, persuasive evidence should exist that fees allocated to delivered products are *not* subject to forfeiture, refund, or other concession. In determining the persuasiveness of the evidence, AcSEC believes that a vendor's history of making concessions that were not required by the provisions of an arrangement is more persuasive than terms included in the arrangement that indicate that no concessions are required.

Delivery

.107 In paragraph .18 of this SOP, AcSEC concluded that for software that is delivered electronically, the delivery criterion of paragraph .08 is deemed to have been met when the customer either (*a*) takes possession of the software via a download or (*b*) has been provided with access codes that allow the customer to take immediate possession of the software on its hardware pursuant to an agreement or purchase order for the software. AcSEC believes that the delivery criterion is met by use of access codes only when software is being delivered electronically.

.108 AcSEC believes that if the fee is not based on the number of copies to be delivered to or made or deployed by the customer, duplication of the software may be incidental to the arrangement. Paragraph .21 of this SOP describes circumstances (arrangements in which duplication is required only if additional copies are requested by the customer; arrangements in which the licensing fee is payable even if no additional copies are requested) that would lead to a conclusion that duplication is incidental to the arrangement. In other arrangements, vendors insist on duplicating the software to maintain quality control or to protect software transmitted by telecommunications. Others agree to duplicate the software as a matter of convenience to the customer.

.109 In arrangements in which duplication is considered incidental, AcSEC believes the vendor has fulfilled its delivery obligation as soon as the first copy or product master of the software has been delivered. Therefore, AcSEC concluded that in such instances, the vendor should not be precluded from recognizing revenue if the customer has not requested additional copies (particularly since the fee is payable regardless of whether such additional copies are requested by the customer). However, the estimated costs of duplicating the software should be accrued when the revenue is recognized.

Fixed or Determinable Fees and Collectibility

.110 In paragraphs .27 through .30, in the discussion of factors that affect the determination of whether a fee is fixed or determinable, AcSEC sought to clarify—but not change—similar provisions in SOP 91-1. In practice, some had interpreted those provisions to mean the following.

- Extended payment considerations could be overcome if customers were creditworthy.
- A fee could never be considered fixed or determinable if payment terms extended for more than twelve months after delivery.

.111 Others had interpreted these provisions to mean the following.

- If payment terms extended beyond customary terms but were twelve months or less, they were fixed or determinable.
- If payment terms exceeded twelve months, a vendor could recognize amounts due in the first twelve months as revenue at the time of the license. Additional revenue would be recognized based on the passage of time such that, at any point, any amounts due within one year would have been recognized as revenue (the *rolling twelve months* approach).

Paragraphs .112 through .114 of this SOP—

- Explain that the concern with extended payment terms is technological obsolescence and similar factors, not customer creditworthiness.
- Describe circumstances in which the presumption that a fee is not fixed or determinable because of extended payment terms may be overcome.
- Confirm that any extended payment terms, even if for less than twelve months, must be assessed for their effects on the fixed or determinable aspects of the fee.
- Clarify that the rolling twelve months approach should not be used.

.112 AcSEC believes that, given the susceptibility of software to significant external factors (in particular, technological obsolescence), the likelihood of vendor refunds or concessions is greater in an arrangement with extended payment terms than in an arrangement without extended payment terms. This is true regardless of the creditworthiness of the customer. Because of this greater likelihood of refunds or concessions, AcSEC believes that *any* extended payment terms outside of a vendor's normal business practices may indicate that the fee is not fixed or determinable.

.113 In paragraph .28 of this SOP, AcSEC concluded that if payment of a significant portion of a licensing fee is not due until after the expiration of the license or more than twelve months after delivery, the fee should be *presumed* not to be fixed or determinable. This conclusion is based on AcSEC's belief that payment terms of such extended duration indicate that vendor refunds or concessions are more likely than not. AcSEC acknowledges that the one-year provision is arbitrary. However, AcSEC concluded that such a limitation is needed to provide greater comparability within the industry.

.114 In considering the "rolling twelve months" approach found in practice, AcSEC considered the guidance in Chapter 1A of ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, paragraph 1, which states that "Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured." Accordingly, if a fee is considered fixed or determinable, it should be recognized as revenue when the sale is effected. If not, AcSEC believes that it should be recognized as revenue as payments from customers become due.

.115 In paragraph .08 of this SOP, AcSEC concluded that collectibility must be probable before revenue may be recognized. This conclusion is based on paragraph 84g of FASB Concepts Statement No. 5, which reads

> If collectibility of assets received for product, services, or other assets is doubtful, revenues and gains may be recognized on the basis of cash received.

.116 AcSEC notes that requiring collectibility enhances the verifiability of the other revenue recognition criteria of paragraph .08, as discussed below.

- *Persuasive evidence of an arrangement*—AcSEC included this criterion in order to prevent revenue recognition on delivery of elements which, in fact, had not been ordered by a customer. AcSEC believes it is unlikely that a customer would pay for an element that had not been ordered. Therefore, AcSEC believes that requiring collectibility of a receivable related to the sale or license acts to verify that an arrangement does exist.

- *Delivery*—AcSEC believes that until delivery of an element has occurred (including delivery of all other items essential to the functionality of the element in question), the customer has not received full use of the element ordered. A customer that has not received full use of the element ordered is likely to withhold payment or require a refund. Therefore, AcSEC believes that requiring collectibility of a receivable related to the sale or license acts to verify that the element has been delivered.

- *Fixed or determinable fee*—Much of AcSEC's concern related to fixed or determinable fees relates to arrangements with extended payment terms. In the software industry, requiring collectibility of a receivable prior to revenue recognition is important because of the frequency with which upgrades, enhancements, or new versions are released. As discussed elsewhere in this SOP, in certain instances it may be difficult to determine which version of an element induced a customer to enter into an arrangement. By requiring collectibility, AcSEC sought to prevent revenue recognition on sales or licenses of an element in situations in which circumstances may prompt the vendor to make subsequent adjustments to the price of a customer's purchase or license of a subsequent version of that element.

  The likelihood that subsequent versions will be released is greater over the long term than over the short term. Therefore, concerns related to concessions increase in arrangements with extended payment terms. AcSEC notes that prohibiting revenue recognition in circumstances in which the price adjustments discussed above could occur serves to ensure that the portion of the fee allocated to each element is fixed or determinable. That is, if the price on a subsequent element cannot be adjusted for concessions, and the amount allocated to the initial element must be collected in full, neither amount is subject to adjustment. Therefore, AcSEC believes that requiring collectibility of a receivable related to the sale or license acts to verify that the fees are fixed or determinable.

Multiple-Element Arrangements

Additional Software Deliverables and Right to Exchange or Return Software

.117 *Upgrades/enhancements.* In paragraph .37 of this SOP, AcSEC concluded that the portion of the arrangement fee allocated to an upgrade right should be based on the price for the upgrade/enhancement that would be charged to existing users of the software product being updated. AcSEC believes that in arrangements that include upgrade rights, it may be difficult to determine which version of the software induced the customer to enter into the arrangement. For example, a customer licensing an existing version of the software may have done so to facilitate obtaining the updated version upon its introduction. To eliminate the possibility of allocating too much revenue to the delivered software (and thereby accelerating recognition), AcSEC concluded that the upgrade price (without the allocation of any discount on the arrangement) should be used to determine the amount to be deferred. The residual amount, if any, is considered to be the fair value of the original product.

.118 AcSEC believes that upgrades/enhancements do not necessarily contain improvements that all customers would desire. A customer may not exercise an upgrade right for various reasons, including any of the following.

a. The benefits to be gained from the related upgrade/enhancement may not be important to that customer.

b. The customer may not wish to learn new commands for what may be perceived by that customer as marginal improvements.

c. The upgrade/enhancement would require more hardware functionality than the customer currently has.

Consequently, AcSEC concluded that amounts allocated to upgrade rights should be reduced to reflect the percentage of customers not expected to exercise the upgrade right, based on vendor-specific evidence.

.119 *Additional Software Products.* As stated in paragraph .118, AcSEC believes that not all customers entitled to an upgrade/enhancement will exercise their upgrade rights. AcSEC believes, however, that it is probable that all customers will choose to receive additional software products. Consequently, AcSEC concluded that the fee allocated to additional software products should not be reduced by the percentage of any customers not expected to exercise the right to receive the additional products.

.120 Paragraphs .48 and .49 of this SOP discuss accounting for software arrangements in which vendors agree to deliver unspecified additional software products in the future. AcSEC concluded that such arrangements should be accounted for as subscriptions, and that the fee from the arrangement should be recognized ratably as revenue over the term of the arrangement. AcSEC notes that, because the vendor is obligated to deliver these items only if they become available during the term of the arrangement, in some situations, the delivery of additional products will not be required. AcSEC believes that because these items are unspecified, vendor-specific objective evidence of fair value of each unspecified additional product cannot exist. However, AcSEC believes that requiring the deferral of all revenue until the end of the arrangement is too onerous because of the following.

a. All other revenue-recognition conditions in paragraphs .08 through .14 of this SOP have been met.

b. The additional software products in fact may never be delivered.

However, AcSEC also was concerned that if revenue recognition were permitted to begin at the inception of the arrangement, revenue may be recognized too early, particularly in arrangements in which the first product was not delivered for some time after inception. Accordingly, AcSEC concluded that revenue from the arrangement should be recognized ratably over the term of the arrangement beginning with the delivery of the first product.

.121 *Rights to Exchange or Return Software.* AcSEC believes that the rights to exchange or return software (including platform transfer rights) are subject to the provisions of FASB Statement No. 48, even if the software is not returned physically. Accordingly, AcSEC concluded that the accounting for exchanges of software for products with no more than minimal differences in price, functionality, and features by users qualify for exchange accounting because, as discussed in footnote 3 to FASB Statement No. 48, (*a*) users are "ultimate customers" and (*b*) exchanges of software with no more than minimal differences in price, functionality, and features represent "exchanges ... of one item for another of the same kind, quality, and price." AcSEC concluded that because resellers are not "ultimate customers," such exchanges by resellers should be considered returns.

.122 AcSEC reached similar conclusions related to certain platform-transfer rights. Additionally, AcSEC concluded that in situations in which customers are entitled to continue using the software that was originally delivered (in addition to the software that is to be delivered for the new platform), the customer has received additional software products, and the platform-transfer right should be accounted for as such. Other platform-transfer rights do not allow customers to continue to use the software on the original platform. Those platform-transfer rights should be accounted for as exchange rights or rights of return.

.123 It is possible that exchange rights may be granted for software that has not been developed for other platforms at the time revenue from the arrangement is recorded. AcSEC did not address the issue of whether such future development costs related to deliverable software, for which no further revenue will be received, should be capitalized pursuant to FASB Statement No. 86 because it was believed that such costs would not be significant. Accordingly, AcSEC concluded that in the event of significant development costs, the vendor would not be likely to be able to demonstrate persuasively that the future software would have similar pricing, features, and functionality, and would be marketed as the same product (that is, qualify as an exchange for accounting purposes). In that event, the vendor has granted a return right that must be accounted for pursuant to FASB Statement No. 48.

Postcontract Customer Support

.124 An obligation to perform PCS is incurred at the inception of a PCS arrangement and is discharged by delivering unspecified upgrades/enhancements, performing services, or both over the period of the PCS arrangement. The obligation also may be discharged by the passage of time. AcSEC concluded that because estimating the timing of expenditures under a PCS arrangement usually is not practicable, revenue from PCS generally should be recognized on a straight-line basis over the period of the PCS arrangement. However, AcSEC also concluded that if there is sufficient vendor-specific historical evidence that costs to provide the support are incurred on other than a straight-line basis, the vendor should recognize revenue in proportion to the amounts expected to be charged to the PCS services rendered during the period.

.125 SOP 91-1 required that revenue from both the PCS and the initial licensing fee be recognized ratably over the period of the PCS arrangement if no basis existed to derive separate prices for the PCS and the initial licensing fee. Diversity in practice arose as to what constituted a sufficient basis in arrangements involving vendors that did not have a basis to derive a separate price for the PCS. In this SOP, AcSEC has concluded that arrangement fees must be allocated to elements of the arrangement based on vendor-specific objective evidence of fair value. Because AcSEC determined that the evidence should be limited to that which is specific to the vendor, AcSEC believes that vendors that do not sell PCS separately have no basis on which to allocate fair values. AcSEC concluded that the total arrangement fee should be recognized in accordance with the provisions on recognition of PCS revenues. AcSEC also believes that, because a substantial portion of the arrangement fee typically is represented by the delivered software (rather than the performance of support), requiring the deferral of all revenues until the PCS obligation is fully satisfied would be too onerous. Accordingly, AcSEC concluded that, as discussed in the previous paragraph, the total arrangement fee generally should be recognized ratably over the period of the PCS arrangement.

Services

.126 Certain software arrangements include both a software element and an obligation to perform non-PCS services. SOP 91-1 provided guidance on the conditions that must be met in order to account for the obligation to provide services separately from the software component. AcSEC is aware that this guidance has been interpreted in varying ways, leading to a diversity in practice. During its deliberations on this SOP, AcSEC reached conclusions intended to clarify this issue, but did not redeliberate the other conclusions related to services that were included in SOP 91-1.

.127 AcSEC believes the service element should be accounted for separately if the following occur.

a. All other revenue allocation provisions of this SOP are met.

b. The services are not essential to the functionality of any other element in the arrangement.

c. The service and product elements are stated separately such that the total price of the arrangement would vary as a result of inclusion or exclusion of the services.

Accordingly, AcSEC concluded that a service element need not be *priced* separately in an agreement in order to account for the services separately. AcSEC believes that this conclusion represents the original intent of SOP 91-1, and wishes to clarify the language at this time.

.128 Paragraphs .129 through .132 of this SOP are carried forward from SOP 91-1 with certain editorial changes.

.129 *Service Elements.* Footnote 1 to paragraph 11 of SOP 81-1 [section 10,330.11, footnote 1] excludes service transactions from the scope of the SOP, as follows.

> This statement is not intended to apply to "service transactions" as defined in the FASB's October 23, 1978 Invitation to Comment, *Accounting for Certain Service Transactions*. However, it applies to separate contracts to provide services essential to the construction or production of tangible property, such as design . . . [and] engineering . . . .

.130 The previously mentioned Invitation to Comment, which was based on an AICPA-proposed SOP, was issued in 1978. The FASB later included service transactions as part of its project to develop general concepts for revenue recognition and measurement. The resulting FASB Concepts Statement No. 5, however, does not address service transactions in detail. Nevertheless, some of the concepts on service transactions developed in the Invitation to Comment are useful in accounting for certain software transactions.

.131 A service transaction is defined in paragraphs 7 and 8 of the Invitation to Comment as follows.

> A transaction between a seller and a purchaser in which, for a mutually agreed price, the seller performs . . . an act or acts . . . that do not alone produce a tangible commodity or product as the principal intended result. . . A service transaction may involve a tangible product that is sold or consumed as an incidental part of the transaction or is clearly identifiable as secondary or subordinate to the rendering of the service.

The term *service transaction* is used in the same sense in this SOP but, as used in this SOP, does not apply to PCS. Items classified as tangible products in software service transactions generally should be limited to off-the-shelf software or hardware.

.132 This SOP, like the Invitation to Comment, recommends the separation of such arrangements with discrete elements into their product and service elements. Paragraph 8(b) of the Invitation to Comment states the following.

> If the seller of a product offers a related service to purchasers of the product but separately states the service and product elements in such a manner that the total transaction price would vary as a result of the inclusion or exclusion of the service, the transaction consists of two components: a product transaction that should be accounted for separately as such and a service transaction . . . .

Contract Accounting

.133 SOP 91-1 included guidance on the application of contract accounting to software transactions. Questions arose as to whether output measures could be used to measure progress-to-completion if the amounts recorded would differ from those that would have been reported had input measures been used. During its deliberations of this SOP, AcSEC reached conclusions intended to clarify this issue, but did not redeliberate the other conclusions related to services that were included in SOP 91-1.

.134 AcSEC believes that the method chosen to measure progress-to-completion on an individual element of a contract should be the method that best approximates progress-to-completion on that element. Accordingly, AcSEC concluded that output measures may be used to measure progress-to-completion, provided that the use of output measures results in "the method that best approximates progress-to-completion."

.135 Paragraphs .136 through .142 of this SOP are carried forward from SOP 91-1 with certain editorial changes.

.136 ARB No. 45 established the basic principles for measuring performance on contracts for the construction of facilities or the production of goods or the provision of related services with specifications provided by the customer. Those principles are supplemented by the guidance in SOP 81-1 [section 10,330].

Distinguishing Transactions Accounted for Using Contract Accounting From Product Sales

.137 SOP 81-1 [section 10,330] suggests that transactions that normally are accounted for as product sales should not be accounted for using contract accounting merely to avoid the delivery requirements for revenue recognition normally associated with product sales. Paragraph 14 of SOP 81-1 [section 10,330.14] states the following:

> Contracts not covered . . . include . . . [s]ales by a manufacturer of goods produced in a standard manufacturing operation, even if produced to buyers' specifications, and sold in the ordinary course of business through the manufacturer's regular marketing channels if such sales are normally recognized as revenue in accordance with the realization principle for sales of products and if their costs are accounted for in accordance with generally accepted principles of inventory costing.

Application of ARB No. 45 and SOP 81-1

.138 SOP 81-1 [section 10,330] provides guidance on the application of ARB No. 45 that applies to a broad range of contractual arrangements. Paragraph 1 of SOP 81-1 [section 10,330.01] describes contracts that are similar in nature to software arrangements, and paragraph 13 [section 10,330.13] includes the following kinds of contracts within the scope of that SOP:

- Contracts to design, develop, manufacture, or modify complex . . . electronic equipment to a buyer's specification or to provide services related to the performance of such contracts
- Contracts for services performed by . . . engineers . . . or engineering design firms

.139 ARB No. 45 presumes that percentage-of-completion accounting should be used when the contractor is capable of making reasonable estimates. Paragraph 15 of ARB No. 45 states the following:

> [I]n general when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable.

Evidence to consider in assessing the presumption that the percentage-of-completion method of accounting should be used includes the technological risks and the reliability of cost estimates, as described in paragraphs 25, 26, 27, 32, and 33 of SOP 81-1 [section 10,330.25, .26, .27, .32, and .33].

.140 Paragraph 24 of SOP 81-1 [section 10,330.24] specifies a further presumption that a contractor is capable of making reasonable estimates and states the following:

> [T]he presumption is that [entities] . . . have the ability to make estimates that are sufficiently dependable to justify the use of the percentage-of-completion method of accounting. Persuasive evidence to the contrary is necessary to overcome that presumption. [Footnote omitted]

.141 Although cost-to-cost measures may be verified easily, they tend to attribute excessive profit to the hardware elements of arrangements with combined software and hardware elements for contracts under which segmentation is not permitted. Although the hardware elements of such arrangements have high cost bases, they generally yield relatively low profit margins to vendors. Furthermore, if excessive revenue is attributed to the hardware element, revenue recognition on the arrangement becomes overly dependent on when that element is included in the measurement of progress-to-completion.

.142 For off-the-shelf software elements, the application of the cost-to-cost method produces the opposite effect. The book basis of the software tends to be low, because most of the costs associated with software development frequently are charged to expense when incurred in conformity with FASB Statement No. 86. Although the profit margins associated with software are generally higher than those for other elements of the arrangement, the application of cost-to-cost measures with a single profit margin for the entire arrangement would attribute little or no profit to the off-the-shelf software. Similarly, the application of the cost-to-cost method to arrangements that include core software, which also has a relatively low cost basis, would attribute a disproportionately small amount of profit to the software.

Effective Date and Transition

.143 AcSEC concluded that the provisions of this SOP should be applied prospectively and that retroactive application should be prohibited. AcSEC recognizes the benefits of comparable financial statements but is concerned that the application of the provisions of this SOP to contracts existing in prior periods would require a significant amount of judgment. The application of that judgment likely would be impacted by the hindsight a company would have, resulting in judgments based on information that did not exist at the time of the initial judgment but that would be called for if the SOP were to be applied retroactively.

.144 Additionally, AcSEC concluded that some entities would be required to incur large expenditures in determining restated amounts or the cumulative effect of adoption. AcSEC concluded that the cost of calculating such amounts likely would exceed the related benefit of that information. This SOP does not preclude an entity from disclosing in the notes to the financial statements the effect of initially applying this SOP if an entity believes it is practicable to do so.

Items Not Retained From SOP 91-1

.145 AcSEC believes that the guidance included in SOP 91-1 related to discounting receivables and the collectibility of receivables (discussed in paragraphs 56 and 78, respectively, of SOP 91-1) is not specific to the software industry and thus does not need to be retained in this SOP.

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Appendix A

Examples of the Application of Certain Provisions of This Statement of Position

Scope—Example 1

Facts

An automobile manufacturer installs software into an automobile model. This software is used solely in connection with operating the automobile and is not sold or marketed separately. Once installed, the software is not updated for new versions that the manufacturer subsequently develops. The automobile manufacturer's costs for the development of the software that are within the scope of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed* and the production costs of such software are insignificant relative to the other development and production costs of the automobile.

Applicability

The Statement of Position (SOP) is not applicable to such software because the software is deemed incidental to the product as a whole.

Discussion

Although the software may be critical to the operations of the automobile, the software itself is not the focus of the marketing effort, nor is it what the customer perceives he or she is obtaining. The development and production costs of the software as a component of the cost of the automobile is incidental.

Scope—Example 2

Facts

An entity develops interactive training courses for sale or licensing to customers. These courses are delivered on a compact disc, which is loaded onto a customer's computer. The courses are developed such that, based on the responses received to a particular question, different questions are generated and content of the course material that is displayed is determined in a manner that directs the user's learning experience in a more focused way. The course developer's costs for the development of the software content are within the scope of FASB Statement No. 86 and are significant. The interactive nature of the courses is mentioned prominently in the marketing efforts.

Applicability

The SOP is applicable because the software is not incidental to the product.

Discussion

Although some might say that the product is educational services, the marketing of the product focuses on the software-reliant interactive features. In addition, the course developer incurs significant costs that are within the scope of FASB Statement No. 86. The nature of the relationship between the vendor and the customer is not one in which the customer would have a need for postcontract services. Consequently, the absence of PCS is not presumptive that software is incidental to the product. Accordingly, a conclusion is reached that the software is not incidental to the product as a whole. Therefore, the provisions of this SOP apply.

Additional Software Products—Price per Copy—Example 1

Facts

A vendor enters into an arrangement under which a customer has the right to make copies of Product A at $100 a copy, copies of Product B at $200 a copy, or copies of Product C at $50 a copy until such time as the customer has made copies aggregating $100,000 based on the per copy prices. The customer is obligated to pay the $100,000 whether or not the customer makes all the copies to which it is entitled under the arrangement. In all other respects, the $100,000 is considered to meet the criteria of a fixed fee, as described in this Statement of Position.

Master copies of products A and B are available currently and have been delivered. Product C is not available yet; therefore, no master copy has been delivered. The contract is clear that no portion of the fee allocable to copies made of products A and B is refundable if Product C is not delivered, nor is there any further obligation to deliver product C if copies of products A and B aggregating $100,000 have been made. The per copy prices included in the arrangement for Products A and B are the per copy prices included in the company's price list, and the company has already approved the per copy price list for Product C to be $50 per copy. Product C is not essential to the functionality of Products A or B.

The maximum number of copies of Product C that can be made is 500.

Revenue Recognition

The vendor should allocate $25,000 of the arrangement fee to Product C. The remaining $75,000 of revenue should be recognized when the master copies of Products A and B are delivered to the customer. The $25,000 allocated to Product C would be recognized when the master copy of Product C is delivered to the customer. If the customer duplicates enough copies of Products A and B so that the revenue allocable to those products exceeds $75,000, the additional revenue should be recognized as the additional copies are made.

Discussion

As discussed in paragraph .43 of this SOP, in an arrangement in which a number of products are not deliverable or specified at the inception of the arrangement, an allocation of the arrangement fee generally cannot be made, because the total revenue allocable to each software product is unknown and depends on choices to be made by the customer and, sometimes, future development activity. As discussed in paragraph .46 of this SOP however, if such an arrangement specifies a maximum number of copies of the undeliverable or unspecified product, a portion of the arrangement fee should be allocated to the undeliverable product(s). This allocation should be made assuming the customer elects to receive the maximum number of copies of the undeliverable product(s).

Because the arrangement states a maximum number of copies of Product C that can be made, a basis for allocating the fair value to each product of the arrangement exists. The amount allocated to the undelivered product is the maximum amount that can be allocable to that product, based on the maximum number of copies of Product C that can be made (500) and the fee per copy ($50). Accordingly, $25,000 should be allocated to Product C and deferred until delivery of the product master. Because all other conditions for revenue recognition in this SOP have been met, revenue related to Products A and B may be recognized upon delivery of the masters of those products as discussed in paragraph .44 of this SOP.

Additional Software Products—Price per Copy—Example 2

Facts

Assume the same facts as in the preceding example, except the arrangement does not state a maximum number of copies of Product C that can be made.

Revenue Recognition

Revenue should be recognized as copies of Products A ($100 of revenue per copy) and B ($200 of revenue per copy) are made, until the master of Product C is delivered to the customer. Any remaining revenue should be recognized upon delivery of the master of Product C.

Discussion

As discussed in paragraph .43 of this SOP, although the fee per copy is fixed at the inception of the arrangement and the cost of duplication is incidental, the total fee allocated to the undelivered software (Product C) is unknown and will depend on the choices made by the customers as to how many copies of each product will be utilized.

Authorization Codes—Example 1

Facts

A vendor includes ten optional functions on a compact disc (CD-ROM) on which its software product is licensed. Access to those optional functions is not available without a permanent key. Users can order the optional functions and receive permanent keys to enable the full use of those functions.

Revenue Recognition

Revenue for each individual optional function should be recognized by the vendor when the user purchases it by placing an order, evidence of such order exists, and the key is delivered to the user.

Discussion

Although the user has received a fully functional version (except for the keys) of the optional functions on the CD-ROM, the user has not agreed to license them. Because no evidence of an arrangement exists (as discussed in paragraphs .15 through .17 of this SOP), revenue for the optional functions may not be recognized when the CD-ROM is delivered.

Authorization Codes—Example 2

Facts

A software vendor's products run on two different levels of central processing units (CPU) of the same manufacturer—Model X and Model Y (both of which are on the same platform). The vendor enters into a license arrangement with a user whereby the user licenses the vendor's products to run on Model X but allows the user to move to Model Y at no additional charge. The vendor delivers the product in the form of a disc pack along with a CPU authorization code. At the time the user chooses to move to Model Y, the user does not receive a new disc pack; rather the vendor gives the user a new CPU authorization code.

Revenue Recognition

Revenue should be recognized on the delivery of the disc pack.

Discussion

Delivery of the authorization code to move to another CPU is not considered to be an additional software deliverable.

Multiple Element Arrangements, Products—Example 1

Facts

A vendor licenses a user one license covering a single copy of products A, B, C, and D for a nonrefundable fixed fee of $80, with no stated price per product. Products A, B, and C are deliverable. Product D is not deliverable and is not essential to the functionality of products A, B, or C. Persuasive evidence exists that indicates that the revenue related to products A, B, or C is not subject to refund, forfeiture, other concessions if product D is not delivered. The vendor has a history of sales prices for products A, B, and C of $25 each. The vendor's pricing committee has established a price for product D of $25. It is probable that the price established by the pricing committee for product D will not change before introduction. Therefore, the vendor is able to derive its specific price for the undelivered software.

Revenue Recognition

Revenue allocated to each product based on the existing prices for products A, B, and C and the probable price for product D should be recognized when each individual product is delivered. The revenue allocated to each of the products would be $20.

Discussion

Revenue allocated to each product should be recognized upon the delivery of that product if the criteria in paragraphs .08 through .14 of this SOP have been met.

The allocation of revenue to each product is based on the relative fair value of each product. As discussed in paragraph .12 of this SOP, sufficient vendor-specific objective evidence must exist to determine allocation. In this example, sufficient vendor-specific objective evidence exists to determine that the fair value of each product on a stand-alone basis is $25. Therefore, in accordance with paragraph .41 of this SOP, the discount should be allocated evenly to each product, and revenue of $20 per product should be recognized when each product is delivered.

Multiple Element Arrangements—Products—Example 2

Facts

The transaction is the same as that outlined in the prior example. The contract is silent about penalties for the nondelivery of product D, but the proposal and other communications indicate that it is a required capability of the offering and that the user does not want any of the vendor's products unless product D is delivered.

Revenue Recognition

All revenue must be deferred until delivery of product D.

Discussion

Because revenue allocable to the delivered software is subject to forfeiture, refund, or other concession if product D is not delivered, all revenue under the agreement should be deferred until product D is delivered, in accordance with paragraph .13 of this SOP.

Multiple Element Arrangements—Products—Example 3

Facts

A vendor licenses version 1.0 of a software product to 100 customers for $300 per copy with a right to receive version 2.0 at no additional cost when it becomes available. The pricing committee has not yet decided whether version 2.0 will be offered to users of version 1.0 for $100 or for $200.

Revenue Recognition

All revenue should be deferred until the pricing committee makes its decision and it is probable that the price established will be the price charged upon introduction.

Discussion

Because the pricing committee has not yet decided whether version 2.0 will be offered at $100 or at $200, sufficient vendor-specific objective evidence does not yet exist supporting the price of the undelivered software. As discussed in paragraph .12 of this SOP, if sufficient vendor-specific objective evidence does not exist to determine the allocation of revenue, all revenue should be deferred until sufficient vendor-specific objective evidence exists.

Multiple Element Arrangements—Products—Example 4

Facts

In the preceding example, assume that the pricing committee determines that version 2.0 will be offered to users of version 1.0 as a specified upgrade/enhancement at a price of $100. It is probable that such price will not change prior to introduction. Persuasive evidence exists indicating that the amount allocated to version 1.0 will not be subject to forfeiture, refund, or other concession. Also, the vendor's experience indicates that 40 percent of customers do not exercise upgrade rights.

Revenue Recognition

The vendor should defer $6,000 (upgrade price of $100 multiplied by 100 copies, reduced by 40 percent to account for the customers expected not to exercise the upgrade right) until delivery of the upgrade/enhancement, and recognize the remaining $24,000 on delivery of version 1.0.

Discussion

The portion of the arrangement fee allocated to the upgrade right is equal to the price for the upgrade/enhancement determined pursuant to paragraph .37 of this SOP. This amount should be deferred and recognized on the delivery of version 2.0. The amount deferred for the specific upgrade/enhancement should be reduced to reflect the percentage of customers that, based on experience, are not expected to exercise the upgrade right (see paragraph .37 of this SOP). Accordingly, the $10,000 revenue allocated to the upgrade right should be reduced by $4,000 (40 percent of the allocated revenue).

If the vendor did not have information based on experience that indicates the percentage of customers that do not exercise the upgrade right, the vendor should defer the entire $10,000 of revenue allocated to the upgrade right, under the assumption that, in the absence of vendor-specific objective evidence to the contrary, 100 percent of customers will exercise the upgrade right.

Multiple Element Arrangements—Products and Services—Example 1

Facts

A vendor has entered into an arrangement to provide a customer with its off-the-shelf software product and related implementation services. The software and service elements of the contract are stated separately and the company has a history of selling these services separately such that the revenue allocation criteria of paragraphs .08 through .14 of this SOP can be satisfied. The software license fees are due under the company's normal trade terms, which are net 30 days. The services are expected to be provided over the next 90 days and are of the type performed routinely by the vendor. The features and functionality of the software are not altered to more than a minor degree as a result of these services.

Revenue Recognition

The vendor should recognize the license revenue allocated to the software element upon its delivery and the revenue allocated to the service element as such services are performed.

Discussion

When license arrangements have multiple elements, revenue should be allocated to each of the elements and recognized when the related element is delivered and the following occur.

1. The undelivered elements are not essential to the functionality of the delivered elements.
2. The revenue allocated to the delivered elements is not subject to forfeiture, refund, or other concession if the undelivered elements are not delivered.
3. Sufficient company-specific objective evidence exists to allocate separate prices to each of the elements.

The service element in this arrangement is not deemed to be essential to the functionality of the software element because the features and functionality of the software are not altered to more than a minor degree as a result of the services.

Multiple Element Arrangements—Products and Services—Example 2

Facts

Assume the same transaction as described above except that the vendor agrees to make more than minor modifications to the functionality of the product to meet needs as defined by the user. Payment terms are 10 percent upon installation of the software, with the remainder according to a time line, and the final 25 percent withheld until acceptance. The desired modifications are not unusual; the vendor has made similar modifications to the product many times and is certain that the planned modifications will meet the user's needs.

Revenue Recognition

This arrangement should be accounted for pursuant to the guidance on contract accounting (using either the percentage-of-completion or completed-contract method, depending on the facts and circumstances) included in paragraphs .74 through .91 of this SOP.

Discussion

The new conditions would preclude service transaction accounting because the functionality of the software product is being altered in more than a minor way, the payment of the fees is coincident with the services being performed, and the software is subject to the user's unique acceptance criteria.

Multiple Element Arrangements—Products and Services—Example 3

Facts

Assume the same transaction as described in "Multiple-Element Arrangements–Products and Services–Example 1," except that the vendor never sells implementation services separately. The implementation services do not involve significant customization of the software.

Revenue Recognition

The vendor should recognize all revenue from the arrangement over the 90 day period during which the services are expected to be performed, commencing with delivery of the software product.

Discussion

The criteria for vendor-specific objective evidence of the fair value require that the element be sold separately or be planned to be sold separately. Because implementation services are neither sold separately nor planned to be sold separately, and upon delivery of the software product such services are the only undelivered elements, paragraph .67 of this SOP requires that all revenue be recognized over the period during which the implementation services are expected to be provided.

Multiple Element Arrangements—Products and Services—Example 4

Facts

A vendor sells software product A for $950. The license arrangement for product A always includes one year of "free" PCS. The annual renewal price of PCS is $150.

Revenue Recognition

Assuming that, apart from the lack of vendor-specific objective evidence of the fair value of the delivered software element, all applicable revenue recognition criteria in this SOP are met, revenue in the amount of $150 should be deferred and recognized in income over the one-year PCS service period. Revenue of $800 should be allocated to the software element and recognized upon delivery of the software.

Discussion

Vendor-specific objective evidence of the fair value of the software does not exist because the software is never sold separately. Consequently, sufficient vendor-specific objective evidence of fair value does not exist for the allocation of revenue to the various elements based on their relative fair values. Paragraph .12 of this SOP states, however, that the residual method should be used when there is vendor-specific objective evidence of the fair values of *all* undelivered elements; all other applicable revenue recognition criteria in this SOP are met; and the fair value of all of the undelivered elements is less than the total arrangement fee.

If there had been vendor-specific objective evidence of the fair value of the delivered software but not of the undelivered PCS, the entire arrangement fee would be deferred and recognized ratably over the contractual PCS period in accordance with paragraphs .12 and .58 of this SOP.

Multiple Element Arrangements—Products and Discounted PCS—Example 1

Facts

A software vendor has entered into an arrangement under which it has licensed software that has a list price of $1 million to a customer for $600,000 (which is the price being charged for the software when sold separately under other arrangements). The arrangement also includes annual PCS, priced for the first year at 15 percent of the discounted license fee, or $90,000 (rather than 15 percent of the list price of the licensed software). After the first year, the customer will have the right to renew annual maintenance on the licensed software at 15 percent of the list price of the software (or $150,000).

There are no other undelivered elements. All revenue recognition conditions of this SOP have been satisfied.

The vendor does not have sufficient vendor-specific historical evidence that costs of providing PCS are incurred on other than a straight-line basis.

Revenue Recognition

In Year 1, the total arrangement fee is $690,000. Of this amount, $552,000 should be allocated to the software element and recognized upon delivery of the software element. The remaining $138,000 should be allocated to the PCS element and recognized ratably over the period during which the PCS services are expected to be performed. The allocation of the $690,000 arrangement fee is determined as shown in the following table.

Fair value when sold separately:

Software element	$600,000	80%
PCS element	150,000	20
	$750,000	100%

Allocation:

PCS element	$690,000 × .20 = $138,000
Software element	$690,000 × .80 = $552,000

Discussion

In allocating the arrangement fee to the PCS element, the vendor should look first to the price the customer will pay for the PCS when it is sold separately as a renewal under the arrangement. In this example, that price is $150,000. This price is considered the vendor-specific objective evidence of the fair value for the PCS element, as discussed in paragraph .10.

If the customer were entitled to the PCS in subsequent years at the same price at which it had been included in the initial year of the arrangement (that is, $90,000), and the vendor's pricing practices were such that renewals of PCS were based on the discounted value of license fees, no additional fees would have been allocated from the software element to the PCS element. Therefore, the vendor would have allocated $600,000 to the software element and $90,000 to the PCS element.

[As amended, effective for transactions entered into in fiscal years beginning after March 15, 1999, by Statement of Position 98-9.]

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Appendix B

Response to Comments Received

B.1. An exposure draft of a proposed Statement of Position (SOP), *Software Revenue Recognition*, was issued for public comment on June 14, 1996.

B.2. The majority of the comments received related to the basic principles of the exposure draft, particularly the provisions requiring the allocation of the arrangement fee to individual elements in a multiple-element arrangement based on vendor-specific objective evidence of the fair value. Several commentators requested clarification of the wording in the exposure draft related to extended payment terms and the effect of such terms on the determination of whether a fee is fixed and determinable or collectible. Some commentators requested guidance on the application of the provisions of the SOP to marketing arrangements in which coupons or other price incentives are offered. Other commentators requested the reconsideration of the transition provisions of the exposure draft, which required a cumulative-effect adjustment.

B.3. These comments and the Accounting Standards Executive Committee's (AcSEC's) response to them are discussed below.

Multiple-Element Arrangements

B.4. Several commentators responded that the limitations on what constitutes vendor-specific objective evidence of the fair value were too onerous. These commentators stated that many instances exist in which elements are not priced separately, and that because of these limitations, revenue related to delivered elements would be deferred even though the customer received the element. Additionally, several commentators expressed concern that the requirement to allocate revenue to all elements, particularly those deliverable "when and if available" was not meaningful. (Obligations to deliver "when and if available" elements were considered by the commentators to be either insignificant vendor obligations or not vendor obligations at all.)

B.5. AcSEC considered these comments but continues to support the provisions of the exposure draft. AcSEC noted that these comments had been considered in the process leading to the exposure draft. Although AcSEC agrees that the provisions of the SOP may be troublesome to some companies, AcSEC notes that commentators did not suggest alternatives that AcSEC considered adequate to meet the criteria of objective evidence of fair value.

B.6. AcSEC continues to believe that the allocation of the arrangement fee to all elements, including those deliverable on a when-and-if-available basis, is meaningful. AcSEC believes that these elements are bargained for by the customer and should be accounted for. Furthermore, AcSEC believes that the concept of significant versus insignificant obligations should not be used to determine whether revenue should be allocated to an element. This concept had been included in SOP 91-1 and had resulted in varying interpretations in practice. AcSEC further notes that these comments had been considered previously by AcSEC during the process leading to the exposure draft.

B.7. Several commentators stated that the limitations on vendor-specific objective evidence of fair value should be expanded to permit the use of prices in published price lists. AcSEC believes that the price for an element as included in a price list does not necessarily represent the fair value of that element.

Extended Payment Terms

B.8. The exposure draft stated that a software licensing fee should not be considered fixed or determinable if the payment of a significant portion of the licensing fee is not due until after the expiration of the license or more than twelve months after delivery. Exceptions were permitted for vendors that have a business practice of using installment contracts and an extended history of entering into contracts with terms in excess of twelve months and successfully enforcing payment terms without making concessions. Several commentators requested clarification of these provisions.

B.9. AcSEC considered these comments and agreed that clarification was needed. Relevant clarifications were made to paragraphs .27 through .29 of the SOP. The revised provisions now state that *any* extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable, particularly if the use of extended payment terms is not the vendor's customary practice. Further, if the payment of a significant portion of the software licensing fee is not due until after the expiration of the license or more than twelve months after delivery, the licensing fee should be *presumed* not to be fixed or determinable. However, this presumption may be overcome by evidence that the vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions. Such a vendor should consider such fees fixed or determinable and should recognize revenue upon the delivery of the software, provided all other conditions for revenue recognition in this SOP have been satisfied.

B.10. Several commentators requested guidance on the application of the SOP to arrangements in which discounts are offered on subsequent licenses of software. The exposure draft did not have provisions addressing such arrangements.

B.11. AcSEC has added wording to the scope section (paragraph .03) of the SOP to address these questions. The new wording states that arrangements in which a vendor offers a small discount on additional licenses of the licensed product or other products that exist at the time of the offer represent marketing and promotional activities that are not unique to software and, therefore, are not included in the scope of this SOP. However, judgment will be required to assess whether price-off and other concessions are so significant that, in substance, additional elements are being offered in the arrangement.

Transition

B.12. The exposure draft required a cumulative-effect adjustment for the adoption of the SOP. Several commentators noted that considerable effort would be required on the part of many vendors to measure the cumulative effect. Additionally, it was noted that in many instances, the application of the provisions of this SOP to contracts existing in prior periods would require a significant amount of judgment. AcSEC was concerned that the application of that judgment likely would be impacted by the hindsight a company would have, resulting in judgments based on information that did not exist at the time of the initial judgment but that would be called for if the SOP were to be applied retroactively.

B.13. AcSEC considered these issues and determined that the transition requirements of the SOP should be amended to require prospective application.

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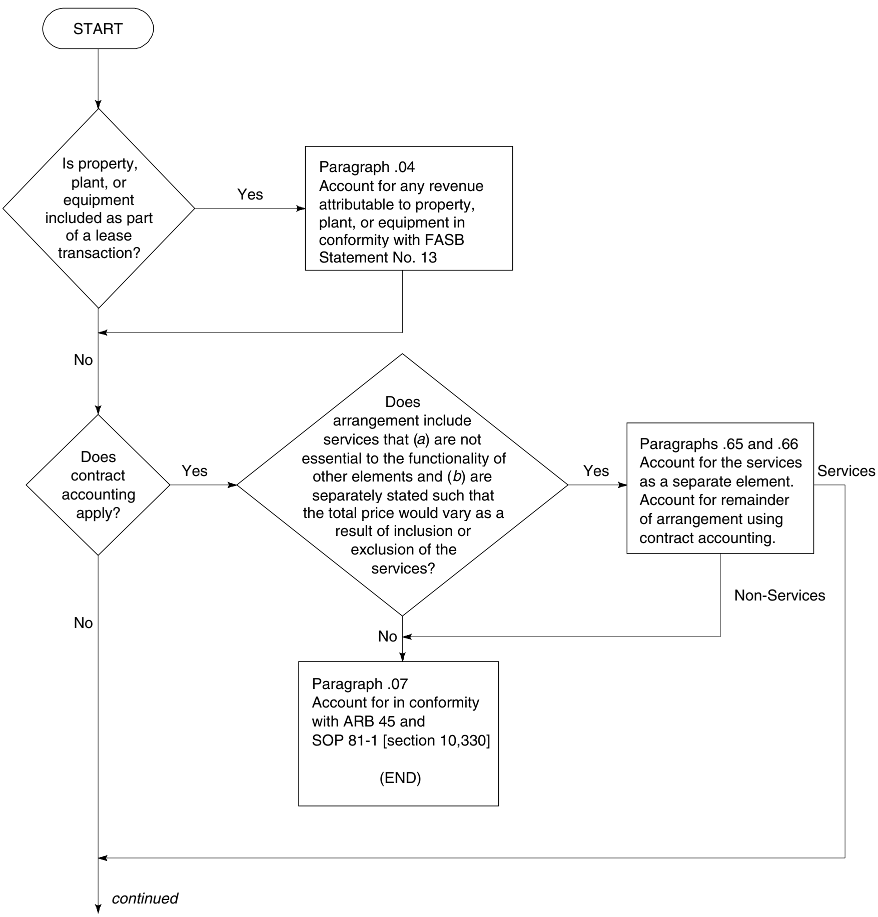
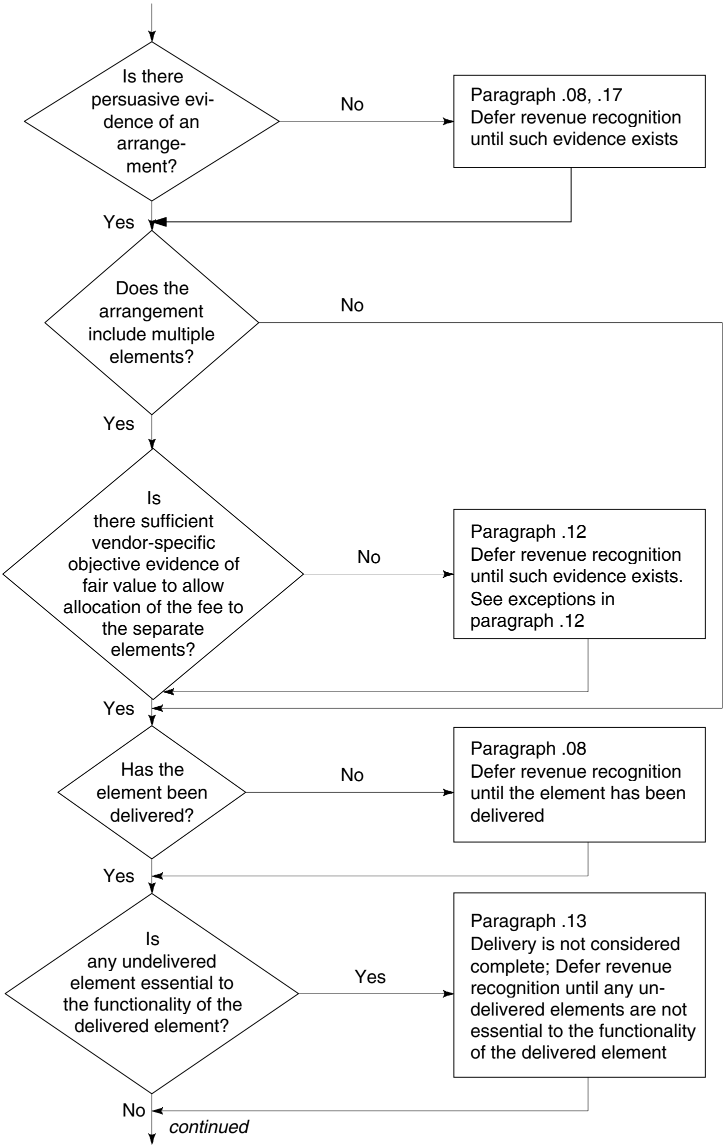
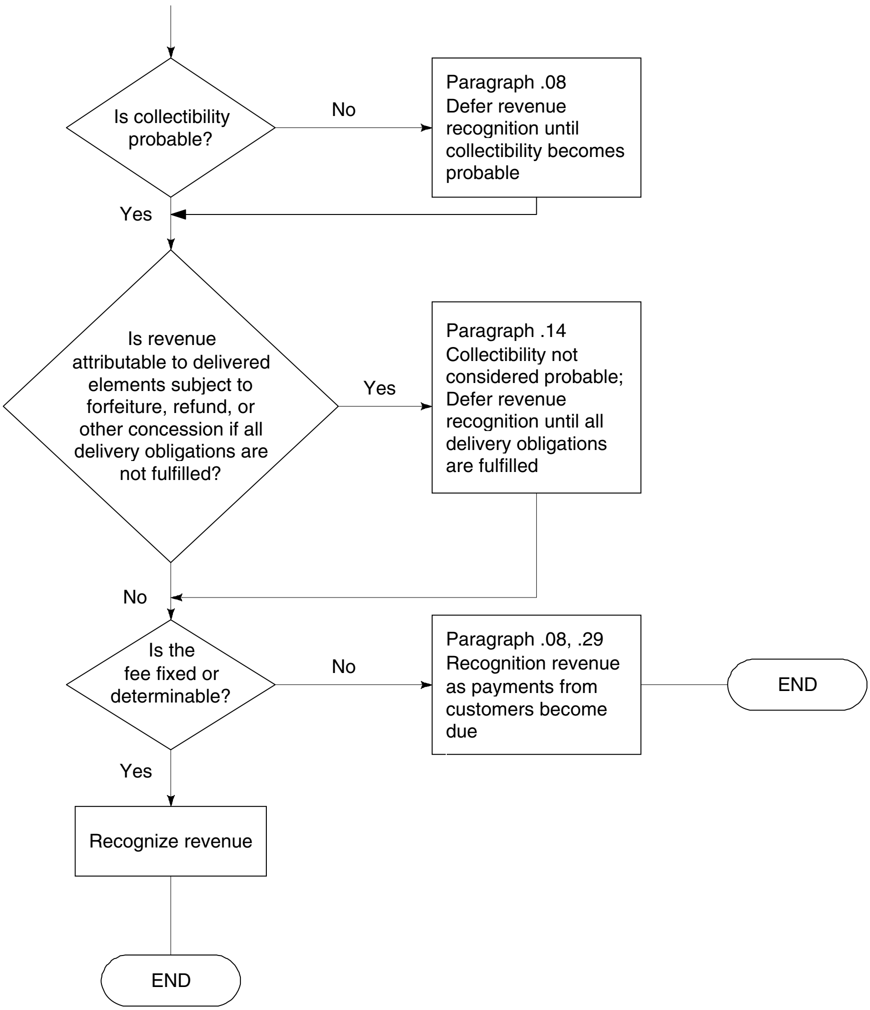
Appendix C

Revenue Recognition on Software Arrangements

The following flowchart illustrates a decision process for recognizing revenue on software arrangements. The flowchart is intended to illustrate the basic principle of revenue recognition and does not address the differences in accounting depending upon the type of element (services, upgrade rights, additional software products, or postcontract customer support) included in the arrangement. The flowchart summarizes certain guidance in this SOP and is not intended as a substitute for the SOP.




Is there persuasive evi-dence of an arrange-ment?
No
Paragraph .08, .17
Defer revenue recognition until such evidence exists
Yes
Does the arrangement include multiple elements?
No
Yes
Is there sufficient vendor-specific objective evidence of fair value to allow allocation of the fee to the separate elements?
No
Paragraph .12
Defer revenue recognition until such evidence exists. See exceptions in paragraph .12
Yes
Has the element been delivered?
No
Paragraph .08
Defer revenue recognition until the element has been delivered
Yes
Is any undelivered element essential to the functionality of the delivered element?
Yes
Paragraph .13
Delivery is not considered complete; Defer revenue recognition until any un-delivered elements are not essential to the functionality of the delivered element
No
continued


Is collectibility probable?
No
Paragraph .08
Defer revenue recognition until collectibility becomes probable
Yes
Is revenue attributable to delivered elements subject to forfeiture, refund, or other concession if all delivery obligations are not fulfilled?
Yes
Paragraph .14
Collectibility not considered probable; Defer revenue recognition until all delivery obligations are fulfilled
No
Is the fee fixed or determinable?
No
Paragraph .08, .29
Recognition revenue as payments from customers become due
END
Yes
Recognize revenue
END

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Glossary

Authorization Codes (keys). A vehicle used by vendors to permit customers access to, use of, or duplication of software that would otherwise be restricted.

Core software. An inventory of software that vendors use in creating other software. Core software is not delivered as is because customers cannot use it unless it is customized to meet system objectives or customer specifications.

Customer. A user or reseller.

Delivery. A transfer of software accompanied by documentation to the customer. The transfer may be by the following:

a. A physical transfer of tape, disk, integrated circuit, or other medium

b. Electronic transmission

c. Making available to the customer software that will not be physically transferred, such as through the facilities of a computer service bureau

d. Authorization for duplication of existing copies in the customer's possession

If a licensing agreement provides a customer with the right to multiple copies of a software product in exchange for a fixed fee, delivery means transfer of the product master, or the first copy if the product master is not to be transferred.

Fixed fee. A fee required to be paid at a set amount that is not subject to refund or adjustment. A fixed fee includes amounts designated as minimum royalties.

Licensing. Granting the right to use but not to own software through leases or licenses.

Milestone. A task associated with long-term contracts that, when completed, provides management with a reliable indicator of progress-to-completion on those contracts.

Off-the-shelf software. Software marketed as a stock item that customers can use with little or no customization.

Platform. The hardware architecture of a particular model or family of computers, the system software, such as the operating system, or both.

Platform-transfer right. A right granted by a vendor to transfer software from one hardware platform or operating system to one or more other hardware platforms or operating systems.

Postcontract customer support (PCS). The right to receive services (other than those separately accounted for as described in paragraphs .65 and .66 of this Statement of Position) or unspecified product upgrades/enhancements, or both, offered to users or resellers, after the software license period begins, or after another time as provided for by the PCS arrangement. Unspecified upgrades/enhancements are PCS only if they are offered on a when-and-if-available basis. PCS does not include the following:

- Installation or other services directly related to the initial license of the software

- Upgrade rights as defined in this Statement of Position
- Rights to additional software products

PCS may be included in the license fee or offered separately. PCS is generally referred to in the software industry as maintenance, a term that is defined, as follows, in paragraph 52 of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*:

> Activities undertaken after the product is available for general release to customers to correct errors or keep the product updated with current information. Those activities include routine changes and additions.

However, the term *maintenance* is not used in this Statement of Position for the following reasons.

1. It has taken on a broader meaning in the industry than the one described in FASB Statement No. 86.
2. It may be confused with hardware maintenance as it is used elsewhere in accounting literature.
3. Its meaning varies from company to company.

The right to receive services and unspecified upgrades/enhancements provided under PCS is generally described by the PCS arrangement. Typical arrangements include services, such as telephone support and correction of errors (bug fixing or debugging), and unspecified product upgrades/enhancements developed by the vendor during the period in which the PCS is provided. PCS arrangements include patterns of providing services or unspecified upgrades/enhancements to users or resellers, although the arrangements may not be evidenced by a written contract signed by the vendor and the customer.

Reseller. Entity licensed by a software vendor to market the vendor's software to users or other resellers. Licensing agreements with resellers typically include arrangements to sublicense, reproduce, or distribute software. Resellers may be distributors of software, hardware, or turnkey systems, or they may be other entities that include software with the products or services they sell.

Site license. A license that permits a customer to use either specified or unlimited numbers of copies of a software product either throughout a company or at a specified location.

Upgrade/Enhancement. An improvement to an existing product that is intended to extend the life or improve significantly the marketability of the original product through added functionality, enhanced performance, or both. The terms upgrade and enhancement are used interchangeably to describe improvements to software products; however, in different segments of the software industry, those terms may connote different levels of packaging or improvements. This definition does not include platform-transfer rights.

Upgrade right. The right to receive one or more specific upgrades/enhancements that are to be sold separately. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor's established practice.

User. Party that ultimately uses the software in an application.

When-and-if-available. An arrangement whereby a vendor agrees to deliver software only when or if it becomes deliverable while the arrangement is in effect. When-and-if-available is an industry term that is commonly used to describe a broad range of contractual commitments. The use of the term when-and-if-available within an arrangement should not lead to a presumption that an obligation does not exist.

Accounting Standards Executive Committee (1996–1997)

Software Revenue Recognition Working Group

AICPA Staff

The Accounting Standards Executive Committee and the Software Revenue Recognition Working Group gratefully acknowledge the contributions of the former Software Revenue Recognition Task Force members Joseph Lhotka, Naomi Erickson, James Gillespie, Francis O'Brien, and Paul Wilde in the development of this Statement of Position.

[The next page is 80,381.]

Section 10,710

Statement of Position 97-3 Accounting by Insurance and Other Enterprises for Insurance-Related Assessments

December 10, 1997

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Introduction

.01 Insurance enterprises as well as noninsurance entities are subject to a variety of assessments related to insurance activities, including those by state guaranty funds and workers' compensation second-injury funds. Some entities may be subject to insurance-related assessments because they self-insure against loss or liability. Current accounting practice is diverse among entities subject to such insurance-related assessments and related recoveries. Some of the diversity is a result of fundamental differences in the methods for assessing entities. Nevertheless, similar assessments are not being accounted for comparably among entities. A number of entities account for assessments on a pay-as-you-go (cash) basis, whereas others account for assessments on an accrual basis. Furthermore, the methods for accrual are varied.

.02 As the prevalence and magnitude of guaranty-fund and other insurance-related assessments have increased, concern about the diversity in practice also has increased. This Statement of Position (SOP) provides guidance on accounting by entities subject to insurance-related assessments and was undertaken to reduce diversity in practice, improve the comparability of the amounts reported, and improve disclosures made by entities subject to guaranty-fund and other insurance-related assessments.

Background Information

Guaranty-Fund Assessments

.03 States have enacted legislation establishing guaranty funds. The state guaranty funds assess entities licensed to sell insurance in the state to provide for the payment of covered claims or to meet other insurance obligations, subject to prescribed limits, of insolvent insurance enterprises. The assessments are generally based upon premium volume for certain covered lines of business. Most state guaranty funds assess entities for costs related to a particular insolvency after the insolvency occurs. At least one state, however, assesses entities prior to insolvencies.

.04 State guaranty funds use a variety of methods for assessing entities. This SOP identifies the following four primary methods of guaranty-fund assessments.

a. *Retrospective-premium-based assessments*. Guaranty funds covering benefit payments of insolvent **life, annuity, and health insurance enterprises** typically assess entities based on **premiums written** or received in one or more years *prior* to the year of insolvency.[1] Assessments in any year are generally limited to an established percentage of an entity's average premiums for the three years preceding the insolvency. Assessments for a given insolvency may take place over several years.

b. *Prospective-premium-based assessments*. Guaranty funds covering claims of insolvent **property and casualty insurance enterprises** typically assess entities based on premiums written in one or more years *after* the insolvency. Assessments in any year are generally limited to an established percentage of an entity's premiums written or received for the year preceding the assessment. Assessments for a given insolvency may take place over several years.

c. *Prefunded-premium-based assessments*. At least one state uses this kind of assessment to cover claims of insolvent property and casualty insurance enterprises. This kind of assessment is intended to prefund the costs of future insolvencies. Assessments are imposed prior to any particular insolvency and are based on the current level of written premiums. Rates to be applied to future premiums are adjusted as necessary.

d. *Administrative-type assessments*. These assessments are typically a flat (annual) amount per entity to fund operations of the guaranty association, regardless of the existence of an insolvency. These assessments are generally expensed in the period assessed and are not addressed further in this SOP.

.05 State laws often allow for recoveries of guaranty-fund assessments by entities subject to assessments through such mechanisms as **premium tax offsets**, policy surcharges, and future premium rate structures.

Other Insurance-Related Assessments

.06 Entities are subject to a variety of other insurance-related assessments. Many states and a number of local governmental units have established

[1] Terms defined in the glossary [paragraph .55] are set in boldface type the first time they appear in this SOP.

other funds supported by assessments. The most prevalent uses for such assessments are (*a*) to fund operating expenses of state insurance regulatory bodies (for example, the state insurance department or workers' compensation board) and (*b*) to fund second-injury funds.[2]

.07 The primary methods used to assess for these other insurance-related assessments are the following.

a. *Premium-based*. The assessing organization imposes the assessment based on the entity's written premiums.[3] The base year of premiums is generally either the current year or the year preceding the assessment.

b. *Loss-based*. The assessing organization imposes the assessment based on the entity's **incurred losses** or paid losses in relation to that amount for all entities subject to that assessment in the particular jurisdiction.

Scope

.08 This SOP applies to all entities that are subject to guaranty-fund and other insurance-related assessments.[4, 5]

.09 Assessments covered by this SOP include any charge mandated by statute or regulatory authority that is related directly or indirectly to underwriting activities (including self-insurance), except for income taxes and premium taxes. This SOP does not apply to amounts payable or paid as a result of reinsurance contracts or arrangements that are in substance reinsurance, including assumed reinsurance activities and certain **involuntary pools** that are covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.*

Conclusions

Reporting Liabilities

.10 Entities subject to assessments should recognize liabilities for insurance-related assessments when all of the following conditions are met.

a. An assessment has been imposed or information available prior to the issuance of the financial statements indicates it is probable that an assessment will be imposed.

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[2] Second-injury funds provide reimbursement to insurance carriers or employers for workers' compensation claims when the cost of a second injury combined with a prior accident or disability is greater than what the second accident alone would have produced. The employer of an injured or handicapped worker is responsible only for the workers' compensation benefit for the most recent injury; the second-injury fund would cover the cost of any additional benefits for aggravation of a prior condition or injury. The intent of the fund is to help insure that employers are not made to suffer a greater monetary loss or increased insurance costs because of hiring previously injured or handicapped employees.

[3] The assessing organization may be at the state, county, municipality, or other such level.

[4] Some entities are subject to insurance-related assessments because they self-insure against loss or liability. For example, one state specifies that self-insurers of workers' compensation should use as a base for assessment the amount of premium the self-insurer would have paid if it had insured its liability with an insurer for the previous calendar year.

[5] This SOP does not apply to assessments of depository institutions related to bank insurance and similar funds.

b. The event obligating an entity to pay (underlying cause of) an imposed or probable assessment has occurred on or before the date of the financial statements.

c. The amount of the assessment can be reasonably estimated.

Probability of Assessment

.11 Premium-based guaranty-fund assessments, except those that are prefunded, are presumed probable when a formal determination of insolvency occurs, and presumed not probable prior to a formal determination of insolvency.[6] Prefunded guaranty-fund assessments and premium-based administrative-type assessments (as defined in paragraph .04), are presumed probable when the premiums on which the assessments are expected to be based are written. Loss-based administrative-type and second-injury fund assessments are presumed probable when the losses on which the assessments are expected to be based are incurred.

Obligating Event

.12 Because of the fundamental differences in how assessment mechanisms operate, the event that makes an assessment probable (for example, an insolvency) may not be the event that obligates an entity. The following defines the event that obligates an entity to pay an assessment for each kind of assessment identified in this SOP.

.13 For premium-based assessments, the event that obligates the entity is generally writing the premiums or becoming **obligated to write** or renew (such as multiple-year, noncancelable policies) the premiums on which the assessments are expected to be based. Some states, through law or regulatory practice, provide that an insurance enterprise cannot avoid paying a particular assessment even if that insurance enterprise reduces its premium writing in the future. In such circumstances, the event that obligates the entity is a formal determination of insolvency or similar triggering event. Regulatory practice would be determined based on the stated intentions or prior history of the insurance regulators.

.14 For loss-based assessments, the event that obligates an entity is an entity's incurring the losses on which the assessments are expected to be based.

Ability to Reasonably Estimate the Liability

.15 One of the conditions in FASB Statement No. 5, *Accounting for Contingencies,* for recognition of a liability is that the amount can be reasonably estimated. FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, provides that some amount of loss can be reasonably estimated when available information indicates that the estimated amount of the loss is within a range of amounts. When no amount within the range is a better estimate than any other amount, the minimum amount in the range shall be accrued.

.16 Entities subject to assessments may be able to obtain information to assist in estimating the total guaranty-fund cost or the following years' assessments, as appropriate, for an insolvency from organizations such as the state

[6] For purposes of this SOP, a formal determination of insolvency occurs when an entity meets a state's (ordinarily the state of domicile of the insolvent insurer) statutory definition of an insolvent insurer. In most states, the entity must be declared to be financially insolvent by a court of competent jurisdiction. In some states, there must also be a final order of liquidation.

guaranty fund associations, the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) and the National Conference of Insurance Guaranty Funds (NCIGF). An entity need not be able to compute the exact amounts of the assessments or be formally notified of such assessments by a guaranty fund to make a reasonable estimate of its liability. Entities subject to assessments may have to make assumptions about future events, such as when the fund will incur costs and pay claims that will determine the amounts and the timing of assessments. The best available information about market share or premiums by state and premiums by line of business generally should be used to estimate the amount of an insurance enterprise's future assessments.

.17 If a noninsurance entity's assessments are based on premiums, it may be necessary to consider the amount of premium the self-insurer would have paid if it had insured its liability with an insurer. If a noninsurance entity's assessments are based on losses, it should consider the losses that have been incurred by the company when determining the liability. Most often, assessments that have an impact of noninsurance entities that self-insure workers' compensation obligations are for second-injury funds. Second-injury funds generally assess insurance entities and self-insurers based on paid losses. A noninsurance entity may develop an accrual for its second-injury liability based on one or more of the following: (*a*) the ratio of the entity's prior period paid workers' compensation claims to aggregate workers' compensation claims in the state that was used as a basis for previous assessments, (*b*) total fund assessments in prior periods, or (*c*) known changes in the current period to either the number of employees self-insured by the entity or the number of workers who are the subject of recoveries from the second-injury fund that might alter total fund assessments and the entity's proportion of the total fund assessments.

.18 Estimates of loss-based assessments should be consistent with estimates of the underlying incurred losses and should be developed based on enacted laws or regulations and expected assessment rates.

.19 Estimates of some insurance-related assessment liabilities may be difficult to derive. The development or determination of estimates is particularly difficult for guaranty-fund assessments because of uncertainties about the cost of the insolvency to the guaranty fund and the portion that will be recovered through assessment. Examples of uncertainties follow:

- Limitations, as provided by statute, on the amount of individual contract liabilities that the guaranty fund will assume, that cause the guaranty fund associations' liability to be less than the amount by which the entity is insolvent
- Contract provisions (for example, credited rates) that may be modified at the time of the insolvency or alternative payout options that may be offered to contractholders that affect the level and payout of the guaranty fund's liability
- The extent and timing of available reinsurance recoveries may be subject to significant uncertainties
- Alternative strategies for the liquidation of assets of the insolvent company that affect the timing and level of assessments
- Certain liabilities of the insolvent insurer may be particularly difficult to estimate (for example, asbestos or environmental liabilities)

Because of the uncertainties surrounding some insurance-related assessments, the range of assessment liability may have to be reevaluated regularly during the assessment process. For some ranges, there may be amounts that appear to be better estimates than any other within the range. If this is the case, the liability recorded should be based on the best estimate within the range. For ranges in which there is no such best estimate, the liability that should be recorded should be based on the amount representing the minimum amount in the range.

Application of Guidance

.20 A discussion on applying the conclusions in paragraphs .10 through .19 to the methods used to address guaranty-fund assessments and other insurance-related assessments (as described in paragraphs .04 and .07) follows.

a. *Retrospective-premium-based guaranty-fund assessments.* An assessment is probable of being imposed when a formal determination of insolvency occurs. At that time, the premium that obligates the entity for the assessment liability has already been written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability for the entire amount of future assessments related to a particular insolvency when a formal determination of insolvency is rendered.

b. *Prospective-premium-based guaranty-fund assessments.* The event that obligates the entity for the assessment liability generally is the writing of, or becoming obligated to write or renew, the premiums on which the expected future assessments are to be based.[7] Therefore, the event that obligates the entity generally will not have occurred at the time of the insolvency.

In states that, through law or regulatory practice, provide that an entity cannot avoid paying a particular assessment in the future (even if the entity reduces premium writings in the future), the event that obligates the entity is a formal determination of insolvency or a similar event. An entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability for the entire amount of future assessments that cannot be avoided related to a particular insolvency when a formal determination of insolvency occurs.

In states without such a law or regulatory practice, the event that obligates the entity is the writing of, or becoming obligated to write, the premiums on which the expected future assessments are to be based. An entity that has the ability to reasonably estimate the amount of the assessments should recognize a liability when the related premiums are written or when the entity becomes obligated to write the premiums.

c. *Prefunded-premium-based guaranty-fund assessments.* A liability for an assessment arises when premiums are written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability as the related premiums are written.

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[7] For example, multiple-year contracts under which an insurance enterprise has no discretion to avoid writing future premiums.

d. *Other premium-based assessments.* Other premium-based assessments, as described in paragraph .06, would be accounted for in the same manner as prefunded-premium-based guaranty-fund assessments.

e. *Loss-based assessments.* An assessment is probable of being asserted when the loss occurs. The obligating event of the assessment also has occurred when the loss occurs. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability as the related loss is incurred.

Present Value

.21 Current practice in the insurance industry is to allow, but not require (with limited exceptions, such as pensions and postretirement benefits), the discounting of liabilities to reflect the time value of money when the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable for a particular liability. Similarly, for assessments that meet those criteria, the liability may be recorded at its present value by discounting the estimated future cash flows at an appropriate interest rate.

Reporting Assets for Premium Tax Offsets and Policy Surcharges

.22 When it is probable that a paid or accrued assessment will result in an amount that is recoverable from premium tax offsets or policy surcharges, an asset should be recognized for that recovery in an amount that is determined based on current laws and projections of future premium collections or policy surcharges from **in-force policies**. In determining the asset to be recorded, in-force policies do not include expected renewals of short-duration contracts but do include assumptions as to persistency rates for long-duration contracts. The recognition of such assets related to prospective-premium-based assessments is limited to the amount of premium an entity has written or is obligated to write and to the amounts recoverable over the life of the in-force policies. This SOP requires an entity to recognize a liability for prospective-premium-based assessments as the premium is written or obligated to be written by the entity. Accordingly, the expected premium tax offset or policy surcharge asset related to the accrual of prospective-premium-based assessments should similarly be based on and limited to the amount recoverable as a result of premiums the insurer has written or is obligated to write.

.23 For retrospective-premium-based assessments, this SOP requires an entity to recognize a liability for such assessments at the time the insolvency has occurred. Accordingly, to the extent that it is probable that paid or accrued assessments will result in a recoverable amount in a future period from business currently in force considering appropriate persistency rates, an asset should be recognized at the time the liability is recorded.

.24 In all cases, the asset shall be subject to a valuation allowance to reflect any portion of the asset that is no longer probable of realization. Considering expected future premiums other than on in-force policies in evaluating the recoverability of premium tax offsets or policy surcharges is not appropriate. An asset shall not be established for paid or accrued assessments that are recoverable through future premium rate structures.

.25 The time value of money need not be considered in the determination of the recorded amount of the potential recovery if the liability is not discounted.

In instances in which the recovery period for the asset is substantially longer than the payout period for the liability, it may be appropriate to record the asset on a discounted basis regardless of whether the liability is discounted.

.26 The policy surcharges referred to in this SOP are those surcharges that are intended to provide an opportunity for assessed entities to recover some or all of the amounts assessed over a period of time. In some instances, there may be policy surcharges that are required as a pass-through to the state or other regulatory bodies, and these surcharges should be accounted for in a manner such that amounts collected or receivable are not recorded as revenues and amounts due or paid are not expensed (meaning, similar to accounting for sales tax).

Disclosures

.27 FASB Statement No. 5, FASB Interpretation No. 14, and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* [section 10,640], address disclosures related to loss contingencies. That guidance is applicable to assessments covered by this SOP. Additionally, if amounts have been discounted, the entity should disclose in the financial statements the undiscounted amounts of the liability and any related asset for premium tax offsets or policy surcharges as well as the discount rate used. If amounts have not been discounted, the entity should disclose in the financial statements the amounts of the liability, any related asset for premium tax offsets or policy surcharges, the periods over which the assessments are expected to be paid, and the period over which the recorded premium tax offsets or policy surcharges are expected to be realized.

Effective Date and Transition

.28 This SOP is effective for financial statements for fiscal years beginning after December 15, 1998. Early adoption is encouraged. Previously issued annual financial statements should not be restated. Initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date and during an interim period other than the first interim period, all prior interim periods should be restated). Entities subject to assessments should report the effect of initially adopting this SOP in a manner similar to the cumulative effect of a change in accounting principle. (Refer to paragraph 20 of Accounting Principles Board Opinion No. 20, *Accounting Changes*).

The provisions of this Statement need not be applied to immaterial items.

Basis for Conclusions

.29 This section discusses considerations that were deemed significant by members of the AcSEC in reaching the conclusions in this SOP. It provides background information and includes reasons for accepting certain views and rejecting others.

.30 The authoritative financial reporting literature does not address explicitly accounting for guaranty-fund and other insurance-related assessments and related premium tax offsets and policy surcharges of entities subject to assessments. AcSEC considered the following pertinent literature in reaching the conclusions in this SOP:

- FASB Statement No. 5, *Accounting for Contingencies*
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*
- FASB Statement No. 87, *Employers' Accounting for Pensions*
- FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*
- FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*
- AICPA SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* [section 10,640]
- AICPA SOP 96-1, *Environmental Remediation Liabilities* [section 10,680]
- Emerging Issues Task Force (EITF) Issue No. 87-22, *Prepayments to the Secondary Reserve of the FSLIC*
- EITF Issue No. 91-10, *Accounting for Special Assessments and Tax Increment Financing Entities*
- EITF Issue No. 92-13, *Accounting for Estimated Payments in Connection with the Coal Industry Retiree Health Benefit Act of 1992*
- EITF Issue No. 93-5, *Accounting for Environmental Liabilities*
- EITF Issue No. 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*
- EITF Topic D-47, *Accounting for the Refund of Bank Insurance Funds and Savings Association Insurance Fund Premiums*
- FASB Concepts Statement No. 6, *Elements of Financial Statements*
- Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 62, *Discounting by Property/Casualty Insurance Companies*
- SEC SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies*

Reporting Liabilities

.31 FASB Statement No. 5, paragraph 8, requires the accrual of a liability when "a. Information available prior to issuance of the financial statements indicates that it is probable that . . . a liability has been incurred at the date of the financial statements" and "b. The amount of loss can be reasonably estimated." With respect to assessments, FASB Statement No. 5, paragraph 33, states, in part:

> The following factors, among others, must be considered in determining whether accrual and/or disclosure is required with respect to pending or threatened litigation and actual or possible claims and assessments:
>
> a. The period in which the underlying cause (i.e., the cause for action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred.

FASB Statement No. 5, paragraph 34, states, in part:

> As a condition for accrual of a loss contingency, paragraph 8(a) requires that information available prior to the issuance of financial statements indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Accordingly, accrual would clearly be inappropriate for . . . assessments whose underlying cause is an event or condition occurring after the date of financial statements . . . .

.32 Therefore, for a liability to be recognized in the financial statements, the underlying cause must have occurred on or before the date of the financial statements. The SOP identifies the obligating event for each kind of assessment, which is the underlying cause.

.33 In reaching the conclusions in this SOP concerning when to recognize liabilities for assessments, AcSEC considered the definition of liabilities in paragraph 35 of FASB Concepts Statement No. 6 and the concept of present obligation:

> Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [*Footnote references omitted.*]

.34 To apply the definition of liabilities in paragraph 35 of FASB Concepts Statement No. 6 to assessments, AcSEC considered the underlying cause that creates a present obligation for entities subject to assessments to pay assessments. In order to have a present obligation, the entity must have little or no discretion to avoid the future sacrifice, and the event that obligates the entity must have occurred no later than the date of the financial statements.

.35 AcSEC concluded that the fundamental differences in the assessment mechanisms justified identifying different events, depending on the kind of assessment, that would obligate an entity and require recognition of a liability.

Obligating Event

.36 More than one event may need to occur before there is a cause for an assessment. AcSEC believes that only when all of the events required to give rise to a cause for action have occurred has the event underlying a liability occurred. AcSEC concluded that the insolvency is the initial event that will give rise to a cause for an assessment, either currently or at some point in the future. The insolvency may or may not also be the final event.

.37 If, through the operation of law or regulatory practice, the enterprise has at the time of an insolvency an unavoidable obligation (subject only to the actual imposition of the assessment) to pay for some portion of the insolvency, no further events are required for there to be an underlying cause of a liability. However, if at the moment of the insolvency the enterprise does not, through the operation of law or regulatory practice, have an unavoidable obligation (subject only to the actual imposition of the assessment), then another event is the final event underlying the obligation.

Assessments Based on Premiums

.38 For assessments based on premiums written after the insolvency, AcSEC concluded that the writing of premiums on which a potential assessment is based generally should be considered the underlying cause of an entity's obligation to pay cash in the future.[8]

.39 In making its decision, AcSEC noted that entities generally have the option of reducing or eliminating their premium-writing activity, thereby reducing or eliminating their assessment. AcSEC was also influenced by the fact that entities subject to assessments that enter a new state or increase market share in a state will be required to pay assessments for insolvencies that occurred before they entered that state or increased their market share. The fact that such entities will have to pay assessments for insolvencies that occurred previously supports the conclusion that the writing of premiums is the underlying cause of the assessments.

.40 AcSEC believes that a number of analogies support the conclusions in this SOP. For example, in EITF Issue No. 93-6, a ceding enterprise would recognize a liability for obligatory retrospectively rated contracts only to the extent that it has an obligation to pay cash (or other consideration) to a reinsurer that would not have been required in the absence of experience under the contract. Furthermore, EITF Issue No. 93-6 specifically prohibits ceding companies from recognizing liabilities for amounts expected to be paid in the future that relate to prior catastrophe losses (for example, through increased costs of reinsurance) when no contractual obligation to make such payments exists. AcSEC believes that entities subject to assessments have no obligation to pay assessments unless the premiums on which the assessments are to be based are written.

.41 In EITF Issue No. 92-13, the EITF reached a consensus that allowed enterprises with operations in the coal industry to account for their obligations under the Coal Industry Retiree Health Benefit Act of 1992 (which created a fund to pay benefits related to certain coal-industry benefit trusts that were operating at deficits) as multiemployer pension plans. Guaranty funds are similar to multiemployer pension plans in that each insurance enterprise's payments to the fund are used to satisfy the general obligations of the fund and are not segregated for the benefit of any one enterprise.

.42 AcSEC also believes that accounting for claims-made insurance provides an appropriate analogy. In claims-made insurance, the insured event is the reporting, during the term of the policy or within a specified period following the coverage period, to the insurer of a claim for a covered loss. For such policies, entities subject to assessments estimate a liability for unpaid claims based only on claims reported, despite the fact that other losses may have been incurred that eventually may result in claims to that insurance enterprise. The agreement between the insurer and the insured is that the insurance enterprise is not obligated to cover those unreported losses, unless that insurance enterprise is providing coverage under a claims-made policy when the claim is made. Similarly, the substance of the arrangement for most premium-based assessment mechanisms is that an insurance enterprise is obligated to pay assessments only if the premiums on which the assessments are to be based are written.

Assessments Based on Losses

.43 For loss-based assessments, AcSEC concluded that the event underlying an insurance enterprise's obligation to pay the assessment is the incur-

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[8] As discussed in paragraph .13, some states, through law or regulatory practice, provide that an insurance enterprise cannot avoid paying a particular assessment even if the insurance enterprise reduces premium writings in the future. For example, in certain states, an insurance enterprise may remain liable for assessments even though the insurance enterprise discontinues the writing of premiums. In this case, the underlying cause of the liability is not the writing of the premium, but the insolvency.

rence of losses on which the assessments are expected to be based (regardless of whether the assessment is based on paid or incurred losses). AcSEC believes that entities subject to assessments have little or no discretion to avoid the future sacrifice once the losses on which the assessments are expected to be based have been incurred. Unlike premium-based assessments, in which the insurance enterprise has the discretion to write or not to write premiums (even if it is unlikely that the insurance enterprise will not write such future premiums), an insurance enterprise is obligated to pay the loss-based assessments once those losses are incurred.

.44 AcSEC considered whether it is appropriate to recognize a liability for assessments for administrative-type state funds as the losses on which the assessments are based are incurred by entities. Some have indicated that it is not appropriate to accrue a liability for operating costs of a state fund that have not yet been incurred by the state fund. AcSEC concluded that loss-based assessments for administrative-type funds should be accrued as losses of an entity occur if it is probable that a related assessment will be made. AcSEC believes this is similar to the accounting in FASB Statement No. 60, whereby liabilities for claim adjustment expenses that relate to unpaid claims are accrued before the costs are incurred. Once the losses are incurred, insurance enterprises have little or no discretion to avoid paying the assessment.

Probability of Assessment

.45 Although entities subject to assessments may be able to determine that future assessments are probable for some period before a formal determination of insolvency occurs, AcSEC concluded that assessments should not be considered probable until a formal determination of insolvency occurs, unless the assessments are being made by a prefunded guaranty fund. AcSEC believes that the formal determination date is the most objectively determinable measurement date and that requiring its use will foster comparability in reporting. Furthermore, AcSEC believes mere speculation about an insurance enterprise's insolvency should not be considered an accounting event.

Present Value

.46 AcSEC believes that recognizing assessment liabilities at their present value provides the most representative measure of the economic substance of the situation. Nevertheless, AcSEC declined to mandate present-value-based measurements while the FASB is still considering the role of present-value-based measurements in financial reporting. For the same reason, this SOP provides no detailed guidance on present-value methodologies and discount rates.

Premium Tax Offsets, Policy Surcharges, and Future Rate Making

.47 AcSEC believes that, when it is probable that paid or accrued assessments will result in premium tax offsets or policy surcharges, the recognition of an asset is appropriate based on current laws and projections of future premium collections from in-force policies. No asset should be recognized related to expected new business or renewal of in-force short-duration contracts. In making this determination, AcSEC considered the characteristics of an asset in paragraph 26 of FASB Concepts Statement No. 6, which states, in part:

> An asset has three essential characteristics: (*a*) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (*b*) a particular entity can obtain the benefit and control others' access to it, and (*c*) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

.48 Premium tax offsets, policy surcharges, and the incorporation of assessment costs in future premium rate structures have a similar purpose, that is, to allow entities subject to assessments to recoup some portion of assessment costs. Nevertheless, AcSEC concluded that the ability to include assessments in future premium rate structures should be treated differently from premium tax offsets and policy surcharges. Premium tax offsets and policy surcharges are statutorily provided and generally are not dependent on the ability or intent of an insurance enterprise to take any action. In contrast, there can be no assurance that the future competitive or regulatory environment will allow an insurance enterprise to include assessments in future premium rate structures in such a manner as to result in a recovery of costs. Thus, AcSEC concluded that the statutory ability to include assessment costs in future premium structures should not result in asset recognition and should not be used to reduce current assessment costs.

.49 To the extent that paid or accrued guaranty-fund costs are expected to result in premium tax offsets or policy surcharges, AcSEC believes that it is appropriate to consider the recognition of such recoveries as assets. AcSEC believes that the amount of the asset should be limited to expected future premiums related to policies in force at the measurement date. AcSEC considered whether it is appropriate to consider all expected future premiums in establishing such recoveries and concluded that this approach would introduce an inconsistency with AcSEC's decision not to recognize a liability for guaranty-fund and similar assessments that are based on future premiums. Therefore, AcSEC determined that considering all expected future premiums in evaluating the recoverability of premium tax offsets or policy surcharges is not appropriate.

.50 AcSEC also considered whether there was an inappropriate inconsistency between requiring the use of persistency assumptions in asset recognition and not for liability recognition in prospective-premium-based assessments (for example, for multiple-year contracts). AcSEC concluded that this treatment was appropriate due to the limited number of instances in which persistency assumptions would be applicable for liability measurement.

Prefunded-Premium-Based Assessments

.51 For prefunded-premium-based assessments, as long as such funds do not provide, either by statute or practice, for a return of excess assessments, no asset should be recorded.

Transition

.52 AcSEC decided to prohibit the retroactive application of this SOP. AcSEC recognizes the benefits of comparative financial statements but believes that the necessary information for entities subject to assessments to create for prior periods the necessary estimates of liabilities for future assessments and of the timing and amounts of cash flows would not be readily available.

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Appendix A

Illustration of Computation of Assessment Liabilities

Example 1—Prospective-Premium-Based Assessment[9]

Scenario

As a result of insolvencies in prior years, ABC Property & Liability Insurance Company (ABC) expects to be assessed in the future by the guaranty fund in a state where it writes premiums. Any such assessments will be limited to 2 percent of premium writings in the prior year and are recoverable through premium tax offsets on a ratable basis over the five-year period following the year of each assessment.

Although it does not expect to do so, ABC is free to cease writing the lines of business that are subject to the guaranty-fund assessments.

As of December 31, 19X0, ABC has neither paid nor received a notice of an assessment related to the insolvencies. Based on communications from the state guaranty association, ABC expects to receive an assessment in 19X1, which is allocated among entities based on 19X0 market share, for at least 1 percent of 19X0 premiums that are subject to the assessment. A best estimate cannot be determined, and no amount within the range of estimates (meaning, from 1 to 2 percent of 19X0 premiums) is a better estimate than any other amount, therefore the minimum amount in the range should be accrued.

Result

As of December 31, 19X0, ABC should recognize a liability equal to 1 percent of the premiums written in 19X0 that are subject to the assessment. No additional liability should be recognized, and no asset related to the premium tax offset should be recognized. Disclosure of the loss contingency of up to an additional 1 percent of the subject premiums should be considered.

Discussion

ABC would recognize a liability only for those future assessments it is obligated to pay as a result of the premiums written. Because ABC is not obligated to write any future premiums, its liability is limited to that related to premiums written in 19X0. Because no amount within the range of estimates is a better estimate than any other amount, the minimum amount in the range is accrued. Further, because the premium tax offset is realizable only on business that will be written in the future (that is, 19X2 and subsequent years), no asset or receivable is recognized as of December 31, 19X0.

Example 2—Retrospective-Premium-Based Assessment

Scenario

As a result of an insolvency that occurred during 19X0, DEF Life and Health Insurance Company (DEF) expects to be assessed in the future by the guaranty

[9] This kind of assessment is considered prospective since the assessment relates to premium written subsequent to the insolvency.

fund in a state where it has written business. Any such assessment will be based on DEF's average market share, determined based on premiums that are subject to the assessment for the three years prior to the insolvency, and limited to 2 percent of the average annual subject premiums for the three years prior to the insolvency. Further, such assessments are recoverable through premium tax offsets over the five-year period following the year of payment for each assessment.

As of December 31, 19X0, DEF has not paid or received a notice of an assessment related to the insolvency. Based on initial input from the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) and experience with other insolvencies, DEF assumes that the first assessment will not be made until 19X3 and that it will take three to five annual assessments in order for the guaranty fund to be able to meet its obligations. Based on the estimated nationwide cost of the insolvency and the distribution of the insolvent company's business, DEF estimates that its assessment will be at least 1 percent of the average annual premiums that are subject to the assessment. No amount within the range of estimates (meaning, from 1 to 2 percent of the average annual premiums for three to five years) is a better estimate than any other amount, therefore the minimum amount in the range should be accrued.

Result

As of December 31, 19X0, DEF should recognize a liability for three years of assessments at 1 percent of the average annual premiums that are subject to the assessment (that is, the assessments expected in 19X3, 19X4, and 19X5). Disclosure of the loss contingency for additional assessments (meaning, in 19X6 and 19X7) or assessment of greater than 1 percent of the average annual premiums that are subject to the assessment should be considered. An asset related to premium tax offsets that are available on accrued assessments would be recorded provided there were sufficient premium taxes based on business in force at December 31, 19X0 (with assumed levels of policy retention) to allow realization of the asset.

The resulting recognized liability and asset are as follows (shown on both a discounted and undiscounted basis, based on paragraphs .21 and .25, discounting is optional), assuming average annual subject premiums of $100,000 for the three years prior to the insolvency.

Schedule of Assessments and Premium Tax Offsets

	Recorded At	Cash Payments									
	12/31/19X0	19X1	19X2	19X3	19X4	19X5	19X6	19X7	19X8	19X9	20X0
Assessments											
19X3 Assessment				1,000							
19X4 Assessment					1,000						
19X5 Assessment						1,000					
Total	3,000			1,000	1,000	1,000					
Premium Tax Offset											
19X3 Assessment (1)					200	200	200	200	200		
19X4 Assessment (1)						200	200	200	200	200	
19X5 Assessment (1)							200	200	200	200	200
Total	3,000				200	400	600	600	600	400	200
Present value of assessments											
at 12/31/19X0 (2)	2,470										
Present value of Premium											
Tax Offset at 12/31/19X0 (2)	2,139										

(1) Assumes that, based upon anticipated levels of policy retention from the business in force at December 31, 19X0, there will be sufficient premium to realize the premium tax offset.

(2) Discounted at 5 percent, assuming all assessments are paid and offsets realized at the end of each year.

Discussion

DEF would record a liability for all future assessments related to the insolvency. Because no amount within the range of estimates (meaning, from 1 to 2 percent of the average annual premiums for three to five years) is a better estimate than any other amount, the minimum amount in the range (meaning, 1 percent per year for three years of assessments) is accrued.

Since it is assumed that based upon the anticipated levels of policy retention from the business in force at December 31, 19X0, there will be sufficient premium to realize the premium tax offset, the premium tax offset is recorded.

Example 3—Loss-Based Assessment

Scenario

GHI Industrial Company (GHI) is self-insured for workers' compensation and therefore participates in the second injury fund in the state where it conducts operations. GHI is entitled to recover from the fund for some or all of the indemnity claims for previously injured workers. GHI is also subject to annual assessments (maximum of 1 percent per year) on indemnity claims paid each year.

Assessment rates have been climbing steadily, from 0.6 percent five years ago to 0.75 percent in 19X0.

Results

As of December 31, 19X0, GHI should have an assessment liability recognized for 0.75 percent of its liability for the payment of future indemnity claims, unless there was information to support the assessment rate being reduced or the assessments being eliminated in the future. Disclosure of the loss contingency of up to an additional 0.25 percent of the liability for the payment of future indemnity claims should be considered.

Discussion

GHI would recognize a liability based on the current assessment rate, unless there was clear evidence that the rate would change. The liability would be based on the entire liability base that was subject to the assessment.

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Appendix B

Discussion of Comments Received on the Exposure Draft

An exposure draft of a proposed statement of position (SOP), *Accounting by Insurance and Other Enterprises for Guaranty-Fund and Certain Other Insurance-Related Assessments*, was issued for public comment on December 5, 1996, and distributed to a variety of interested parties to encourage comment by those who would be affected by the proposal. Twenty-four comment letters were received in response on the exposure draft. The most significant and pervasive comments received were in the following four areas:

1. Reporting assets and policy surcharges
2. Estimation of the assessment liability
3. Accounting for prospective-premium-based assessments
4. Scope

Reporting Assets and Policy Surcharges

The guidance in the exposure draft on reporting assets and policy surcharges caused some confusion. Several respondents requested clarification about the kind of entity that would recognize assets for premium tax offsets and policy surcharges. AcSEC clarified the guidance to explain how an asset should be accounted for when it is probable that a paid or accrued assessment will result in an amount that is expected to be recoverable.

Estimation of the Assessment Liability

Several respondents commented that they do not believe a liability can be reasonably estimated by an entity for guaranty-fund assessments because the entity will not have the necessary information to estimate the amount of loss. These respondents commented that a determination of estimates is particularly difficult for guaranty-fund assessments because of uncertainties about the cost of the insolvency to the guaranty fund and the portion that will be recovered through assessment because of such factors as alternative strategies for the liquidation of assets of the insolvent company that affect the timing and level of assessments and certain liabilities of the insolvent insurer may be particularly difficult to estimate (for example, asbestos or environmental liabilities). AcSEC believes that, although it may be difficult to calculate a point estimate in certain circumstances (see paragraph .19), in the majority of cases, enough information is available to calculate a range of estimates. Further, in the case of prospective-premium-based assessments, the liability to be recorded is related only to premiums written or obligated to be written, rather than to all expected future premiums.

Accounting for Prospective-Premium-Based Assessments

The exposure draft contained an alternative view on accounting for prospective-premium-based assessments, which discussed that a minority of AcSEC believed that the insolvency should be considered the underlying cause of an entity's obligation to pay future assessments, irrespective of the basis used to determine the amount due from each insurance enterprise subject to the assessment. The majority of respondents did not support this minority view. AcSEC continues to believe that the writing of the premium on which potential assessments are expected to be based is the underlying cause of an entity's obligation to pay cash in the future.

Scope

Because entities other than insurance enterprises are assessed insurance-related assessments, the scope of the exposure draft included all reporting entities. Although some noninsurance entities requested to be excluded from the scope, most of the respondents believe that both insurance enterprises and noninsurance enterprises would have sufficient information to recognize a liability for the assessments covered in the SOP.

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Glossary

incurred losses. Losses paid or unpaid for which the company has become liable during a period.

in-force policies. Policies effective before a specified date that have not yet expired or been canceled.

involuntary pools. A residual market mechanism for insureds who cannot obtain insurance in the voluntary market.

life, annuity, and health insurance enterprise. An enterprise that may issue annuity, endowment, and accident and health insurance contracts as well as life insurance contracts. Life and health insurance enterprises may be either stock or mutual organizations.

obligated to write. If an entity has no discretion to cancel a policy because of legal obligation under state statute or contract terms, or regulatory practice and is required to offer or issue insurance policies for a period in the future.

premium tax offsets. Offsets against premium taxes levied on insurance companies by states.

premiums written. The premiums on all policies a company has issued in a period.

property and casualty insurance enterprise. An enterprise that issues insurance contracts providing protection against either (1) damage to or loss of property caused by various perils, such as fire and theft or (2) legal liability resulting from injuries to other persons or damage to their property. Property and liability insurance enterprises may be either stock or mutual organizations.

Accounting Standards Executive Committee (1996–1997)

Insurance Companies Committee (1996-1997)

Assessments Task Force

AICPA Staff

The task force and staff gratefully acknowledge the contributions made to the development of this Statement of Position by David B. Greenfield and former members Joseph Zubretsky and John E. Schramm.

[The next page is 80,411.]

Section 10,720

Statement of Position 98-1
Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

March 4, 1998

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) provides guidance on accounting for the costs of computer software developed or obtained for internal use. The SOP requires the following:

- Computer software meeting the characteristics specified in this SOP is internal-use software.
- Computer software costs that are incurred in the preliminary project stage should be expensed as incurred. Once the capitalization criteria of the SOP have been met, external direct costs of materials and services consumed in developing or obtaining internal-use computer software; payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal-use computer software project (to the extent of the time spent directly on the project); and interest costs incurred when developing computer software for internal use should be capitalized. Training costs and data conversion costs, except as noted in paragraph .21, should be expensed as incurred.
- Internal costs incurred for upgrades and enhancements should be expensed or capitalized in accordance with paragraphs .20–.23. Internal costs incurred for maintenance should be expensed as incurred. Entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements should expense such costs as incurred.

- External costs incurred under agreements related to specified upgrades and enhancements should be expensed or capitalized in accordance with paragraphs .20–.23. However, external costs related to maintenance, unspecified upgrades and enhancements, and costs under agreements that combine the costs of maintenance and unspecified upgrades and enhancements should be recognized in expense over the contract period on a straight-line basis unless another systematic and rational basis is more representative of the services received.
- Impairment should be recognized and measured in accordance with the provisions of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*.[*]
- The capitalized costs of computer software developed or obtained for internal use should be amortized on a straight-line basis unless another systematic and rational basis is more representative of the software's use.
- If, after the development of internal-use software is completed, an entity decides to market the software, proceeds received from the license of the computer software, net of direct incremental costs of marketing, should be applied against the carrying amount of that software.

The SOP identifies the characteristics of internal-use software and provides examples to assist in determining when computer software is for internal use.

The SOP applies to all nongovernmental entities and is effective for financial statements for fiscal years beginning after December 15, 1998. The provisions of this SOP should be applied to internal-use software costs incurred in those fiscal years for all projects, including those projects in progress upon initial application of the SOP. Earlier application is encouraged in fiscal years for which annual financial statements have not been issued. Costs incurred prior to initial application of this SOP, whether capitalized or not, should not be adjusted to the amounts that would have been capitalized had this SOP been in effect when those costs were incurred.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

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[*] FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, supersedes FASB Statement No. 121. [Footnote added, October 2002, to reflect conforming changes necessary due to the issuance of FASB Statement No. 144.]

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Introduction and Background

.01 The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, in 1985. At that time, the FASB considered expanding the scope of that project to include costs incurred for the development of computer software for internal use. The FASB concluded, however, that accounting for the costs of software used internally was not a significant problem and, therefore, decided not to expand the scope of the project. The FASB stated that it recognized that at that time the majority of entities expensed all costs of developing software for internal use, and it was not convinced that the predominant practice was improper.

.02 Because of the absence of authoritative literature that specifically addresses accounting for the costs of computer software developed or obtained for internal use and the growing magnitude of those costs, practice became diverse. Some entities capitalize costs of internal-use computer software, whereas some entities expense costs as incurred. Still other entities capitalize costs of purchased internal-use computer software and expense costs of internally developed internal-use computer software as incurred.

.03 The staff of the Securities and Exchange Commission (SEC) and other interested parties have requested that standard setters develop authoritative guidance to eliminate the inconsistencies in practice. In a November 1994 letter, the Chief Accountant of the SEC suggested that the Emerging Issues Task Force (EITF) develop that guidance. However, the EITF and the Accounting Standards Executive Committee (AcSEC) agreed that AcSEC should develop the guidance.

.04 AcSEC issued an exposure draft of a proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, on December 17, 1996. AcSEC received about 130 comment letters in response to the exposure draft.

Scope

.05 This SOP provides guidance on accounting by all nongovernmental entities, including not-for-profit organizations, for the costs of computer software developed or obtained for internal use and provides guidance for determining whether computer software is for internal use.

.06 This SOP clarifies that the costs of computer software developed or obtained are costs of either (*a*) software to be sold, leased, or otherwise marketed as a separate product or as part of a product or process, subject to FASB Statement No. 86; (*b*) software to be used in research and development, subject to FASB Statement No. 2, *Accounting for Research and Development Costs*, and FASB Interpretation No. 6, *Applicability of FASB Statement No. 2 to Computer Software*; (*c*) software developed for others under a contractual arrangement, subject to contract accounting standards; or (*d*) internal-use software, subject to this SOP. This SOP does not change any of the provisions in FASB Statement Nos. 86, 2, or FASB Interpretation No. 6.

.07 Costs of computer software that is "sold, leased, or otherwise marketed as a separate product or as part of a product or process" are within the scope of FASB Statement No. 86. The Appendix of this SOP includes examples of computer software considered to be for internal use and thus not "part of a product or process."

.08 This SOP provides guidance on when costs incurred for internal-use computer software are and are not capitalized.

.09 This SOP provides guidance on accounting for the proceeds of computer software developed or obtained for internal use that is marketed.

.10 This SOP provides guidance on accounting for computer software that consists of more than one component or module. For example, an entity may develop an accounting software system containing three elements: a general ledger, an accounts payable subledger, and an accounts receivable subledger. In this example, each element might be viewed as a component or module of the entire accounting software system. The guidance in this SOP should be applied to individual components or modules.

.11 Accounting for costs of reengineering activities, which often are associated with new or upgraded software applications, is not included within the scope of this SOP.[1]

Conclusions

Characteristics of Internal-Use Computer Software

.12 For purposes of this SOP, internal-use software is software having the following characteristics:

a. The software is acquired, internally developed, or modified solely to meet the entity's internal needs.

b. During the software's development or modification, no substantive plan exists or is being developed to market the software externally.

A substantive plan to market software externally could include the selection of a marketing channel or channels with identified promotional, delivery, billing, and support activities. To be considered a substantive plan under this SOP, implementation of the plan should be reasonably possible. Arrangements providing for the joint development of software for mutual internal use (for example, cost-sharing arrangements) are not substantive plans to market software for purposes of this SOP. Similarly, routine market feasibility studies are not substantive plans to market software for purposes of this SOP.

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[1] This SOP does not change the conclusions reached in Emerging Issues Task Force Issue No. 97-13, *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation*, which requires that the costs of reengineering activities be expensed as incurred.

.13 An entity must meet both characteristics in paragraph .12 for software to be considered for internal use.

.14 An entity's past practices related to selling software may help determine whether the software is for internal use or is subject to a plan to be marketed externally. For example, an entity in the business of selling computer software often both uses and sells its own software products. Such a past practice of both using and selling computer software creates a rebuttable presumption that any software developed by that entity is intended for sale, lease, or other marketing, and thus is subject to the guidance in FASB Statement No. 86.

.15 Computer software to be sold, leased, or otherwise marketed includes software that is part of a product or process to be sold to a customer and should be accounted for under FASB Statement No. 86. For example, software designed for and embedded in a semiconductor chip is included in the scope of FASB Statement No. 86 because it is an integral part of the product. By contrast, software for internal use, though it may be used in developing a product, is not part of or included in the actual product or service sold. If software is used by the vendor in the production of the product or providing the service but the customer does not acquire the software or the future right to use it, the software is covered by this SOP. For example, for a communications company selling telephone services, software included in a telephone switch is part of the internal equipment used to deliver a service but is not part of the product or service actually being acquired or received by the customer.

.16 The Appendix [paragraph .93] provides examples of when computer software is and is not for internal use.

Stages of Computer Software Development

.17 The following table illustrates the various stages and related processes of computer software development.

Preliminary Project Stage	*Application Development Stage*	*Post-Implementation/ Operation Stage*
Conceptual formulation of alternatives	Design of chosen path, including software configuration and software interfaces	Training
Evaluation of alternatives	Coding	Application maintenance
Determination of existence of needed technology	Installation to hardware	
Final selection of alternatives	Testing, including parallel processing phase	

The SOP recognizes that the development of internal-use computer software may not follow the order shown above. For example, coding and testing are often performed simultaneously. Regardless, for costs incurred subsequent to completion of the preliminary project stage, the SOP should be applied based on the nature of the costs incurred, not the timing of their incurrence. For example, while some training may occur in the application development stage, it should be expensed as incurred as required in paragraphs .21 and .23.

Research and Development

.18 The following costs of internal-use computer software are included in research and development and should be accounted for in accordance with the provisions of FASB Statement No. 2:

a. Purchased or leased computer software used in research and development activities where the software does not have alternative future uses.

b. All internally developed internal-use computer software[2] (including software developed by third parties, for example, programmer consultants) if (1) the software is a pilot project (that is, software of a nature similar to a pilot plant as noted in paragraph 9(h) of FASB Statement No. 2) or (2) the software is used in a particular research and development project, regardless of whether the software has alternative future uses.

Capitalize or Expense

.19 *Preliminary Project Stage.* When a computer software project is in the preliminary project stage, entities will likely—

a. Make strategic decisions to allocate resources between alternative projects at a given point in time. For example, should programmers develop a new payroll system or direct their efforts toward correcting existing problems in an operating payroll system?

b. Determine the performance requirements (that is, what it is that they need the software to do) and systems requirements for the computer software project it has proposed to undertake.

c. Invite vendors to perform demonstrations of how their software will fulfill an entity's needs.

d. Explore alternative means of achieving specified performance requirements. For example, should an entity make or buy the software? Should the software run on a mainframe or a client server system?

e. Determine that the technology needed to achieve performance requirements exists.

f. Select a vendor if an entity chooses to obtain software.

g. Select a consultant to assist in the development or installation of the software.

.20 Internal and external costs incurred during the preliminary project stage should be expensed as they are incurred.

.21 *Application Development Stage.* Internal and external costs incurred to develop internal-use computer software during the application development stage should be capitalized. Costs to develop or obtain software that allows for access or conversion of old data by new systems should also be capitalized. Training costs are not internal-use software development costs and, if incurred during this stage, should be expensed as incurred.

.22 The process of data conversion from old to new systems may include purging or cleansing of existing data, reconciliation or balancing of the old data

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[2] FASB Interpretation No. 6 excludes from research and development costs computer software related to an entity's selling and administrative activities.

and the data in the new system, creation of new/additional data, and conversion of old data to the new system. Data conversion often occurs during the application development stage. Data conversion costs, except as noted in paragraph .21, should be expensed as incurred.

.23 *Post-Implementation/Operation Stage*. Internal and external training costs and maintenance costs should be expensed as incurred.

.24 *Upgrades and Enhancements*. For purposes of this SOP, upgrades and enhancements are defined as modifications to existing internal-use software that result in additional functionality—that is, modifications to enable the software to perform tasks that it was previously incapable of performing. Upgrades and enhancements normally require new software specifications and may also require a change to all or part of the existing software specifications. In order for costs of specified upgrades and enhancements to internal-use computer software to be capitalized in accordance with paragraphs .25 and .26, it must be probable[3] that those expenditures will result in additional functionality.[4]

.25 Internal costs incurred for upgrades and enhancements should be expensed or capitalized in accordance with paragraphs .20–.23.[5] Internal costs incurred for maintenance should be expensed as incurred. Entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements should expense such costs as incurred.

.26 External costs incurred under agreements related to specified upgrades and enhancements should be expensed or capitalized in accordance with paragraphs .20–.23. (If maintenance is combined with specified upgrades and enhancements in a single contract, the cost should be allocated between the elements as discussed in paragraph .33 and the maintenance costs should be expensed over the contract period.) However, external costs related to maintenance, unspecified upgrades and enhancements, and costs under agreements that combine the costs of maintenance and unspecified upgrades and enhancements should be recognized in expense over the contract period on a straight-line basis unless another systematic and rational basis is more representative of the services received.

.27 Capitalization of costs should begin when both of the following occur.

a. Preliminary project stage is completed.

b. Management, with the relevant authority, implicitly or explicitly authorizes and commits to funding a computer software project and it is probable[6] that the project will be completed and the software will be used to perform the function intended. Examples of authorization include the execution of a contract with a third party to develop the software, approval of expenditures related to internal development, or a commitment to obtain the software from a third party.

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[3] See paragraph .62 of this SOP for meaning of “probable.”

[4] This SOP does not change the conclusions reached in Emerging Issues Task Force Issue No. 96-14, *Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*, which requires that external and internal costs associated with modifying internal-use software currently in use for the Year 2000 be charged to expense as incurred. New internal-use software developed or obtained that replaces previously existing internal-use software should be accounted for in accordance with this SOP.

[5] See footnote 4.

[6] See paragraph .62 of this SOP for meaning of “probable.”

.28 When it is no longer probable[7] that the computer software project will be completed and placed in service, no further costs should be capitalized, and guidance in paragraphs .34 and .35 on impairment should be applied to existing balances.

.29 Capitalization should cease no later than the point at which a computer software project is substantially complete and ready for its intended use. For purposes of this SOP, computer software is ready for its intended use after all substantial testing is completed.

.30 New software development activities should trigger consideration of remaining useful lives of software that is to be replaced. When an entity replaces existing software with new software, unamortized costs of the old software should be expensed when the new software is ready for its intended use.

Capitalizable Costs

.31 Costs of computer software developed or obtained for internal use that should be capitalized include only the following:

a. External direct costs of materials and services consumed in developing or obtaining internal-use computer software. Examples of those costs include but are not limited to fees paid to third parties for services provided to develop the software during the application development stage, costs incurred to obtain computer software from third parties, and travel expenses incurred by employees in their duties directly associated with developing software.

b. Payroll and payroll-related costs (for example, costs of employee benefits) for employees who are directly associated with and who devote time to the internal-use computer software project, to the extent of the time spent directly on the project. Examples of employee activities include but are not limited to coding and testing during the application development stage.

c. Interest costs incurred while developing internal-use computer software. Interest should be capitalized in accordance with the provisions of FASB Statement No. 34, *Capitalization of Interest Cost.*[8]

General and administrative costs and overhead costs should not be capitalized as costs of internal-use software.

.32 Entities often license internal-use software from third parties. Though FASB Statement No. 13, *Accounting for Leases*, excludes licensing agreements from its scope, entities should analogize to that Statement when determining the asset acquired in a software licensing arrangement.

Multiple-Element Software Arrangements Included in Purchase Price

.33 Entities may purchase internal-use computer software from a third party. In some cases, the purchase price includes multiple elements, such as training for the software, maintenance fees for routine maintenance work to be

[7] See paragraph .62 of this SOP for meaning of "probable."

[8] Paragraph 17 of FASB Statement No. 34, *Capitalization of Interest Cost*, states, "If the enterprise suspends substantially all activities related to acquisition of the asset, interest capitalization shall cease until activities are resumed."

performed by the third party, data conversion costs, reengineering costs, and rights to future upgrades and enhancements. Entities should allocate the cost among all individual elements. The allocation should be based on objective evidence of fair value of the elements in the contract, not necessarily separate prices stated within the contract for each element. Those elements included in the scope of this SOP should be accounted for in accordance with the provisions of this SOP.

Impairment

.34 Impairment should be recognized and measured in accordance with the provisions of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*.[*] Paragraph 8 of FASB Statement No. 121[*] requires that assets should be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets. FASB Statement No. 121[*] guidance is applicable, for example, when one of the following occurs related to computer software being developed or currently in use:

a. Internal-use computer software is not expected to provide substantive service potential,

b. A significant change occurs in the extent or manner in which the software is used or is expected to be used,

c. A significant change is made or will be made to the software program,

d. Costs of developing or modifying internal-use computer software significantly exceed the amount originally expected to develop or modify the software.

.35 Paragraph 10 of FASB Statement No. 121[*] requires that "if the asset is not expected to provide any service potential to the entity, the asset shall be accounted for as if abandoned or held for disposal in accordance with the provisions of paragraph 15 of [FASB Statement No. 121[*]]." When it is no longer probable[9] that computer software being developed will be completed and placed in service, the asset should be reported at the lower of the carrying amount or fair value, if any, less costs to sell. The rebuttable presumption is that such uncompleted software has a fair value of zero. Indications that the software may no longer be expected to be completed and placed in service include the following:

a. A lack of expenditures budgeted or incurred for the project

b. Programming difficulties that cannot be resolved on a timely basis

c. Significant cost overruns

d. Information has been obtained indicating that the costs of internally developed software will significantly exceed the cost of comparable third-party software or software products, so that management intends to obtain the third-party software or software products instead of completing the internally developed software

e. Technologies are introduced in the marketplace, so that management intends to obtain the third-party software or software products instead of completing the internally developed software

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[*] FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, supersedes FASB Statement No. 121. [Footnote added, October 2002, to reflect conforming changes necessary due to the issuance of FASB Statement No. 144.]

[9] See paragraph .62 of this SOP for meaning of "probable."

f. Business segment or unit to which the software relates is unprofitable or has been or will be discontinued.

Amortization

.36 The costs of computer software developed or obtained for internal use should be amortized on a straight-line basis unless another systematic and rational basis is more representative of the software's use.

.37 In determining and periodically reassessing the estimated useful life over which the costs incurred for internal-use computer software will be amortized, entities should consider the effects of obsolescence, technology, competition, and other economic factors. Entities should consider rapid changes that may be occurring in the development of software products, software operating systems, or computer hardware and whether management intends to replace any technologically inferior software or hardware. Given the history of rapid changes in technology, software often has had a relatively short useful life.

.38 For each module or component of a software project, amortization should begin when the computer software is ready for its intended use, regardless of whether the software will be placed in service in planned stages that may extend beyond a reporting period. For purposes of this SOP, computer software is ready for its intended use after all substantial testing is completed. If the functionality of a module is entirely dependent on the completion of other modules, amortization of that module should begin when both that module and the other modules upon which it is functionally dependent are ready for their intended use.

Internal-Use Computer Software Marketed

.39 If, after the development of internal-use software is completed, an entity decides to market the software, proceeds received from the license of the computer software, net of direct incremental costs of marketing, such as commissions, software reproduction costs, warranty and service obligations, and installation costs, should be applied against the carrying amount of that software. No profit should be recognized until aggregate net proceeds from licenses and amortization have reduced the carrying amount of the software to zero. Subsequent proceeds should be recognized in revenue as earned.

.40 If, during the development of internal-use software, an entity decides to market the software to others, the entity should follow FASB Statement No. 86. Amounts previously capitalized under this SOP should be evaluated at each balance sheet date in accordance with paragraph 10 of FASB Statement No. 86. Capitalized software costs should be amortized in accordance with paragraph 8 of FASB Statement No. 86. A pattern of deciding to market internal-use software during its development creates a rebuttable presumption that any software developed by that entity is intended for sale, lease, or other marketing, and thus is subject to the guidance in FASB Statement No. 86.

Disclosures

.41 This SOP does not require any new disclosures; disclosure should be made in accordance with existing authoritative literature, including Accounting Principles Board (APB) Opinion No. 12, *Disclosure of Depreciable Assets and*

Depreciation; APB Opinion No. 22, *Disclosure of Accounting Policies* (for example, amortization methods); FASB Statement Nos. 2 and 121*; and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

Effective Date and Transition

.42 This SOP is effective for financial statements for fiscal years beginning after December 15, 1998, and should be applied to internal-use computer software costs incurred in those fiscal years for all projects, including those projects in progress upon initial application of this SOP. Earlier application is encouraged in fiscal years for which annual financial statements have not been issued.

.43 Costs incurred prior to initial application of this SOP, whether capitalized or not, should not be adjusted to the amounts that would have been capitalized had this SOP been in effect when those costs were incurred. However, the provisions of this SOP concerning amortization and impairment should be applied to any unamortized costs capitalized prior to initial application of this SOP that continue to be reported as assets after the effective date. In accordance with paragraph 33 of APB Opinion No. 20, *Accounting Changes*, the effect on income before extraordinary items, net income, and related per share amounts of the current period should be disclosed for the change in accounting.

.44 Initial application of this SOP should be as of the beginning of the fiscal year in which the SOP is first adopted (that is, if the SOP is adopted prior to the effective date and during an interim period other than the first interim period, all prior interim periods of that fiscal year should be restated).

The provisions of this Statement need not be applied to immaterial items.

Basis for Conclusions

Characteristics of Internal-Use Computer Software

.45 AcSEC recognizes that entities may develop computer software for internal use and also plan to sell, lease, or otherwise market the software to recover some costs. AcSEC believes that the presence of a substantive plan to market software externally before or during software development indicates an intent to sell, lease, or otherwise market software, which requires accounting prescribed by FASB Statement No. 86. AcSEC believes that it is impractical to allocate costs between internal-use software and software to be marketed.

.46 AcSEC considered whether one of the characteristics of internal-use computer software should be that during the software's development, no substantive plan *or intent* to market the software externally exists. AcSEC decided that it could not provide operational guidance to help entities define intent. For example, many entities will consider opportunities to recover some of the software development costs through subsequent sales of the product. AcSEC believes that it cannot provide guidance to distinguish between a true intent to market software and routine inquiries and studies about the possibility of recovering some costs.

* FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, supersedes FASB Statement No. 121. [Footnote added, October 2002, to reflect conforming changes necessary due to the issuance of FASB Statement No. 144.]

.47 Because FASB Statement No. 86 does not define "part of a product or process," many entities have difficulty determining whether computer software is for internal use and subject to the SOP or "part of a product or process" and subject to the accounting prescribed by FASB Statement No. 86. A FASB staff article (which Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Accordance With Generally Accepted Accounting Principles, subordinates to an SOP) *Computer Software: Guidance on Applying Statement No. 86* that appeared in a 1986 FASB Status Report attempted to clarify that term as follows: "Indications that the software in question falls under the Statement's scope include the dependence of the company on the software to provide the service. In other words, could the company earn revenue from providing the service without the software? Would the service be as timely or accurate without the software? If the answer to any of these questions is no, that may indicate that the software is part of a product or process and is included in the scope of Statement No. 86."

.48 In this SOP, AcSEC provides what it believes to be operational guidance that will help entities determine if computer software is for internal use. AcSEC believes that the distinction can be based on what the customer is buying. If the customer is acquiring the software or the future right to use it, the costs of that software are accounted for in accordance with the provisions of FASB Statement No. 86. However, if the software is used by the vendor in production of the product or in providing the service but the customer does not acquire the software or the future right to use it, the software is for internal use. The Appendix [paragraph .93] provides examples of when computer software is and is not for internal use.

.49 AcSEC believes that the guidance in this SOP should be applied at the component or module level. One computer software project may result in several different working modules, which with appropriate software interfaces can be used independently of other modules. AcSEC analogized to an entity that constructs a building complex. Though several buildings are ultimately constructed, each building is an asset and may function without the others.

Research and Development

.50 Some respondents to the exposure draft believe that the costs of computer software developed or obtained for internal use should be charged to expense when incurred as research and development until technological feasibility has been established for the software. They believe that, like the costs of computer software to be sold, leased, or otherwise marketed, the costs of internal-use computer software are within the scope of paragraph 9(i) of FASB Statement No. 2, which states that "engineering activity required to advance the design of a product to the point that it meets specific functional and economic requirements and is ready for manufacture," and therefore those costs should be included within research and development.

.51 AcSEC considered whether this SOP should require entities to meet some technological feasibility threshold before they could capitalize costs of internal-use computer software. AcSEC decided and most respondents to the exposure draft agreed that technological feasibility should not apply to this SOP. AcSEC reasoned that the technological feasibility criteria applied in FASB Statement No. 86 to software that is sold, leased, or otherwise marketed were appropriate to an inventory model. That inventory model includes an implicit marketability test, a notion that is not applicable to this SOP.

.52 FASB Interpretation No. 6 states that the costs of computer software that is developed or obtained for use in an entity's selling and administrative activities are not research and development costs. In addition, it states that, "costs incurred to purchase or lease computer software developed by others are not research and development costs under FASB Statement No. 2 unless the software is for use in research and development activities." Further, FASB Interpretation No. 6 states, "costs incurred by an enterprise in developing computer software internally for use in its research and development activities are research and development costs . . ., " regardless of whether the software has alternative future uses.

.53 AcSEC also considered the guidance of paragraphs 9(h) and 10(h) of FASB Statement No. 2 to determine whether other costs of internal-use software are excluded from research and development. Paragraph 10(h) of FASB Statement No. 2 states that "activity, including design and construction engineering, related to the construction, relocation, rearrangement, or start-up of facilities or equipment other than (1) pilot plants and (2) facilities or equipment whose sole use is for a particular research and development project" are excluded from research and development.

.54 Because of the guidance in FASB Statement No. 2 and FASB Interpretation No. 6, AcSEC concluded that not all internal-use software costs are research and development costs (see paragraph 52). However, AcSEC evaluated the process of developing internal-use software within the context of FASB Statement No. 2 because that statement is either directly relevant or is a reasonable basis for determining which costs of internal-use software development activities should be expensed. Consistent with FASB Statement No. 2, AcSEC did not specify the income statement classifications of expensed internal-use software development costs.

.55 Paragraphs 9(c) and 9(d), respectively, of FASB Statement No. 2 include "conceptual formulation and design of possible product or process alternatives" and "testing in search for or evaluation of product or process alternatives" as examples of activities that are research and development and therefore are expensed as incurred. AcSEC believes paragraphs 9(c) and 9(d) are relevant to the process of developing internal-use computer software. AcSEC believes that as part of these activities an entity will determine whether the needed technology exists. If the technology does not exist, then research and development-type activities have not yet been completed, and therefore those costs should be expensed as incurred.

.56 AcSEC also believes that development risks associated with creating internal-use computer software are conceptually no different from development risks associated with creating other assets such as high-tech automated plants. Entities, at the start of both kinds of projects, often expect that existing technology will allow the entity to complete projects that will provide future benefits.

Capitalize or Expense

.57 About two-thirds of the respondents to the exposure draft believe that the internal and external costs of computer software developed or obtained for internal use should be reported as assets. However, certain representatives of the financial statement user community oppose capitalization of internal costs incurred to develop or obtain internal-use software.

.58 Those users and some others oppose the exposure draft's provisions for capitalization because they believe that the benefits of capitalizing internal costs are limited. They believe that capitalized internal costs related to developing or obtaining internal-use software are often unrelated to the software's actual value and that such capitalized costs are often irrelevant in the investment and credit evaluation process. In addition, some who oppose the exposure draft believe that external costs of developing or obtaining internal-use software are a more reliable measure of the software asset than internal costs.

.59 Some respondents to the exposure draft believe that costs of computer software developed or obtained for internal use should be expensed as incurred. They believe that such costs should not be capitalized because they do not result in demonstrable probable future economic benefits. They believe that capitalization would result in assets that have arbitrary amortization periods. They cite paragraph 148 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, which states that some "costs are also recognized as expenses in the period in which they are incurred because the period to which they otherwise relate is indeterminable or not worth the effort to determine."

.60 Some respondents to the exposure draft believe that capitalizing the costs of computer software developed or obtained for internal use frequently results in a subsequent writeoff of those costs when they are eventually determined to not be recoverable. Thus, they believe that readers of financial statements can be misled by the initial capitalization and subsequent writeoff of those costs.

.61 AcSEC considered all of these views. AcSEC believes that entities develop or obtain internal-use computer software often for the same end-purposes that they develop or obtain other assets. Examples are to reduce costs, operate more efficiently, improve internal controls, service customers better, and gain competitive advantages.

.62 Paragraph 25 in FASB Concepts Statement No. 6 defines assets as "*probable* future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." Footnote 18 to FASB Concepts Statement No. 6 states that "probable is used with its general meaning, rather than in a specific accounting or technical sense, . . . and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved . . . . " Paragraph 26 states: "An asset has three essential characteristics: (*a*) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (*b*) a particular entity can obtain the benefit and control others' access to it, and (*c*) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred."

.63 Paragraph 63 in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, sets forth the following criteria that should be met to recognize an item in the financial statements:

- *Definitions*—The item meets the definition of an element of financial statements.
- *Measurability*—It has a relevant attribute measurable with sufficient reliability.
- *Relevance*—The information about it is capable of making a difference in user decisions.
- *Reliability*—The information is representationally faithful, verifiable, and neutral.

.64 Some proponents of capitalization of internal-use software observe that paragraph 24 of APB Opinion 17, *Intangible Assets*, requires that entities capitalize acquired intangible assets. Paragraph 24 also states that "costs of developing, maintaining, or restoring intangible assets which are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole—such as goodwill—should be deducted from income when incurred." AcSEC believes that the costs of computer software developed or obtained for internal use are specifically identifiable, have determinate lives, relate to probable future economic benefits (FASB Concepts Statement No. 6), and meet the recognition criteria of definitions, measurability, relevance, and reliability (FASB Concepts Statement No. 5).

.65 AcSEC decided that it was not necessary to characterize computer software as either intangible assets or tangible assets when similar characterizations have not been made for most other assets.[†]

.66 One of the characteristics of an asset in FASB Concepts Statement No. 6 is that it must contribute directly or indirectly to future net cash inflows, thus providing probable future economic benefits. AcSEC recognizes that the specific future economic benefits related to the costs of computer software will sometimes be difficult to identify. However, AcSEC believes that this is also true for some other assets. For example, computer hardware or furniture used in back-office operations are indirectly related to future benefits. Likewise, corporate office facilities do not result in identifiable future benefits, but the facilities do support the operations of the company.

.67 AcSEC also recognizes that costs of computer software developed or obtained for internal use reported as assets may be subsequently written-off due to lack of adequate funding or lack of management's continued commitment to a project. However, AcSEC believes similar changes in direction also occur for long-lived-asset projects. Regardless, AcSEC has established guidance to determine when capitalization should cease and when impairment should be recognized and measured.

.68 *Preliminary Project Stage*. AcSEC believes that activities performed during the preliminary project stage of development for internal-use software are analogous to research and development activities, and costs incurred during this stage should be expensed as they are incurred.

.69 *Application Development Stage*. AcSEC believes that software development activities performed during the application development stage create probable future economic benefits. Therefore, software development costs incurred during this stage should be capitalized.

.70 AcSEC believes that paragraph 24 of APB Opinion No. 17 applies to the costs of data conversion. Therefore, AcSEC believes that data conversion costs, as discussed in paragraph .22, should be expensed as they are incurred. However, AcSEC also believes that computer software developed or obtained for old and new systems interface is internal-use software that is subject to the guidance in this SOP.

.71 *Post-Implementation/Operation Stage*. AcSEC believes that training costs are not software development costs and should be expensed as they

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[†] Paragraph A14 section e(2) of FASB Statement No. 141, *Business Combinations*, identifies computer software as an intangible asset that meets the criteria for recognition apart from goodwill. [Footnote added, May 2005, to reflect conforming changes necessary due to the issuance of FASB Statement No. 141.]

are incurred because entities do not control the continued employment of the trained employees, are not able to identify the specific future period benefitted, and amortization periods would be arbitrary.

.72 A number of respondents to the exposure draft said that they could not distinguish between internal costs of maintenance and upgrades/enhancements; many of those respondents requested further guidance from AcSEC. AcSEC decided that it could not provide examples that would adequately distinguish between all possible activities related to maintenance and upgrades/enhancements. As a result, AcSEC concluded that entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements should expense such costs as incurred.

.73 AcSEC acknowledges that SOP 97-2, *Software Revenue Recognition*, defines an upgrade and enhancement, in part, as an extension of useful life. AcSEC concluded that, from the perspective of the user of the software, solely extending the software's useful life without adding additional functionality is a maintenance activity rather than an activity for which the costs should be capitalized. Accordingly, AcSEC's criteria for determining capitalizable upgrades and enhancements focus on providing additional functionality.

.74 AcSEC believes and most respondents to the exposure draft agree that entities should not have the option to expense or capitalize costs of computer software developed or obtained for internal use as those costs are incurred. FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, states: "Comparability between enterprises and consistency in the application of methods over time increases the informational value of comparisons of relative economic opportunities or performance. The significance of information, especially quantitative information, depends to a great extent on the user's ability to relate it to some benchmark."

.75 Capitalization should begin when (*a*) the preliminary project stage is completed and (*b*) management, with the relevant authority, implicitly or explicitly authorizes and commits to funding a computer software project and it is probable that the project will be completed and the software will be used to perform the function intended. Capitalization should cease when it is no longer probable that the computer software project will be completed and placed in service. Capitalization should cease no later than the point at which a computer software project is substantially complete and ready for its intended use. *Probable* does not require absolute certainty. *Probable* is used in the same context as it is in FASB Concepts Statement No. 6, which states that "probable is used with its general meaning, rather than in a specific accounting or technical sense, . . . and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved . . . . "

.76 AcSEC used paragraph 18 of FASB Statement No. 34 as a basis for concluding that capitalization should cease no later than the point at which a computer software project is substantially complete and ready for its intended use.

.77 AcSEC considered whether it should provide guidance to limit the amount of costs that could be capitalized to the amount an entity would spend to purchase a viable alternative software product from a third party. AcSEC concluded that it could not provide practicable guidance other than the ability to recover the capitalized costs as discussed in FASB Statement No. 121. AcSEC believes that many entities will not be able to identify a third-party software product that is comparable to the entity's internal-use software. In addition, AcSEC believes that many entities would incur undue costs in trying to determine what is a viable alternative software product.

.78 AcSEC believes that it would be desirable for the costs of internally developed computer software (whether developed by employees or per diem independent contractors) that are capitalized to be accounted for no differently than the capitalized costs of purchased software (whether the software is obtained retail or developed by outside consultants for a flat fee or price). AcSEC acknowledges, however, that certain costs of internally developed software will be expensed as research and development whereas a portion of the research and development costs incurred by a third party will be capitalized by the purchasing entity because the third party's research and development costs are implicitly part of the acquisition price of the software. AcSEC noted that similar differences exist elsewhere; for example, the costs of acquiring a patent are usually capitalized and the costs of developing a patent are usually expensed as incurred.

.79 AcSEC believes that users of financial information will find the results of this SOP useful. AcSEC believes that the marketplace inherently considers the technological capabilities, including software, of many entities when it establishes market values. This SOP provides a reasonable methodology to record the costs of internal-use software. In addition, AcSEC believes that the disclosures required by existing authoritative literature are sufficient to help users make informed decisions.

Capitalizable Costs

.80 AcSEC used SOP 93-7, *Reporting on Advertising Costs*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, as a basis for determining the kinds of costs of computer software developed or obtained for internal use that should be included in amounts reported as assets. AcSEC recognizes that the costs of some activities, such as allocated overhead, may be part of the overall cost of assets, but it excluded such costs because it believes that, as a practical matter, costs of accumulating and assigning overhead to software projects would generally exceed the benefits that would be derived from a "full costing" accounting approach. AcSEC considered that costing systems for inventory and plant construction activities, while sometimes complex, were necessary costs given the routine activities that such systems support. Overhead costs associated with a particular internal-use software development project could be even more complex to measure than production overhead and, as they most often represent an allocation among capitalizable and expensed functions, may not be sufficiently reliable. Moreover, certain users commented that they believe that overhead costs had little relationship to the value of software. In light of such apparently high costs, modest benefits, and the view of some users that such costs should be expensed, AcSEC chose to analogize to advertising costs and FASB Statement No. 91 and to require such costs to be expensed as incurred.

Multiple-Element Software Arrangements Included in Purchase Price

.81 This SOP requires that, when a software arrangement includes multiple elements, entities should estimate the fair value of those multiple elements and exclude the fair value of the appropriate elements from the capitalized cost of the software. This approach is consistent with the treatment of executory costs that are included in a lease payment to a lessor, but which are not specified in the lease agreement. Paragraph 10 of FASB Statement No. 13, *Accounting for Leases*, requires the lessee to make an estimate of the executory costs and exclude that amount from the minimum lease payments. The treatment of the costs of the multiple elements specified here is consistent with those provisions.

.82 In addition, AcSEC believes that the guidance related to recognizing combined maintenance and unspecified upgrade/enhancement fees over the contract period is consistent with paragraph 3 in FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*.

.83 The SOP requires that entities allocate costs based on relative fair values. AcSEC decided that the SOP should be consistent with SOP 97-2, *Software Revenue Recognition*, though vendor-specific information is not as relevant to this SOP.

Impairment

.84 AcSEC considered whether there were any alternatives to following FASB Statement No. 121 for impairment of internal-use computer software. AcSEC concluded that internal-use computer software is a long-lived asset covered by FASB Statement No. 121.

.85 Paragraphs 7, 8, 10, and 15 of FASB Statement No. 121 are the basis for the guidance in this SOP on accounting for internal-use computer software that is not expected to provide substantive future service potential to an entity.

.86 AcSEC concluded that when it is no longer probable that computer software being developed will be completed and placed in service, the asset should be reported at the lower of carrying amount or fair value, if any, less costs to sell, in accordance with FASB Statement No. 121. AcSEC believes that uncompleted internal-use computer software is not likely to have any fair value (measured in accordance with paragraph 7 of FASB Statement No. 121).

.87 A number of respondents to the exposure draft requested that AcSEC provide more guidance and/or examples of how to recognize and measure impairment of internal-use computer software. AcSEC concluded that there are broader implications to this request and that if further guidance on impairment is to be provided, it should be provided by the FASB.

Amortization

.88 AcSEC used Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, chapter 9, section C, and APB Opinion 17 as a basis for its conclusions on amortization. AcSEC decided not to specify a maximum amortization period because each entity is better able to determine an appropriate useful life.

Internal-Use Computer Software Marketed

.89 The SOP requires that entities use the cost recovery method of accounting for internal-use computer software subsequently marketed. AcSEC believes that this method will provide a reasonable reporting outcome for instances in which enterprises find that internally developed software can meet a market demand.

Disclosures

.90 In the spirit of minimizing less relevant disclosures, AcSEC decided not to include any new disclosures in the exposure draft (though entities are required to follow disclosure requirements set forth in existing authoritative literature). AcSEC continues to believe that existing authoritative literature requires adequate disclosures to help meet financial statement user needs.

Effective Date and Transition

.91 AcSEC believes that the transition guidance in the SOP should be comparable to that contained in FASB Statement No. 86. Some enterprises that develop or purchase software for internal use currently expense those costs as incurred. AcSEC believes that the costs of developing the information that would be necessary to determine the amounts that would be capitalized if this SOP were to be applied retroactively would exceed the benefits retroactive application might offer and that such a retroactive determination should not be made. However, AcSEC decided to permit but not require application in financial statements for a fiscal year for which annual financial statements have not been issued. AcSEC further concluded that costs capitalized before the application of this SOP should be subject to the impairment and amortization provisions in this SOP, but should not otherwise be adjusted to an amount that would have been capitalized had this SOP been applied. Amortization and impairment of previously capitalized costs in accordance with the provisions of this SOP should result in an acceptable level of comparability and understandability.

.92 AcSEC considered whether it should provide materiality thresholds to determine when an entity should follow the guidance in this SOP. AcSEC decided not to do so because it believes an entity can best determine the materiality of internal-use computer software costs in its individual circumstances.

.93

Appendix

Examples Illustrating When Computer Software Is for Internal Use

1. A manufacturing entity purchases robots and customizes the software that the robots use to function. The robots are used in a manufacturing process that results in finished goods.
2. An entity develops software that helps it improve its cash management, which may allow the entity to earn more revenue.
3. An entity purchases or develops software to process payroll, accounts payable, and accounts receivable.
4. An entity purchases software related to the installation of an online system used to keep membership data.
5. A travel agency purchases a software system to price vacation packages and obtain airfares.
6. A bank develops software that allows a customer to withdraw cash, inquire about balances, make loan payments, and execute wire transfers.
7. A mortgage loan servicing entity develops or purchases computer software to enhance the speed of services provided to customers.
8. A telecommunications company develops software to run its switches that are necessary for various telephone services such as voice mail and call forwarding.
9. An entity is in the process of developing an accounts receivable system. The software specifications meet the company's internal needs and the company did not have a marketing plan before or during the development of the software. In addition, the company has not sold any of its internal-use software in the past. Two years after completion of the project, the company decided to market the product to recoup some or all of its costs.
10. A broker-dealer entity develops a software database and charges for financial information distributed through the database.
11. An entity develops software to be used to create components of music videos (for example, the software used to blend and change the faces of models in music videos). The entity then sells the final music videos, which do not contain the software, to another entity.
12. An entity purchases software to computerize a manual catalog and then sells the manual catalog to the public.
13. A law firm develops an intranet research tool that allows firm members to locate and search the firm's databases for information relevant to their cases. The system provides users with the ability to print cases, search for related topics, and annotate their personal copies of the database.

Examples Illustrating When Computer Software Is *Not* Internal Use

14. An entity sells software required to operate its products, such as robots, electronic game systems, video cassette recorders, automobiles, voice-mail systems, satellites, and cash registers.

15. A pharmaceutical company buys machines and writes all of the software that allows the machines to function. The pharmaceutical company then sells the machines, which help control the dispensation of medication to patients and help control inventory, to hospitals.

16. A semiconductor entity develops software embedded in a microcomputer chip used in automobile electronic systems.

17. An entity purchases software to computerize a manual catalog and then sells the computer version and the related software to the public.

18. A software company develops an operating system for sale and for internal use. Though the specifications of the software meet the company's internal needs, the company had a marketing plan before the project was complete. In addition, the company has a history of selling software that it also uses internally and the plan has a reasonable possibility of being implemented.

19. An entity is developing software for a point-of-sale system. The system is for internal use; however, a marketing plan is being developed concurrently with the software development. The plan has a reasonable possibility of being implemented.

20. A telecommunications entity purchases computer software to be used in research and development activities.

21. An entity incurs costs to develop computer software for another entity under a contract with that other entity.

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Section 10,730

Statement of Position 98-2 Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising

March 11, 1998

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by either the Financial Accounting Standards Board (for financial statements of nongovernmental entities) or the Governmental Accounting Standards Board (for financial statements of state and local governmental entities), as sources of established accounting principles in category b of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) applies to all nongovernmental not-for-profit organizations (NPOs) and all state and local governmental entities that solicit contributions.

This SOP requires—

- If the criteria of purpose, audience, and content as defined in this SOP are met, the costs of joint activities that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function.
- If any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.

- Certain financial statement disclosures if joint costs are allocated.
- Some commonly used and acceptable allocation methods are described and illustrated although no methods are prescribed or prohibited.

This SOP amends existing guidance in AICPA Audit and Accounting Guides *Health Care Organizations*, *Not-for-Profit Organizations* (which was issued in August 1996 and supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into the Guide), and *Audits of State and Local Governmental Units*.*

This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB and the GASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members and three of the five GASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.†

The criteria applied by the FASB and the GASB in their review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

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* The AICPA Audit and Accounting Guide *State and Local Governments* supersedes the 1994 AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and subsequent editions of that Guide with conforming changes made by the AICPA staff. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance on the application of this Statement of Position (SOP) to state and local governments. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of the AICPA Audit and Accounting Guide *State and Local Governments*.]

† This document was cleared prior to July 1, 1997. In July 1997, the GASB increased to seven members. Documents considered by the GASB after July 1, 1997 are cleared if at least four of the seven GASB members do not object. [Footnote renumbered, June 2004, to reflect conforming changes necessary due to the issuance of the AICPA Audit and Accounting Guide *State and Local Governments*.]

In many situations, prior to clearance, the FASB and the GASB will propose suggestions, many of which are included in the documents.

Introduction

.01 Some nongovernmental not-for-profit organizations (NPOs) and some state and local governmental entities,[1] such as governmental colleges and universities and governmental health care providers, solicit support through a variety of **fund-raising activities.**[2] These **activities** include direct mail, telephone solicitation, door-to-door canvassing, telethons, special events, and others. Sometimes fund-raising activities are conducted with activities related to other functions, such as **program activities** or supporting services, such as **management and general activities**.[3] Sometimes fund-raising activities include components that would otherwise be associated with program or supporting services, but in fact support fund raising.

.02 External users of financial statements—including contributors, creditors, accreditation agencies, and regulators—want assurance that fund-raising costs, as well as program costs and management and general costs, are stated fairly.

.03 In 1987, the AICPA issued Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*.[4] SOP 87-2 required that all circumstances concerning informational materials and activities that include a fund-raising appeal be considered in accounting for **joint costs** of those materials and activities and that certain criteria be applied

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[1] This Statement of Position (SOP) uses the term *entity* to refer to both nongovernmental not-for-profit organizations (NPOs) and state and local governments.

[2] Terms that appear in the Glossary [paragraph .30] are set in **boldface type** the first time they appear.

[3] The functional classifications of fund raising, program, and management and general are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Some entities have a functional structure that does not include fund raising, program, or management and general, or that includes other functional classifications, such as **membership development**. This SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. In circumstances in which entities that have a functional structure that includes other functional classifications conduct joint activities, all costs of those joint activities should be charged to fund raising (or the category in which fund raising is reported—see the following two parenthetical sentences), unless the purpose, audience, and content of those joint activities are appropriate for achieving those other functions. (An example of an entity that reports fund raising in a category other than fund raising is a state and local governmental entity applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8. As discussed in paragraph D.5 of this SOP [paragraph .24], those entities are required to report fund raising as part of the "institutional support" function. See also footnote ** to paragraph D.5.) [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34 and No. 35.]

[4] In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*. The Guide supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*. *Not-for-Profit Organizations* applies to all nongovernmental NPOs other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*. Also, SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*.

in determining whether joint costs of those materials and activities should be charged to fund raising or allocated to program or management and general. Those criteria include requiring verifiable indications of the reasons for conducting the activity, such as the content, audience, and action, if any, requested of the participant, as well as other corroborating evidence. Further, SOP 87-2 required that all joint costs of those materials and activities be charged to fund raising unless the appeal is designed to motivate its audience to action other than providing financial support to the organization.

.04 The provisions of SOP 87-2 have been difficult to implement and have been applied inconsistently in practice. (Appendix B [paragraph .22], "Background," discusses this further.)

.05 This SOP establishes financial accounting standards for accounting for **costs of joint activities**. In addition, this SOP requires financial statement disclosures about the nature of the activities for which joint costs have been allocated and the amounts of joint costs. Appendix F [paragraph .26] provides explanations and illustrations of some acceptable allocation methods.

Scope

.06 This SOP applies to all nongovernmental NPOs and all state and local governmental entities that solicit **contributions**.

Conclusions

Accounting for Joint Activities

.07 If the criteria of purpose, audience, and content are met, the costs of a **joint activity** that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.

Purpose

.08 The purpose criterion is met if the purpose of the joint activity includes accomplishing program or management and general functions. (Paragraphs .09 and .10 provide guidance that should be considered in determining whether the purpose criterion is met. Paragraph .09 provides guidance pertaining to program functions only. Paragraph .10 provides guidance pertaining to both program and management and general functions.)

.09 *Program functions.* To accomplish program functions, the activity should call for specific action by the audience that will **help accomplish the entity's mission**. For purposes of applying the guidance in this SOP, the following are examples of activities that do and do not call for specific action by the audience that will help accomplish the entity's mission:

- An entity's mission includes improving individuals' physical health. For that entity, motivating the audience to take specific action that will improve their physical health is a call for specific action by the audience that will help accomplish the entity's mission. An example of an activity that motivates the audience to take specific action that will improve their physical health is sending the audience a brochure that urges them to stop smoking and suggests specific methods, instructions, references, and resources that may be used to stop smoking.

- An entity's mission includes educating individuals in areas other than the causes, conditions, needs, or concerns that the entity's programs are designed to address (referred to hereafter in this SOP as "causes"). For that entity, educating the audience in areas other than causes or motivating the audience to otherwise engage in specific activities that will educate them in areas other than causes is a call for specific action by the audience that will help accomplish the entity's mission. Examples of entities whose mission includes educating individuals in areas other than causes are universities and possibly other entities. An example of an activity motivating individuals to engage in education in areas other than causes is a university inviting individuals to attend a lecture or class in which the individuals will learn about the solar system.

- Educating the audience about causes or motivating the audience to otherwise engage in specific activities that will educate them about causes is not a call for specific action by the audience that will help accomplish the entity's mission. Such activities are considered in support of fund raising. (However, some educational activities that might otherwise be considered as educating the audience about causes may implicitly call for specific action by the audience that will help accomplish the entity's mission. For example, activities that educate the audience about environmental problems caused by not recycling implicitly call for that audience to increase recycling. If the need for and benefits of the specific action are clearly evident from the educational message, the message is considered to include an implicit call for specific action by the audience that will help accomplish the entity's mission.)

- Asking the audience to make contributions is not a call for specific action by the audience that will help accomplish the entity's mission.

If the activity calls for specific action by the audience that will help accomplish the entity's mission, the guidance in paragraph .10 should also be considered in determining whether the purpose criterion is met.

.10 *Program and management and general functions.* The following factors should be considered, in the order in which they are listed,[5] to determine whether the purpose criterion is met:

a. *Whether **compensation or fees** for performing the activity are based on contributions raised.* The purpose criterion is *not* met if a majority of compensation or fees for any party's performance of any component

[5] In considering the guidance in paragraph .10, the factor in paragraph .10*a* (the compensation or fees test) is the preeminent guidance. If the factor in paragraph .10*a* is not determinative, the factor in paragraph .10*b* (whether a similar program or management and general activity is conducted separately and on a similar or greater scale) should be considered. If the factor in paragraph .10*b* is not determinative, the factor in paragraph .10*c* (other evidence) should be considered.

of the discrete joint activity varies based on contributions raised for that discrete joint activity.[6, 7]

b. *Whether a similar program or management and general activity is conducted separately and on a similar or greater scale.* The purpose criterion is met if either of the following two conditions is met:

(1) *Condition 1:*

— The program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and

— A similar program component is conducted without the fund-raising component using the same **medium** and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.[8]

(2) *Condition 2:*

A management and general activity that is similar to the management and general component of the joint activity being accounted for is conducted without the fund-raising component using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.

If the purpose criterion is met based on the factor in paragraph .10*b*, the factor in paragraph .10*c* should not be considered.

c. *Other evidence.* If the factors in paragraph .10*a* or .10*b* do not determine whether the purpose criterion is met, other evidence may determine whether the criterion is met. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

.11 The following are examples of indicators that provide evidence for determining whether the purpose criterion is met:

a. Evidence that the purpose criterion may be met includes—

- *Measuring program results and accomplishments of the activity.* The facts may indicate that the purpose criterion is met if the entity measures program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes).

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[6] Some compensation contracts provide that compensation for performing the activity is based on a factor other than contributions raised, but not to exceed a specified portion of contributions raised. For example, a contract may provide that compensation for performing the activity is $10 per contact hour, but not to exceed 60 percent of contributions raised. In such circumstances, compensation is not considered based on amounts raised, unless the stated maximum percentage is met. In circumstances in which it is not yet known whether the stated maximum percentage is met, compensation is not considered based on amounts raised, unless it is probable that the stated maximum percentage will be met.

[7] The *compensation or fees test* is a negative test in that it either (*a*) results in failing the purpose criterion or (*b*) is not determinative of whether the purpose criterion is met. Therefore, if the activity fails the purpose criterion based on this factor (the compensation or fees test), the activity fails the purpose criterion and the factor in paragraph .10*b* should not be considered. If the purpose criterion is not failed based on this factor, this factor is not determinative of whether the purpose criterion is met and the factor in paragraph .10*b* should be considered.

[8] Determining the scale on which an activity is conducted may be a subjective determination. Factors to consider in determining the scale on which an activity is conducted may include dollars spent, the size of the audience reached, and the degree to which the characteristics of the audience are similar to the characteristics of the audience of the activity being evaluated.

- *Medium*. The facts may indicate that the purpose criterion is met if the program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and if the entity conducts the program component without a significant fund-raising component in a different medium. Also, the facts may indicate that the purpose criterion is met if the entity conducts the management and general component of the joint activity without a significant fund-raising component in a different medium.

b. Evidence that the purpose criterion may not be met includes—

- *Evaluation or compensation*. The facts may indicate that the purpose criterion is not met if (*a*) the evaluation of any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity or (*b*) some, but less than a majority, of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.

c. Evidence that the purpose criterion may be either met or not met includes—

- *Evaluation of measured results of the activity*. The entity may have a process to evaluate measured program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes). If the entity has such a process, in evaluating the effectiveness of the joint activity, the entity may place significantly greater weight on the activity's effectiveness in accomplishing program goals or may place significantly greater weight on the activity's effectiveness in raising contributions. The former may indicate that the purpose criterion is met. The latter may indicate that the purpose criterion is not met.

- *Qualifications*. The qualifications and duties of those performing the joint activity should be considered.

  — If a third party, such as a consultant or contractor, performs part or all of the joint activity, such as producing brochures or making telephone calls, the third party's experience and the range of services provided to the entity should be considered in determining whether the third party is performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity.

  — If the entity's employees perform part or all of the joint activity, the full range of their job duties should be considered in determining whether those employees are performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity. For example, (*a*) employees who are not members of the fund-raising department and (*b*) employees who are members of the fund-raising department but who perform non-fund-raising activities are more likely to perform activities that include program or management and general functions than are employees who otherwise devote significant time to fund raising.

- *Tangible evidence of intent.* Tangible evidence indicating the intended purpose of the joint activity should be considered. Examples of such tangible evidence include
  - The entity's written mission statement, as stated in its fund-raising activities, bylaws, or annual report.
  - Minutes of board of directors', committees', or other meetings.
  - Restrictions imposed by donors (who are not related parties) on gifts intended to fund the joint activity.
  - Long-range plans or operating policies.
  - Written instructions to other entities, such as script writers, consultants, or list brokers, concerning the purpose of the joint activity, audience to be targeted, or method of conducting the joint activity.
  - Internal management memoranda.

Audience

.12 A rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for one or more of the reasons in paragraph .13*a*, .13*b*, or .13*c*. In determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for one or more of the reasons in paragraph .13*a*, .13*b*, or .13*c*. For example, if the audience's ability or likelihood to contribute is a significant factor in its selection and it has a need for the action related to the program component of the joint activity, but having that need is an insignificant factor in its selection, the presumption would not be overcome.

.13 In circumstances in which the audience includes no prior donors and is not otherwise selected based on its ability or likelihood to contribute to the entity, the audience criterion is met if the audience is selected for one or more of the following reasons:

a. The audience's need to use or reasonable potential for use of the specific action called for by the program component of the joint activity

b. The audience's ability to take specific action to assist the entity in meeting the goals of the program component of the joint activity

c. The entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component

Content

.14 The content criterion is met if the joint activity supports program or management and general functions, as follows:

a. *Program.* The joint activity calls for specific action by the recipient that will help accomplish the entity's mission. If the need for and benefits of the action are not clearly evident, information describing the action and explaining the need for and benefits of the action is provided.

b. *Management and general.* The joint activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity.[9]

.15 Information identifying and describing the entity, causes, or how the contributions provided will be used is considered in support of fund raising.

Allocation Methods

.16 The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances.

Incidental Activities

.17 Some fund-raising activities conducted in conjunction with program or management and general activities are incidental to such program or management and general activities. For example, an entity may conduct a fund-raising activity by including a generic message, "Contributions to Organization X may be sent to [*address*]" on a small area of a message that would otherwise be considered a program or management and general activity based on its purpose, audience, and content. That fund-raising activity likely would be considered incidental to the program or management and general activity being conducted. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. For example, an entity may conduct a program activity by including a generic program message such as "Continue to pray for [*a particular cause*]" on a small area of a message that would otherwise be considered fund raising based on its purpose, audience, and content. That program activity would likely be considered incidental to the fund-raising activity being conducted. Similarly, an entity may conduct a management and general activity by including a brief management and general message—"We recently changed our phone number. Our new number is 123-4567"—on a small area of a message that would otherwise be considered a program or fund-raising activity based on its purpose, audience, and content. That management and general activity would likely be considered incidental to the program or fund-raising activity being conducted. In circumstances in which a fund-raising, program, or management and general activity is conducted in conjunction with another activity and is incidental to that other activity, and the conditions in this SOP for allocation are met, joint costs are permitted but not required to be allocated and may therefore be charged to the functional classification related to the activity that is not the incidental activity. However, in circumstances in which the program or management and general activities are incidental to the fund-raising activities, it is unlikely that the conditions required by this SOP to permit allocation of joint costs would be met.

Disclosures

.18 Entities that allocate joint costs should disclose the following in the notes to their financial statements:

a. The types of activities for which joint costs have been incurred

b. A statement that such costs have been allocated

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[9] Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. For purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities.

c. The total amount allocated during the period and the portion allocated to each functional expense category

.19 This SOP encourages, but does not require, that the amount of joint costs for each kind of joint activity be disclosed, if practical.

Effective Date

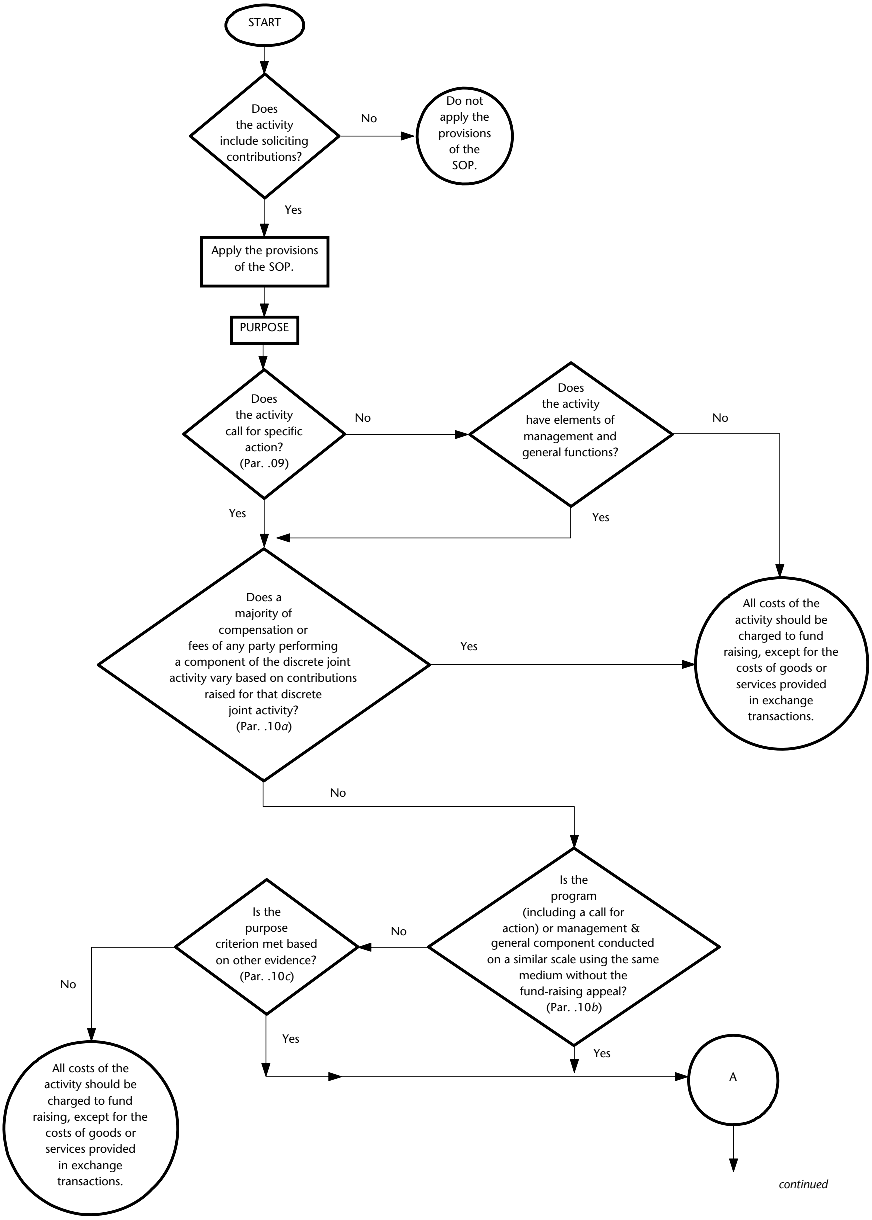
.20 This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

The provisions of this Statement of Position need not be applied to immaterial items.

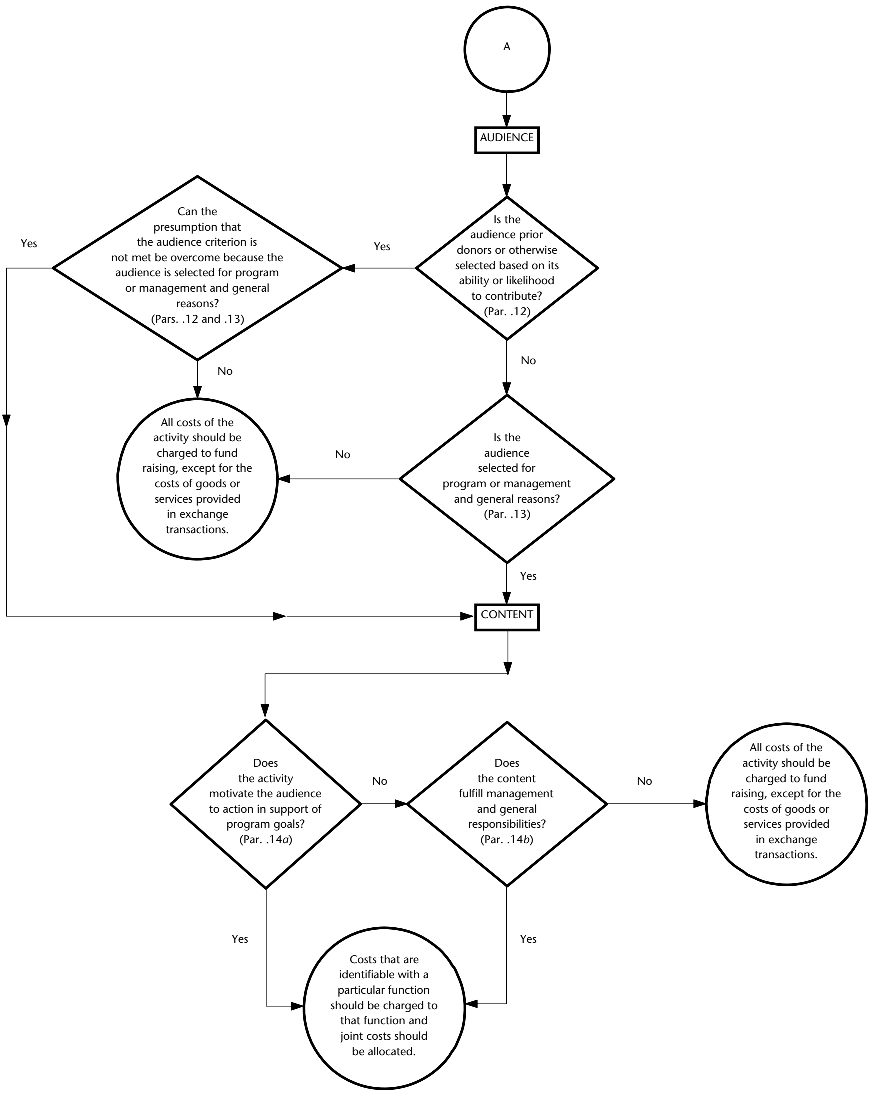
.21

Appendix A

Accounting for Joint Activities[10]



[10] ***Note:*** This flowchart summarizes certain guidance in this SOP and is not intended as a substitute for the SOP.


A
AUDIENCE
Is the audience prior donors or otherwise selected based on its ability or likelihood to contribute? (Par. .12)
Yes
No
Can the presumption that the audience criterion is not met be overcome because the audience is selected for program or management and general reasons? (Pars. .12 and .13)
Yes
No
All costs of the activity should be charged to fund raising, except for the costs of goods or services provided in exchange transactions.
Is the audience selected for program or management and general reasons? (Par. .13)
No
Yes
CONTENT
Does the activity motivate the audience to action in support of program goals? (Par. .14a)
No
Does the content fulfill management and general responsibilities? (Par. .14b)
No
All costs of the activity should be charged to fund raising, except for the costs of goods or services provided in exchange transactions.
Yes
Yes
Costs that are identifiable with a particular function should be charged to that function and joint costs should be allocated.

.22

Appendix B

Background

B.1. As stated in paragraph .04, the provisions of Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, have been difficult to implement and applied inconsistently in practice. That difficulty has been due in part to the following:

- The second sentence of paragraph 1 of SOP 87-2 stated that "some of the costs incurred by such organizations are clearly identifiable with fundraising, such as the cost of fund-raising consulting services." It is unclear whether activities that would otherwise be considered program activities should be characterized as program activities if they are performed or overseen by professional fund raisers. Also, it is unclear whether activities would be reported differently (for example, as program rather than fund raising) depending on whether the fund-raising consultant is compensated by a predetermined fee or by some other method, such as a percentage of contributions raised.
- SOP 87-2 was unclear about whether allocation of costs to fund-raising expense is required if the activity for which the costs were incurred would not have been undertaken without the fund-raising component.
- SOP 87-2 defined joint costs through examples, and it is therefore unclear what kinds of costs were covered by SOP 87-2. For example, it is unclear whether salaries and indirect costs can be joint costs.
- Some believe the guidance in SOP 87-2 was inadequate to determine whether joint activities, such as those that request contributions and also list the warning signs of a disease, are designed to motivate their audiences to action other than to provide contributions to the entity. It is unclear what attributes the targeted audience should possess in order to conclude that a program function is being conducted.

B.2. In 1992, the Accounting Standards Executive Committee (AcSEC) undertook a project to supersede SOP 87-2, to provide clearer guidance than that provided by SOP 87-2, as well as to provide guidance that would improve on the guidance in SOP 87-2. In September 1993, AcSEC released an exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, for public comment. AcSEC received more than 300 comment letters on the exposure draft. AcSEC redeliberated the issues based on the comments received.

B.3. In 1996, after redeliberating the issues based on the comments received and making certain revisions to the draft SOP, AcSEC conducted a field test of the draft SOP. The objectives of the field test were to determine whether the provisions of the draft SOP were sufficiently clear and definitive to generate consistent and comparable application of the SOP. Based on the field test results, AcSEC concluded that the provisions of the draft SOP, with certain revisions, were sufficiently clear and definitive to generate consistent and comparable application of the SOP.

B.4. Some respondents who commented on the exposure draft, as well as some interested parties who followed the project through its due process subsequent to the exposure draft, commented that the SOP should be reexposed for public comment. Reasons cited include:

- Approximately three years had passed between the end of the comment period and AcSEC's decision to issue the SOP.
- AcSEC made significant revisions to the SOP subsequent to releasing the exposure draft for comment.

Considering whether a proposed standard should be reexposed for public comment is inherently a subjective process. Factors that AcSEC considered include—

- The significance of changes made to the exposure draft and whether those changes result in guidance that the public did not have an opportunity to consider.
- Whether the scope was revised in such a way that affected entities did not have an opportunity to comment.
- New information about or changes in the nature of the transactions being considered, practice, or other factors.

AcSEC believes that the length of time between exposure and final issuance is not pertinent to whether the SOP should be reexposed for public comment.

B.5. Based on consideration of the factors identified, AcSEC believes that the SOP should not be reexposed for public comment. AcSEC notes that although the SOP has been revised based on comments received on the exposure draft, those revisions do not change the overall model in the SOP. Those revisions were made primarily to clarify the SOP and improve its operationality. Further, AcSEC believes that the project received a high level of attention from interested parties. AcSEC provided working drafts to interested parties and those parties provided input throughout the process, up to and including the Financial Accounting Standard Board's and the Governmental Accounting Standards Board's clearance of the SOP for issuance.

B.6. Appendix C [paragraph .23] discusses the key issues in the exposure draft and comments received on those issues, as well as the basis for AcSEC's conclusions on those and certain other issues.

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Appendix C

Basis for Conclusions

C.1. This section discusses considerations that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position (SOP). It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

Overall Framework

C.2. This SOP uses the model in SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal,* as a starting point and clarifies guidance that was unclear, provides more detailed guidance, revises some guidance, and expands the scope of costs covered to include all costs of joint activities. The model established by SOP 87-2 was to account for joint costs as fund raising unless an entity could demonstrate that a program or management and general function had been conducted. SOP 87-2 used verifiable indications of the reasons for conducting the activity, such as content, audience, the action requested, if any, and other corroborating evidence as a basis for determining whether a program or management and general function had been conducted.

C.3. On an overall basis, the majority of respondents who commented on the September 1993 exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, opposed it, for various reasons, including the following:

- The guidance in SOP 87-2 is operational, results in sound financial reporting, and should be retained.
- The guidance in SOP 87-2 should be retained but clarified.
- The guidance proposed in the exposure draft should be revised. (Some commented that it overstates fund raising; others commented that it understates fund raising.)

C.4. AcSEC concluded that it supports the model in the exposure draft, subject to certain revisions. AcSEC believes that this SOP provides clear, detailed accounting guidance that, when applied, will increase comparability of financial statements. Those statements will also include more meaningful disclosures without incurring increased costs.

C.5. Some respondents commented that the model in the exposure draft would adversely affect entities both financially and operationally. Various reasons were given, including the following:

- It would inhibit the ability of entities, particularly small entities and entities that raise contributions through direct solicitations, to generate the necessary revenue to perform their program services.
- Most entities would not meet the criteria in this SOP for reporting costs of joint activities as program or management and general, because they must combine their mission statements, public informa-

tion and education, and fund-raising appeals due to a lack of resources. Some noted that this may result in unsatisfactory ratings from public watchdog groups.

AcSEC did not find these arguments compelling. This SOP provides accounting guidance; it provides no guidance concerning how entities should undertake their activities. Also, this SOP does not prohibit allocation merely because activities carrying out different functions are combined. In fact, this SOP provides guidance for reporting costs as program or management and general in circumstances in which those activities are combined with fund-raising. Moreover, actions taken by financial statement users are not the direct result of the requirements of this SOP. Rather, those actions may result from more relevant and useful information on which to base decisions.

C.6. Some respondents commented that the exposure draft is biased toward reporting expenses as fund raising. AcSEC believes that determining whether the costs of joint activities should be classified as program, management and general, or fund raising sometimes is difficult, and such distinctions sometimes are subject to a high degree of judgment. AcSEC believes that external financial statement users focus on and have perceptions about amounts reported as program, management and general, and fund raising. That focus and those perceptions provide incentives for entities to report expenses as program or management and general rather than fund raising. Therefore, in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. The criteria in this SOP provide guidance for entities to overcome that presumption.

Accounting for Joint Activities

C.7. This SOP requires that if any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund raising, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising. (This SOP expands on the model established by SOP 87-2 by including all costs of joint activities other than costs of goods or services provided in exchange transactions, rather than merely joint costs.) AcSEC believes that the criteria of purpose, audience, and content are each relevant in determining whether a joint activity should be reported as fund raising, program, or management and general because each provides significant evidence about the benefits expected to be obtained by undertaking the activity.

C.8. Some respondents commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising is misleading and that the scope of the SOP should include only joint costs of joint activities. Some commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising conflicts with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, which defines fund raising, program, and management and general and requires not-for-profit organizations (NPOs) to report information about expenses using those functional classifications.

C.9. AcSEC believes that the purpose for which costs other than joint costs are incurred may be fund raising, program, or management and general, depending on the context in which they are used in the activity undertaken. For example, a program-related pamphlet may be sent to an audience in need of the program. In that context, the pamphlet is used for program purposes. However, in order to demonstrate to potential donors that the entity's programs are worthwhile, that same pamphlet may be sent to an audience that is likely to contribute, but that has no need or reasonable potential for use of the program. In that context, the pamphlet is used for fund raising. AcSEC believes this broader scope will result in more comparability and more meaningful financial reporting by covering all costs of activities that include fund raising and by assigning those costs to the function for which they are incurred, consistent with the guidance in Statement No. 117.

C.10. AcSEC believes that costs of goods or services provided in exchange transactions should not be charged to fund raising because those costs are incurred in exchange for revenues other than contributions.

Criteria of Purpose, Audience, and Content

Call For Action

C.11. The definition of *program* in FASB Statement No. 117 includes public education. As noted in paragraph C.6, AcSEC believes that in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. AcSEC believes that in order to overcome that presumption, it is not enough that (*a*) the purpose of the activity include educating the public about causes, (*b*) the audience has a need or reasonable potential for use of any educational component of the activity pertaining to causes, or (*c*) the audience has the ability to assist the entity in meeting the goals of the program component of the activity by becoming educated about causes. Therefore, AcSEC concluded that for purposes of this SOP, in order to conclude that the criteria of purpose, audience, and content are met program activities are required to call for specific action by the recipient (other than becoming educated about causes) that will help accomplish the entity's mission. As discussed in paragraph .09, in certain circumstances educational activities may call for specific action by the recipient that will help accomplish the entity's mission.

Purpose

C.12. AcSEC believes meeting the purpose criterion demonstrates that the purpose of the activity includes accomplishing program or management and general functions. Inherent in the notion of a joint activity is that the activity has elements of more than one function. Accordingly, the purpose criterion provides guidance for determining whether the purpose of the activity includes accomplishing program or management and general functions in addition to fund raising.

Compensation and Evaluation Tests

C.13. The exposure draft proposed that all costs of the joint activity should be charged to fund raising if (*a*) substantially all compensation or fees for performing the activity are based on amounts raised or (*b*) the evaluation of the party performing the activity is based on amounts raised. Some respondents commented that basing the method of compensation or evaluating the performance of the party performing the activity based on contributions raised should not lead to the conclusion that all costs of the activity should be charged to fund raising. Others commented that the method of compensation is unrelated to whether the purpose criterion is met. The reasons given included the following:

- It is counterintuitive to imply that those performing multipurpose activities that include fund raising would not be compensated or evaluated based on amounts raised.
- Such guidance would create a bias toward entities that use employees to raise contributions and against entities that hire professional fund raisers and public relations firms and is therefore not neutral.

Some respondents gave examples of circumstances in which substantially all compensation is based on contributions raised and asserted that the activity was nevertheless a program activity. In each of those examples, AcSEC considered all the facts presented and concluded that the activity was fund raising.

C.14. AcSEC continues to support the spirit of the proposed guidance, because AcSEC believes that basing a majority of compensation on funds raised is persuasive evidence that the activity is a fund-raising activity. Nevertheless, AcSEC believes that the proposed guidance was unclear and would be difficult to implement, primarily because of the broad definition of "based on contributions raised" included in the glossary of the exposure draft. In connection with that issue, AcSEC was concerned that any joint activities performed by a fund-raising department or by individuals whose duties include fund raising, such as executive officers of small NPOs who are employed based on their ability to raise contributions, would be required to be reported as fund raising because the compensation of the parties performing those activities is based on amounts raised. Also, AcSEC had concerns that it would be difficult to determine whether fixed contract amounts were negotiated based on expected contributions. Therefore, AcSEC concluded that the compensation test should be revised to provide that the purpose criterion is not met if a majority of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity. AcSEC believes that guidance is sound and is operational.

C.15. AcSEC believes that the guidance in paragraph .10*a* is not biased against entities that hire professional fund raisers, because it applies to the entity's employees as well as professional fund raisers. For example, if a majority of an employee's compensation or fees for performing a component of a discrete joint activity varies based on contributions raised for that discrete joint activity, the purpose criterion is not met.

Similar Function-Similar Medium Test

C.16. Some respondents misinterpreted the exposure draft as providing that, in order to meet the purpose criterion, the program or management and general activity must be conducted without the fund-raising component, using the same medium and on a scale that is similar to or greater than the program or management and general component of the activity being accounted for. That was not a requirement proposed by the exposure draft. The exposure draft proposed that meeting that condition would result in meeting the purpose criterion. Failing the criterion merely leads to consideration of other evidence, such as the indicators in paragraph .11. AcSEC has revised the SOP to state this more clearly.

Other Evidence

C.17. The compensation test and the similar function-similar medium test may not always be determinative because the attributes that they consider may not be present. Therefore, this SOP includes indicators that should be considered in circumstances in which the compensation test and the similar function-similar medium test are not determinative. The nature of those indicators is such that they may be present in varying degrees. Therefore, all available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

Audience

C.18. The exposure draft proposed that if the audience for the materials or activities is selected principally on its ability or likelihood to contribute, the audience criterion is not met and all the costs of the activity should be charged to fund raising. Further, the exposure draft proposed that if the audience is selected principally based on its need for the program or because it can assist the entity in meeting its program goals other than by financial support provided to the entity, the audience criterion is met. Some respondents commented that that audience criterion is too narrow, because it is based on the principal reason for selecting the audience. They asserted that for some activities no principal reason exists for selecting an audience; entities select the audience for those activities for multiple reasons, such as both the audience's ability to contribute and its ability to help meet program goals. Some commented that for some activities, entities select audiences that have provided past financial support because, by providing financial support, those audiences have expressed an interest in the program.

C.19. AcSEC believes that meeting the audience criterion should demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions. Therefore, the reasons for selecting the audience should be consistent with the program or management and general content of the activity. However, AcSEC believes it is inherent in the notion of joint activities that the activity has elements of more than one function, including fund raising, and acknowledges that it may be difficult to determine the principal reason for selecting the audience. Accordingly, AcSEC concluded that if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute, a rebuttable presumption should exist that the audience was selected to raise funds. AcSEC believes that the reasons for selecting the audience that can overcome that presumption, which are included in paragraph .13 of this SOP, demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions based on the program or management and general content of the activity.

Content

C.20. AcSEC believes that meeting the content criterion demonstrates that the content of the activity supports program or management and general functions. AcSEC believes that accounting guidance should not impose value judgments about whether the entity's mission, programs, and responsibilities are worthwhile. Therefore, whether the content criterion is met depends on the relationship of the content to the entity's mission, programs, and management and general responsibilities.

C.21. Paragraph .14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. The exposure draft proposed that slogans, general calls to prayer, and general calls to protest do not meet the content criterion; some respondents disagreed. AcSEC concluded that this SOP should be silent concerning whether slogans, general calls to prayer, and general calls to protest are calls to action that meet the content criterion. AcSEC believes that determining whether those items are calls to action that meet the content criterion requires judgments based on the particular facts and circumstances.

C.22. Some respondents commented that educating the public about causes without calling for specific action should satisfy the content criterion. They noted that this is particularly relevant for NPOs subject to Internal Revenue Code (IRC) Section 501(c)4, because those NPOs are involved in legislative reform. Also, some noted that it may be the entity's mission or goal to educate the public about causes. They believe that, in those cases, the NPO's program is to educate the public about causes without necessarily calling for specific action by the recipient.

C.23. As discussed in paragraph C.11, AcSEC concluded that education that does not motivate the audience to action is in fact done in support of fund raising. However, this SOP acknowledges that some educational messages motivate the audience to specific action, and those messages meet the content criterion. AcSEC believes that that provision will result in the activities of some NPOs subject to IRC Section 501(c)4 (and some other entities, whose mission or goal is to educate the public) meeting the content criterion.

C.24. Paragraph .13*c* provides that one way that the audience criterion is met is if the entity is required to direct the management and general component of the activity to the particular audience. Further, as discussed in paragraph D.13, in *Discussion of Conclusions*, an audience that includes prior donors and is selected because the entity is required to send them certain information to comply with requirements of the Internal Revenue Service (IRS) is an example of an audience that is selected because the entity is required to direct the management and general component of the activity to that audience. Paragraph .14*b* provides that one way that the content criterion is met is if the activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity. However, footnote 9 to paragraph .14*b* provides that disclosures made when soliciting contributions to comply with requirements of states or other regulatory bodies are considered fund-raising activities, and are not considered management and general activities. AcSEC considered whether it is inconsistent to conclude both that (*a*) activities conducted to comply with requirements of regulatory bodies concerning contributions that have been received are management and general activities, and that (*b*) activities conducted to comply with requirements of regulatory bodies concerning soliciting contributions are fund-raising activities. AcSEC believes that those provisions are not inconsistent. AcSEC believes there is a distinction between (*a*) requirements that must be met as a result of receiving contributions and (*b*) requirements that must be met in order to solicit contributions. AcSEC believes that activities that are undertaken as a result of receiving contributions are management and general activities while activities that are undertaken in order to solicit contributions are fund-raising activities.

Incidental Activities

C.25. Many entities conduct fund-raising activities in conjunction with program or management and general activities that are incidental to such program or management and general activities. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. Such efforts may be a practical and efficient means for entities to conduct activities, although the principal purpose of the activity may be to fulfill either fund-raising, program, or management and general functions. The exposure draft proposed that incidental activities need not be considered in applying this SOP. Some respondents disagreed with that guidance, while others commented that it was confusing. AcSEC continues to support that guidance. AcSEC believes that guidance is necessary to avoid requiring complex allocations in circumstances in which the criteria of purpose, audience, and content are met but the activity is overwhelmingly either fund raising, program, or management and general.

Allocation Methods

C.26. Respondents had various comments concerning allocation methods, including the following:

- The SOP should focus on allocation methods rather than on circumstances in which entities should allocate.
- The SOP should prescribe allocation methods.
- The approach taken in the SOP—discussing, rather than requiring or prohibiting allocation methods—is sound.
- Certain allocation methods should be prohibited.
- The SOP should set maximum allocation percentages.

AcSEC believes that no particular allocation method or methods are necessarily more desirable than other methods in all circumstances. Therefore, this SOP neither prescribes nor prohibits any particular allocation methods. AcSEC believes entities should apply the allocation methods that result in the most reasonable cost allocations for their activities. Appendix F [paragraph .26] of this SOP illustrates several allocation methods, any one of which may result in a reasonable or unreasonable allocation of costs in particular circumstances. The methods illustrated are not the only acceptable methods. However, AcSEC believes that the methods illustrated in this SOP are among those most likely to result in meaningful cost allocations.

C.27. Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, states in paragraph 7 that "the term *accounting principle* includes 'not only accounting principles and practices but also the methods of applying them.'" APB Opinion 20 also states in paragraphs 15 and 16 that

> . . . In the preparation of financial statements there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type . . . . The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle [*allocation method*] on the basis that it is preferable.

A change in cost allocation methodology may be a change in accounting principle for entities covered by this SOP. Accordingly, paragraph .16 of this SOP provides that the cost allocation methodology used should be applied consistently, given similar facts and circumstances.

Disclosures

C.28. Respondents made various comments concerning the required and encouraged disclosures, including recommendations for additional disclosures and recommendations that certain disclosures be deleted. AcSEC was not persuaded that the costs of the other disclosures recommended by respondents are justified by their benefits. AcSEC believes that, with the exception of one disclosure, the disclosures prescribed by the exposure draft provide relevant information about the kinds of activities for which joint costs have been incurred and the manner in which those costs are reported in the financial statements. In considering disclosures proposed by the exposure draft about the allocation method, AcSEC observed that there are no requirements to disclose methods of allocating other expenses and questioned the utility of disclosing the allocation method in this circumstance. AcSEC concluded that the requirement to disclose the allocation method should be deleted.

C.29. Paragraph .19 encourages, but does not require, certain disclosures. AcSEC believes those disclosures provide useful information but that they should be encouraged rather than required because the costs of making them may not be justified by the benefits in all cases.

Effective Date

C.30. Some respondents commented that the effective date should be deferred. AcSEC believes that the accounting systems required to implement this SOP are already in place and that implementation should be relatively straightforward. However, AcSEC acknowledges that some entities may change their operations based on the reporting that would result from this SOP. Therefore, AcSEC concluded that this SOP should be effective for financial statements for years beginning on or after December 15, 1998.

Cost-Benefit

C.31. Some respondents commented that the guidance would increase record keeping costs. AcSEC believes that implementing this SOP will not significantly increase record keeping costs, which are primarily the costs of documenting reasons for undertaking joint activities. Further, AcSEC believes that the costs of making the disclosures required by this SOP should be minimal, because entities should already have the information that is required to be disclosed. AcSEC believes that implementing this SOP will result in more relevant, meaningful, and comparable financial reporting and that the cost of implementing this SOP will be justified by its benefits.

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Appendix D

Discussion of Conclusions

Scope

D.1. This Statement of Position (SOP) applies only to costs of joint activities. It does not address allocations of costs in other circumstances.

Reporting Models and Related Requirements

D.2. Paragraph 26 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, specifies that a statement of activities or notes to the financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities. Paragraph 13.34 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, provides that the financial statements of not-for-profit organizations (NPOs) should disclose the total fund-raising expenses. [Revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

D.3. Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities,* provides that governmental entities should not change their accounting and financial reporting to apply the provisions of FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made*, and No. 117. GASB Statement No. 29 permits governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations,* or in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* (modified by all applicable FASB pronouncements issued through November 30, 1989, and by most applicable GASB pronouncements) to continue to do so, pending GASB pronouncements on the accounting and financial reporting model for governmental entities. Alternatively, those governmental entities are permitted to change to the current governmental financial reporting model.[‡]

D.4. GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, requires governmental colleges and universities to use one of two accounting and financial reporting models. One model, referred to as the "AICPA College Guide Model," encompasses the accounting and financial reporting guidance in the 1973 AICPA Industry

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[‡] GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, supersedes the provisions of GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, relating to the use of the AICPA Not-for-Profit model. See GASB Statement No. 34, including paragraph 147. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance on the application of this SOP to state and local governments. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statement No. 34.]

Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements. (The other model, referred to as the "Governmental Model," is based on the pronouncements of the National Council on Governmental Accounting [NCGA] and the GASB.)[||]

D.5. For state and local governmental entities, some are required to report expenses by function using the functional classifications of program, management and general, and fund raising. Other state and local governmental entities that report expenses or expenditures by function have a functional structure that does not include fund raising, program, or management and general. Still other state and local governmental entities do not report expenses or expenditures by function. Examples of those various reporting requirements are as follows:[#]

- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*, as well as those that follow SOP 78-10 and that receive significant amounts of contributions from the public, are required to report separately the costs of the fund-raising, program, and management and general functions.
- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, are required to report fund raising as part of the "institutional support" function.

D.6. As discussed in footnote 3 to paragraph .01 of this SOP, this SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. Rather, those functional classifications are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Entities that do not use the functional classifications of fund raising, program, and management and general should apply the guidance in this SOP for purposes of accounting for joint activities, using their reporting model. For example, some entities may conduct membership-development activities. As discussed in the Glossary [paragraph .30] of this SOP, if there are no significant benefits or duties connected with membership, the substance of the membership-development activities may, in fact, be fund raising. In such circumstances, the costs of those activities should be charged to fund raising. To the extent that member benefits are received, membership is an exchange transaction. In circumstances in which membership development is in part soliciting revenues from exchange transactions and in part soliciting contributions and the purpose, audience, and content of the activity are appropriate for achieving membership development, joint costs should be allocated between fund raising and the exchange transaction.

[||] GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities,* supersedes GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*. See GASB Statements No. 34 and No. 35. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance on the application of this SOP to governmental (public) colleges and universities. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statement No. 35.]

[#] This discussion is no longer applicable. See footnotes ‡ and || in paragraphs D.3 and D.4, respectively. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34 and No. 35.]

Assigning Costs of Joint Activities

D.7. Paragraph .07 provides: "If the criteria of purpose, audience, and content are met, the costs of a joint activity that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity. . . ." For example, if the criteria are met, the costs of materials that accomplish program goals and that are unrelated to fund raising, such as the costs of a program-related pamphlet included in a joint activity, should be charged to program, while joint costs, such as postage, should be allocated between fund raising and program. However, if the pamphlet is used in fund-raising packets and the criteria are not met, the costs of the pamphlets used in the fund-raising packets, as well as the joint costs, should be charged to fund raising. (If some pamphlets are used in program activities that include no fund raising, the cost of the pamphlets used in those separate program activities that include no fund raising should be charged to program.)

Educational Activities

D.8. Some entities have missions that include educating the public (students) in areas other than causes. Paragraph .09 provides that, for those entities, educating the audience in areas other than causes or motivating the audience to engage in specific activities, such as attending a lecture or class, that will educate them in areas other than causes is considered a call for specific action by the recipients that will help accomplish the entity's mission. Educating the audience about causes or motivating the audience to engage in specific activities that will educate them about causes without educating them in other subjects is not considered a call for specific action by the audience that will help accomplish the entity's mission. An example of a lecture or class that will educate students in an area other than causes is a lecture on the nesting habits of the bald eagle, given by the Save the Bald Eagle Society, an NPO whose mission is to save the bald eagle from extinction and educate the public about the bald eagle. An example of a lecture or class that will address particular causes is a lecture by the Bald Eagle Society on the potential extinction of bald eagles and the need to raise contributions to prevent their extinction. For purposes of applying the guidance in this SOP, motivating the audience to attend a lecture on the nesting habits of the bald eagle is a call for specific action that will help accomplish the entity's mission. If the lecture merely addresses the potential extinction of bald eagles and the need to raise contributions to prevent their extinction, without addressing the nesting habits of the bald eagle, motivating the audience to attend the lecture is not considered a call for specific action by the recipient that will help accomplish the entity's mission.

D.9. AcSEC notes that most transactions in which a student attends a lecture or class are exchange transactions and are not joint activities. Such transactions are joint activities only if the activity includes fund raising.

Audience

D.10. Paragraph .12 provides that a rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for the program or management and general reasons specified in paragraph .13. Further, paragraph .12 provides that in determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for the reasons that may overcome that presumption. Some organizations conduct joint activities that are special events, such as symposia, dinners, dances, and theater parties, in which the attendee receives a direct benefit (for example, a meal or theater ticket) and for which the admission price includes a contribution. For example, it may cost $500 to attend a dinner with a fair value of $50. In that case, the audience is required to make a $450 contribution in order to attend. In circumstances in which the audience is required to make a contribution to participate in a joint activity, such as attending a special event, the audience's ability or likelihood to contribute is a significant factor in its selection. Therefore, in circumstances in which the audience is required to make a contribution to participate in a joint activity, the extent to which the audience is selected for the program or management and general reasons in paragraph .13 must be overwhelmingly significant in order to rebut the presumption that the audience criterion is not met.

D.11. The source of the names and the characteristics of the audience should be considered in determining the reason for selecting the audience. Some entities use lists compiled by others to reach new audiences. The source of such lists may indicate the purpose or purposes for which they were selected. For example, lists acquired from entities with similar or related programs are more likely to meet the audience criterion than are lists acquired from entities with dissimilar or unrelated programs. Also, the characteristics of those on the lists may indicate the purpose or purposes for which they were selected. For example, a list based on a consumer profile of those who buy environmentally friendly products may be useful to an entity whose mission addresses environmental concerns and could therefore indicate that the audience was selected for its ability to take action to assist the entity in meeting program goals. However, a list based on net worth would indicate that the audience was selected based on its ability or likelihood to contribute, unless there was a correlation between net worth and the program or management and general components of the activity.

D.12. Some audiences may be selected because they have an interest in or affinity to the program. For example, homeowners may have an interest in the homeless because they are sympathetic to the plight of the homeless. Nevertheless, including homeowners in the audience of a program activity to provide services to the homeless would not meet the audience criterion, because they do not have a need or reasonable potential for use of services to the homeless.

D.13. Paragraph .13*c* provides that the audience criterion is met if the entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component. An example of a joint activity in which the audience is selected because the entity is required to direct the management and general component of the joint activity to the particular audience is an activity in which the entity sends a written acknowledgment or other information to comply with requirements of the Internal Revenue Service to prior donors and includes a request for contributions. An example of a joint activity in which the audience is selected because the audience has reasonable potential for use of the management and general component is an activity in which the entity sends its annual report to prior donors and includes a request for contributions.

Content

D.14. Paragraph .14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. As discussed in the Glossary [paragraph .30], the action should benefit the recipient or society. Examples of actions that benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or society (such as by addressing societal problems) include the following:

a. Actions that benefit the recipient:

- *Stop smoking.* Specific methods, instructions, references, and resources should be suggested.
- *Do not use alcohol or drugs.* Specific methods, instructions, references, and resources should be suggested.

b. Actions that benefit society:

- *Write or call.* The party to communicate with and the subject matter to be communicated should be specified.
- *Complete and return the enclosed questionnaire.* The results of the questionnaire should help the entity achieve its mission. For example, if the entity discards the questionnaire, it does not help the entity achieve its mission.
- *Boycott.* The particular product or company to be boycotted should be specified.

D.15. Paragraph .14*b* provides that to meet the content criterion, management and general functions are required to fulfill one or more of the entity's management and general responsibilities through a component of the joint activity. Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. Paragraph .14, footnote 9, of this SOP provides that for purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities. Some examples of such disclosures include the following:

- Information filed with the attorney general concerning this charitable solicitation may be obtained from the attorney general of [*the state*] by calling 123-4567. Registration with the attorney general does not imply endorsement.
- A copy of the registration and financial information may be obtained from the Division of Consumer Services by calling toll-free, within [*the state*], 1-800-123-4567. Registration does not imply endorsement, approval, or recommendation by [*the state*].
- Information about the cost of postage and copying, and other information required to be filed under [*the state*] law, can be obtained by calling 123-4567.
- The organization's latest annual report can be obtained by calling 123-4567.

Allocation Methods

D.16. Paragraph .16 of this SOP states, "The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances." The allocation of joint costs should be based on the degree to which costs were incurred for the functions to which the costs are allocated (that is, program, management and general, or fund raising). For purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities, facts and circumstances that may be considered include factors related to the content and relative costs of the components of the activity. The audience should not be considered in determining whether the facts and circumstances are similar for purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities.

Practicability of Measuring Joint Costs

D.17. The Glossary [paragraph .30] of this SOP includes a definition of joint costs. Some costs, such as utilities, rent, and insurance, commonly referred to as indirect costs, may be joint costs. For example, the telephone bill for a department that, among other things, prepares materials that include both fund-raising and program components may commonly be referred to as an indirect cost. Such telephone bills may also be joint costs. However, for some entities, it is impracticable to measure and allocate the portion of the costs that are joint costs. Considerations about which joint costs should be measured and allocated, such as considerations about materiality and the costs and benefits of developing and providing the information, are the same as considerations about cost allocations in other circumstances.

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Appendix E

Illustrations of Applying the Criteria of Purpose, Audience, and Content to Determine Whether a Program or Management and General Activity Has Been Conducted

Illustration 1

Facts

E.1. Entity A's mission is to prevent drug abuse. Entity A's annual report states that one of its objectives in fulfilling that mission is to assist parents in preventing their children from abusing drugs.

E.2. Entity A mails informational materials to the parents of all junior high school students explaining the prevalence and dangers of drug abuse. The materials encourage parents to counsel children about the dangers of drug abuse and inform them about how to detect drug abuse. The mailing includes a request for contributions. Entity A conducts other activities informing the public about the dangers of drug abuse and encouraging parents to counsel their children about drug abuse that do not include requests for contributions and that are conducted in different media. Entity A's executive director is involved in the development of the informational materials as well as the request for contributions. The executive director's annual compensation includes a significant bonus if total annual contributions exceed a predetermined amount.

Conclusion

E.3. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.4. The activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. (Although Entity A's executive director's annual compensation varies based on annual contributions, the executive director's compensation does not vary based on contributions raised for this discrete joint activity.) Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the program component of this activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse) that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (*b*) performing such programs helps accomplish Entity A's mission. (Note that had Entity A conducted the activity using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions, the purpose criterion would have been met under paragraph .10*b*.)

E.5. The audience criterion is met because the audience (parents of junior high school students) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.6. The content criterion is met because the activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission (assisting parents in preventing their children from abusing drugs), and it explains the need for and benefits of the action (the prevalence and dangers of drug abuse).

Illustration 2

Facts

E.7. Entity B's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity B's objectives in fulfilling that mission is to inform the public about the effects and early warning signs of the disease and specific action that should be taken to prevent the disease.

E.8. Entity B maintains a list of its prior donors and sends them donor renewal mailings. The mailings include messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it. That information is also sent to a similar-sized audience but without the request for contributions. Also, Entity B believes that recent donors are more likely to contribute than nondonors or donors who have not contributed recently. Prior donors are deleted from the mailing list if they have not contributed to Entity B recently, and new donors are added to the list. There is no evidence of a correlation between recent contributions and participation in the program component of the activity. Also, the prior donors' need to use or reasonable potential for use of the messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it is an insignificant factor in their selection.

Conclusion

E.9. The purpose and content criteria are met. The audience criterion is not met.[11] All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, should be charged to fund raising.

E.10. The activity calls for specific action by the recipient (action that should be taken to prevent ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (to reduce the incidence of illness from the disease), and (*b*) the program is also

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[11] Paragraph .07 of this SOP provides that all costs of joint activities, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should be charged to fund raising if any of the criteria of purpose, audience, or content are not met. Accordingly, if one or more criteria are not met, the other criteria need not be considered. However, the illustrations in this Appendix provide conclusions about whether each of the criteria would be met in circumstances in which one or more criteria are not met in order to provide further guidance.

conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (a similar mailing is done without the request for contributions, to a similar-sized audience).

E.11. The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is not overcome in this illustration. Although the audience has a need to use or reasonable potential for use of the program component, that was an insignificant factor in its selection.

E.12. The content criterion is met because the activity calls for specific action by the recipient (actions to prevent ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 3

Facts

E.13. Entity C's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity C's objectives in fulfilling that mission is to increase governmental funding for research about ABC disease.

E.14. Entity C maintains a list of its prior donors and its employees call them on the telephone reminding them of the effects of ABC disease, asking for contributions, and encouraging them to contact their elected officials to urge increased governmental funding for research about ABC disease. The callers are educated about ABC, do not otherwise perform fund-raising functions, and are not compensated or evaluated based on contributions raised. Entity C's research indicates that recent donors are likely to contact their elected officials about such funding while nonrecent donors are not. Prior donors are deleted from the calling list if they have not contributed to Entity C recently, and new donors are added to the list.

Conclusion

E.15. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.16. The activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the callers are educated about ABC and do not otherwise perform fund-raising functions), (*b*) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised), and (*c*) performing such programs helps accomplish Entity C's mission.

E.17. The audience criterion is met because the audience (recent donors) is selected based on its ability to assist Entity C in meeting the goals of the program component of the activity (recent donors are likely to contact their elected officials about such funding while nonrecent donors are not).

E.18. The content criterion is met because the activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 4

Facts

E.19. Entity D's mission is to improve the quality of life for senior citizens. One of Entity D's objectives included in that mission is to increase the physical activity of senior citizens. One of Entity D's programs to attain that objective is to send representatives to speak to groups about the importance of exercise and to conduct exercise classes.

E.20. Entity D mails a brochure on the importance of exercise that encourages exercise in later years to residents over the age of sixty-five in three zip code areas. The last two pages of the four-page brochure include a perforated contribution remittance form on which Entity D explains its program and makes an appeal for contributions. The content of the first two pages of the brochure is primarily educational; it explains how seniors can undertake a self-supervised exercise program and encourages them to undertake such a program. In addition, Entity D includes a second brochure on various exercise techniques that can be used by those undertaking an exercise program.

E.21. The brochures are distributed to educate people in this age group about the importance of exercising, to help them exercise properly, and to raise contributions for Entity D. These objectives are documented in a letter to the public relations firm that developed the brochures. The audience is selected based on age, without regard to ability to contribute. Entity D believes that most of the recipients would benefit from the information about exercise.

Conclusion

E.22. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the second brochure should be charged to program because all the costs of the brochure are identifiable with the program function.)

E.23. The activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) performing such programs helps accomplish Entity D's mission, and (*b*) the objectives of the program are documented in a letter to the public relations firm that developed the brochure.

E.24. The audience criterion is met because the audience (residents over sixty-five in certain zip codes) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.25. The content criterion is met because the activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission (increasing the physical activity of senior citizens), and the need for and benefits of the action are clearly evident (explains the importance of exercising).

Illustration 5

Facts

E.26. The facts are the same as those in Illustration 4, except that Entity E employs a fund-raising consultant to develop the first brochure and pays that consultant 30 percent of contributions raised.

Conclusion

E.27. The content and audience criteria are met. The purpose criterion is not met, however, because a majority of compensation or fees for the fund-raising consultant varies based on contributions raised for this discrete joint activity (the fund-raising consultant is paid 30 percent of contributions raised). All costs should be charged to fund raising, including the costs of the second brochure and any other costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity.

Illustration 6

Facts

E.28. Entity F's mission is to protect the environment. One of Entity F's objectives included in that mission is to take action that will increase the portion of waste recycled by the public.

E.29. Entity F conducts a door-to-door canvass of a community that recycles a low portion of its waste. The purpose of the activity is to help increase recycling by educating the community about environmental problems created by not recycling, and to raise contributions. Based on the information communicated by the canvassers, the need for and benefits of the action are clearly evident. The ability or likelihood of the residents to contribute is not a basis for communities selected, and all neighborhoods in the geographic area are covered if their recycling falls below a predetermined rate. The canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns. The canvassers have not previously participated in fund-raising activities.

Conclusion

E.30. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.31. The activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns), and (*b*) performing such programs helps accomplish Entity F's mission (to protect the environment).

E.32. The audience criterion is met because the audience (neighborhoods whose recycling falls below a predetermined rate) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.33. The content criterion is met because the activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission (to protect the environment), and the need for and benefits of the action are clearly evident (increased recycling will help alleviate environmental problems).

Illustration 7

Facts

E.34. Entity G's mission is to provide summer camps for economically disadvantaged youths. Educating the families of ineligible youths about the camps is not one of the program objectives included in that mission.

E.35. Entity G conducts a door-to-door solicitation campaign for its camp programs. In the campaign, volunteers with canisters visit homes in middle-class neighborhoods to collect contributions. Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute. The volunteers explain the camp's programs, including why the disadvantaged children benefit from the program, and distribute leaflets to the residents regardless of whether they contribute to the camp. The leaflets describe the camp, its activities, who can attend, and the benefits to attendees. Requests for contributions are not included in the leaflets.

Conclusion

E.36. The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

E.37. The activity does not include a call for specific action because it only educates the audience about causes (describing the camp, its activities, who can attend, and the benefits to attendees). Therefore, the purpose criterion is not met.

E.38. The audience criterion is not met, because the audience is selected based on its ability or likelihood to contribute, rather than based on (*a*) its need to use or reasonable potential for use of the action called for by the program component, or (*b*) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute.)

E.39. The content criterion is not met because the activity does not call for specific action by the recipient. (The content educates the audience about causes that the program is designed to address without calling for specific action.)

Illustration 8

Facts

E.40. Entity H's mission is to educate the public about lifesaving techniques in order to increase the number of lives saved. One of Entity H's objectives in fulfilling that mission, as stated in the minutes of the board's meetings, is to produce and show television broadcasts including information about lifesaving techniques.

E.41. Entity H conducts an annual national telethon to raise contributions and to reach the American public with lifesaving educational messages, such as summary instructions concerning dealing with certain life-threatening situations. Based on the information communicated by the messages, the need for and benefits of the action are clearly evident. The broadcast includes segments describing Entity H's services. Entity H broadcasts the telethon to the entire country, not merely to areas selected on the basis of giving potential or prior fund raising results. Also, Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising.

Conclusion

E.42. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.43. The activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish Entity H's mission (to save lives by educating the public), and (*b*) a similar program activity is conducted without the fund raising using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the appeal (Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising).

E.44. The audience criterion is met because the audience (a broad segment of the population) is selected based on its need to use or reasonable potential for use of the action called for by the program activity.

E.45. The content criterion is met because the activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission (to save lives by educating the public), and the need for and benefits of the action are clearly evident (saving lives is desirable).

Illustration 9

Facts

E.46. Entity I's mission is to provide food, clothing, and medical care to children in developing countries.

E.47. Entity I conducts television broadcasts in the United States that describe its programs, show the needy children, and end with appeals for contributions. Entity I's operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries and to raise contributions. The employees producing the programs are trained in audiovisual production and are familiar with Entity I's programs. Also, the executive producer is paid $25,000 for this activity, with a $5,000 bonus if the activity raises over $1,000,000.

Conclusion

E.48. The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

E.49. The activity does not include a call for specific action because it only educates the audience about causes (describing its programs and showing the needy children). Therefore, the purpose criterion is not met. (Also, note that if the factor in paragraph .10*a* were considered, it would not be determinative of whether the purpose criterion is met. Although the executive producer will be paid $5,000 if the activity raises over $1,000,000, that amount would not be a majority of the executive producer's total compensation for this activity, because $5,000 would not be a majority of the executive producer's total compensation of $30,000 for this activity. Also, note that if other evidence, such as the indicators in paragraph .11, were considered, the purpose criterion would not be met based on the other evidence. Although the qualifications and duties of the personnel performing the activity indicate that the employees producing the program are familiar with Entity I's programs, the facts that some, but less than a majority, of the executive producer's compensation varies based on contributions raised, and that the operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries [with no call for specific action by recipients] and to raise contributions, indicate that the purpose is fund raising.)

E.50. The audience criterion is not met because the audience is selected based on its ability or likelihood to contribute, rather than based on (*a*) its need to use or reasonable potential for use of the action called for by the program component, or (*b*) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (The audience is a broad segment of the population of a country that is not in need of or has no reasonable potential for use of the program activity.)

E.51. The content criterion is not met because the activity does not call for specific action by the recipient that will help accomplish the entity's mission. (The content educates the audience about the causes without calling for specific action.)

Illustration 10

Facts

E.52. Entity J is a university that distributes its annual report, which includes reports on mission accomplishments, to those who have made significant contributions over the previous year, its board of trustees, and its employees. The annual report is primarily prepared by management and general personnel, such as the accounting department and executive staff. The activity is coordinated by the public relations department. Internal management memoranda indicate that the purpose of the annual report is to report on how management discharged its stewardship responsibilities, including the university's overall performance, goals, financial position, cash flows, and results of operations. Included in the package containing the annual report are requests for contributions and donor reply cards.

Conclusion

E.53. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.54. The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the employees performing the activity are not members of the fund-raising department and perform other non-fund-raising activities and (*b*) internal management memoranda indicate that the purpose of the annual report is to fulfill one of the university's management and general responsibilities.

E.55. The audience criterion is met because the audience is selected based on its reasonable potential for use of the management and general component. Although the activity is directed primarily at those who have previously made significant contributions, the audience was selected based on its presumed interest in Entity J's annual report (prior donors who have made significant contributions are likely to have an interest in matters discussed in the annual report).

E.56. The content criterion is met because the activity (distributing annual reports) fulfills one of the entity's management and general responsibilities (reporting concerning management's fulfillment of its stewardship function).

Illustration 11

Facts

E.57. Entity K is an NPO. In accordance with internal management memoranda documenting its policies requiring it to comply with Internal Revenue Service (IRS) regulations, it mails prior donors who have made quid pro quo payments in excess of $75 documentation required by the IRS. The documentation is included on a perforated piece of paper. The information above the perforation line pertains to the documentation required by the IRS. The information below the perforation line includes a request for contributions and may be used as a donor reply card.

Conclusion

E.58. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the information below the perforation line are identifiable with fund raising and therefore should be charged to fund raising.)

E.59. The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because internal management memoranda indicate that the purpose of the activity is to fulfill one of Entity K's management and general responsibilities.

E.60. The audience criterion is met because the entity is required to direct the management and general component of the activity to the particular audience. Although the activity is directed at those who have previously contributed, the audience was selected based on its need for the documentation.

E.61. The content criterion is met because the activity (sending documentation required by the IRS) fulfills one of the entity's management and general responsibilities (complying with IRS regulations).

Illustration 12

Facts

E.62. Entity L is an animal rights organization. It mails a package of material to individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own. In addition to donor response cards and return envelopes, the package includes (*a*) materials urging recipients to contact their legislators and urge the legislators to support legislation to protect those rights, and (*b*) postcards addressed to legislators urging support for legislation restricting the use of animal testing for cosmetic products. The mail campaign is part of an overall strategy that includes magazine advertisements and the distribution of similar materials at various community events, some of which are undertaken without fund-raising appeals. The advertising and community events reach audiences similar in size and demographics to the audience reached by the mailing.

Conclusion

E.63. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.64. The activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the program component of this activity calls for specific action by the recipient that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (*b*) performing such programs helps accomplish Entity L's mission.

E.65. The audience criterion is met because the audience (individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own) is selected based on its ability to take action to assist the entity in meeting the goals of the program component of the activity.

E.66. The content criterion is met because the activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission (to protect animal rights), and the need for and benefits of the action are clearly evident (to protect animal rights).

Illustration 13

Facts

E.67. Entity M is a performing arts organization whose mission is to make the arts available to residents in its area. Entity M charges a fee for attending performances and sends advertisements, including subscription forms, for the performances to residents in its area. These advertisements include a return envelope with a request for contributions. Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received. In performing that evaluation, Entity M places more weight on the number of subscriptions sold than on the contributions received. Also, Entity M advertises the performances on local television and radio without a request for contributions but on a smaller scale than the mail advertising.

Conclusion

E.68. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.69. The activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the entity measures program results and accomplishments of the joint activity and in evaluating the effectiveness of the activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received and places more weight on the number of subscriptions sold than on the contributions received), (*b*) it otherwise conducts the program activity without a request for contributions, and (*c*) performing such programs helps accomplish Entity M's mission (to make the arts available to residents in its area).

E.70. The audience criterion is met because the audience (a broad segment of the population in Entity M's area) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.71. The content criterion is met because the activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission (making the arts available to area residents), and the need for and benefits of the action are clearly evident (attending the performance is a positive cultural experience). (Note that the purchase of subscriptions is an exchange transaction and, therefore, is not a contribution.)

Illustration 14

Facts

E.72. Entity N is a university whose mission is to educate the public (students) in various academic pursuits. Entity N's political science department holds a special lecture series in which prominent world leaders speak about current events. The speakers command relatively high fees and, in order to cover costs and make a modest profit, the university sets a relatively expensive fee to attend. However, the tickets are priced at the fair value of the lecture and no portion of the ticket purchase price is a contribution. Entity N advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. At some of the lectures, including the lecture being considered in this illustration, deans and other faculty members of Entity N solicit significant contributions from attendees. Other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions. Entity N's records indicate that historically 75 percent of the attendees have attended prior lectures. Of the 75 percent who have attended prior lectures, 15 percent have made prior contributions to Entity N. Of the 15 percent who have made prior contributions to Entity N, 5 percent have made contributions in response to solicitations made at the events. (Therefore, one-half of one percent of attendees make contributions in response to solicitations made at the events. However, those contributions are significant.) Overall, the audience's ability or likelihood to contribute is an insignificant factor in its selection. Entity N evaluates the effectiveness of the activity based on the number of tickets sold, as well as contributions received. In performing that evaluation, Entity N places more weight on the number of tickets sold than on the contributions received.

Conclusion

E.73. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.74. The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions).

E.75. The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is overcome in this illustration because the audience (those who have shown prior interest in the lecture series, prior donors, a broad segment of the population in Entity N's area, and those attending the lecture) is also selected for its reasonable potential for use of the program component (attending the lecture). Although the audience may make significant contributions, that was an insignificant factor in its selection.

E.76. The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph .07 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.[12])

Illustration 15

Facts

E.77. Entity O is a university whose mission is to educate the public (students) in various academic pursuits. Entity O's political science department holds a special lecture series in which prominent world leaders speak about current events. Admission is priced at $250, which is above the $50 fair value of the lecture and, therefore, $200 of the admission price is a contribution. Therefore, the audience's likelihood to contribute to the entity is a significant factor in its selection. Entity O advertises the lectures by sending invitations

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[12] Paragraphs 13.21–13.26 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events. [Footnote revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. Entity O presents similar lectures that are priced at the fair value of those lectures.

Conclusion

E.78. The purpose and content criteria are met. The audience criterion is not met. All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, except for the costs of the direct donor benefit (the lecture), should be charged to fund raising.

E.79. The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without including a contribution in the admission price.)

E.80. The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute to the entity is not overcome in this illustration. The fact that the $250 admission price includes a $200 contribution leads to the conclusion that the audience's ability or likelihood to contribute is an overwhelmingly significant factor in its selection, whereas there is no evidence that the extent to which the audience is selected for its need to use or reasonable potential for use of the action called for by the program component (attending the lecture) is overwhelmingly significant.

E.81. The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph .07 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.[13])

Illustration 16

Facts

E.82. Entity P's mission is to reduce the incidence of illness from ABC disease, which primarily afflicts people over sixty-five years of age. One of Entity P's objectives in fulfilling that mission is to have all persons over sixty-five screened for ABC disease.

E.83. Entity P rents space at events attended primarily by people over sixty-five years of age and conducts free screening for ABC disease. Entity P's

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[13] Paragraphs 13.21–13.26 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events. [Footnote revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

employees, who are educated about ABC disease and screening procedures and do not otherwise perform fund-raising functions, educate interested parties about the effects of ABC disease and the ease and benefits of screening for it. Entity P also solicits contributions at the events. The effectiveness of the activity is evaluated primarily based on how many screening tests are performed, and only minimally based on contributions raised. The employees are not compensated or evaluated based on contributions raised.

Conclusion

E.84. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.85. The activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) a process exists to evaluate measured program results and accomplishments and in evaluating the effectiveness of the joint activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity P evaluates the effectiveness of the activity based on the number of screening tests conducted as well as contributions received and places more weight on the number of tests conducted than on the contributions received); (*b*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the employees are educated about ABC disease and the testing procedures and do not otherwise perform fund-raising functions); (*c*) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised); and (*d*) performing such programs helps accomplish Entity P's mission (to prevent ABC disease).

E.86. The audience criterion is met because the audience (people over sixty-five years of age) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.87. The content criterion is met because the activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 17

Facts

E.88. Entity Q's mission is to provide cultural and educational television programming to residents in its area. Entity Q owns a public television station and holds a membership drive in which it solicits new members. The drive is conducted by station employees and consists of solicitations that are shown during long breaks between the station's regularly scheduled programs. Entity Q's internal management memoranda state that these drives are designed to raise contributions. Entity Q evaluates the effectiveness of the activity based on the amount of contributions received. Entity Q shows the programs on a similar scale, without the request for contributions. The audience is members of the general public who watch the programs shown during the drive. Station member benefits are given to those who contribute and consist of tokens of appreciation with a nominal value.

Conclusion

E.89. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that there would be few, if any, joint costs. Costs associated with the fund-raising activities, such as costs of airtime, would be separately identifiable from costs of the program activities, such as licensing costs for a particular television program. Also, note that because no significant benefits or duties are associated with membership, member dues are contributions. Therefore, the substance of the membership-development activities is, in fact, fund raising.)

E.90. The activity calls for specific action by the recipient (watching the television program) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission, and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (Entity Q shows the television programs on a similar scale, without the request for contributions).

E.91. The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute is overcome in this illustration because the audience (members of the general public who watch the television programs shown during the drive) is also selected for its reasonable potential for use of the program component (watching the television programs). Although the audience may make contributions, that was an insignificant factor in its selection.

E.92. The content criterion is met because the activity calls for specific action by the recipient (watching the television programs) that will help accomplish the entity's mission (providing cultural and educational television programming to residents in its area), and the need for and benefits of the action are clearly evident (watching the programs is a positive cultural and educational experience).

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Appendix F

Illustrations of Allocation Methods

F.1. Some commonly used cost allocation methods follow.

Physical Units Method

F.2. Joint costs are allocated to materials and activities in proportion to the number of units of output that can be attributed to each of the materials and activities. Examples of units of output are lines, square inches, and physical content measures. This method assumes that the benefits received by the fund-raising, program, or management and general component of the materials or activity from the joint costs incurred are directly proportional to the lines, square inches, or other physical output measures attributed to each component of the activity. This method may result in an unreasonable allocation of joint costs if the units of output, for example, line counts, do not reflect the degree to which costs are incurred for the joint activity. Use of the physical units method may also result in an unreasonable allocation if the physical units cannot be clearly ascribed to fund raising, program, or management and general. For example, direct mail and telephone solicitations sometimes include content that is not identifiable with fund raising, program, or management and general; or the physical units of such content are inseparable.

Illustration

F.3. Assume a direct mail campaign is used to conduct programs of the entity and to solicit contributions to support the entity and its programs. Further, assume that the appeal meets the criteria for allocation of joint costs to more than one function.

F.4. The letter and reply card include a total of one hundred lines. Forty-five lines pertain to program because they include a call for action by the recipient that will help accomplish the entity's mission, while fifty-five lines pertain to the fund-raising appeal. Accordingly, 45 percent of the costs are allocated to program and 55 percent to fund-raising.

Relative Direct Cost Method

F.5. Joint costs are allocated to each of the components on the basis of their respective direct costs. Direct costs are those costs that are incurred in connection with the multipurpose materials or activity and that are specifically identifiable with a function (program, fund raising, or management and general). This method may result in an unreasonable allocation of joint costs if the joint costs of the materials and activity are not incurred in approximately the same proportion and for the same reasons as the direct costs of the materials and activity. For example, if a relatively costly booklet informing the reader about the entity's mission (including a call for action by the recipient that will help accomplish the entity's mission) is included with a relatively inexpensive fund-raising letter, the allocation of joint costs based on the cost of these pieces may be unreasonable, particularly if the booklet and letter weigh approximately the same and therefore contribute equally to the postage costs.

Illustration

F.6. The costs of a direct mail campaign that can be specifically identified with program services are the costs of separate program materials and a postcard which calls for specific action by the recipient that will help accomplish the entity's mission. They total $20,000. The direct costs of the fund-raising component of the direct mail campaign consist of the costs to develop and produce the fund-raising letter. They total $80,000. Joint costs associated with the direct mail campaign total $40,000 and would be allocated as follows under the relative direct cost method:

Program	$20,000/$100,000 × $40,000 = $8,000
Fund raising	$80,000/$100,000 × $40,000 = $32,000

Stand-Alone Joint-Cost-Allocation Method

F.7. Joint costs are allocated to each component of the activity based on a ratio that uses estimates of costs of items included in joint costs that would have been incurred had the components been conducted independently. The numerator of the ratio is the cost (of items included in joint costs) of conducting a single component independently; the denominator is the cost (of items included in joint costs) of conducting all components independently. This method assumes that efforts for each component in the stand-alone situation are proportionate to the efforts actually undertaken in the joint cost situation. This method may result in an unreasonable allocation because it ignores the effect of each function, which is performed jointly with other functions, on other such functions. For example, the programmatic impact of a direct mail campaign or a telemarketing phone message may be significantly lessened when performed in conjunction with a fund-raising appeal.

Illustration

F.8. Assume that the joint costs associated with a direct mail campaign including both program and fund-raising components are the costs of stationery, postage, and envelopes at a total of $100,000. The costs of stationery, postage, and envelopes to produce and distribute each component separately would have been $90,000 for the program component and $70,000 for the fund-raising component. Under the stand-alone joint-cost-allocation method, the $100,000 in joint costs would be allocated as follows: $90,000/$160,000 × $100,000 = $56,250 to program services and $70,000/$160,000 × $100,000 = $43,750 to fund raising.

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Appendix G

Illustrations of Disclosures

G.1. The disclosures discussed in paragraphs .18 and .19 are illustrated below. Alternative 1 reports the required and encouraged information in narrative format. Alternative 2 reports that information in tabular format, as well as information concerning joint costs incurred for each kind of activity by functional classification, which is neither required nor encouraged, but which is not prohibited.

Alternative 1

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included requests for contributions, as well as program and management and general components. Those activities included direct mail campaigns, special events, and a telethon. The costs of conducting those activities included a total of $310,000 of joint costs, which are not specifically attributable to particular components of the activities (joint costs). [***Note to reader:*** *The following sentence is encouraged but not required.*] Joint costs for each kind of activity were $50,000, $150,000, and $110,000 respectively. These joint costs were allocated as follows:

Fund raising	$180,000
Program A	80,000
Program B	40,000
Management and general	10,000
Total	$310,000

Alternative 2

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included appeals for contributions and incurred joint costs of $310,000. These activities included direct mail campaigns, special events, and a telethon. Joint costs were allocated as follows:

	Direct Mail	*Special Events*	*Telethon*	*Total*
Fund raising	$40,000	$50,000	$90,000	$180,000
Program A	10,000	65,000	5,000	80,000
Program B		25,000	15,000	40,000
Management and general		10,000		10,000
Total	$50,000	$150,000	$110,000	$310,000

[***Note to reader:*** *Shading is used to highlight information that is neither required nor encouraged, but which is not prohibited. However, entities may prefer to disclose it. Disclosing the total joint costs for each kind of activity ($50,000, $150,000, and $110,000) is encouraged but not required.*]

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Appendix H

Contrast of Guidance in This SOP With the Guidance in SOP 87-2[14,**]

This SOP	*SOP 87-2*
Applies to all entities that solicit contributions, including state and local governments.	Applied to entities that follow the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* or SOP 78-10. (SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities.*)
Covers *all* costs of joint activities. (Costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event [for example, a meal], should be charged to fund raising unless the criteria in the SOP are met.)	Covers only joint costs of joint activities.
Criteria of purpose, audience, and content should all be met in order to charge costs of the activity to program or management and general.	Unclear concerning whether all criteria should be met in order to charge costs of the activity to program or management and general.

(continued)

[14] In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*, which superseded SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal,* because the guidance in SOP 87-2 is incorporated into paragraphs 13.36 to 13.45 of the Guide. Also, *Not-for-Profit Organizations* superseded the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* and SOP 78-10. *Not-for-Profit Organizations* applies to all nongovernmental not-for-profit organizations other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. Therefore, incorporating the guidance in SOP 87-2 into *Not-for-Profit Organizations* broadened the scope of the guidance previously included in SOP 87-2 to all not-for-profit organizations other than those required to follow *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*, except that the guidance in *Not-for-Profit Organizations* applies to all not-for-profit organizations other than those required to follow *Health Care Organizations*.

** See footnotes ‡ and || in paragraphs D.3 and D.4, respectively. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34 and No. 35.]

This SOP	*SOP 87-2*
Neither prescribes nor prohibits any allocation methods. Includes a discussion to help users determine whether an allocation is reasonable, and provides some illustrations.	Neither prescribes nor prohibits any allocation methods. No illustrations are provided.
Requires note disclosures about the types of activities for which joint costs have been incurred, amounts allocated during the period, and amounts allocated to each functional expense or expenditure category.	Requires less extensive note disclosures: total amount allocated during the period and amounts allocated to each functional expense category.

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Appendix I

Effects on Other Guidance

I.1. For nongovernmental organizations, this Statement of Position (SOP) amends the AICPA Audit and Accounting Guide *Health Care Organizations* and paragraphs 13.35 to 13.44 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations.* [Revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

I.2. Also, this SOP amends the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* to clarify that costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund-raising. In particular, paragraphs 13.21, 13.23, and 13.24 of *Not-for-Profit Organizations* are amended as follows:

> **13.21** Some organizations conduct joint activities[9] that are special events, including special social and educational events (such as symposia, dinners, dances, and theater parties) in which the attendee receives a direct benefit (for example, a meal or theater ticket). FASB Statement No. 117 requires the reporting of the gross amounts of revenues and expenses from special events and other fund-raising activities that are ongoing major or central activities, but permits (but does not require) reporting net amounts if the receipts and related costs result from special events that are peripheral or incidental activities.
>
> [9] See footnote 1.
>
> **13.23** For example, assume that an organization has a special event that is an ongoing and major activity with a ticket price of $100. Assume that the activity does not meet the audience criterion in SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, and, therefore, all costs of the activity, other than the direct donor benefits, should be reported as fund raising. The event includes a dinner that costs the organization $25 and that has a fair value of $30. (Chapter 5, "Contributions Received and Agency Transactions," of this Guide, discusses the appropriate reporting if the meal or other items of value are donated to the organization for resale.) In addition, the organization incurs other direct costs of the event in connection with promoting and conducting the event, including incremental direct costs incurred in transactions with independent third parties and the payroll and payroll-related costs for the activities of employees who are directly associated with, and devote time to, the event. Those other direct costs, which include (*a*) $5 that otherwise might be considered management and general costs if they had been incurred in a different activity, and (*b*) fund-raising costs of $10, are unrelated to the direct benefits to donors and, accordingly, should not be included as costs of benefits to donors. In addition, the organization has the following transactions, which are unrelated to the special event: unrestricted contributions of $200, program expenses of $60, management and general expenses of $20, and fund-raising expenses of $20.
>
> **13.24** Some ways in which the organization could display the results of the special event as part of its statement of activities are illustrated as follows:

Illustration 1

Changes in unrestricted net assets:		
Contributions		$200
Special event revenue	100	
Less: Costs of direct benefits to donors	(25)	
Net revenues from special events		75
Contributions and net revenues from special events		275
Other expenses:		
Program		60
Management and general		20
Fund raising		35
Total other expenses		115
Increase in unrestricted net assets		$160

Illustration 2

Changes in unrestricted net assets:	
Revenues:	
Contributions	$200
Special event revenue	100
Total revenues	300
Expenses:	
Program	60
Costs of direct benefits to donors	25
Management and general	20
Fund raising	35
Total expenses	140
Increase in unrestricted net assets	$160

Illustration 3

Changes in unrestricted net asset:	
Contributions	$270
Dinner sales	30
Less: Costs of direct benefits to donors	(25)
Gross profit on special events	5
Contributions and net revenues from special events	275
Other expenses:	
Program	60
Management and general	20
Fund raising	35
Total other expenses	115
Increase in unrestricted net assets	$160

[Revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

I.3. For governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations,* or the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* (modified by all applicable Financial Accounting Standards Board [FASB] pronouncements issued through November 30, 1989, and by most applicable Governmental Accounting Standards Board [GASB] pronouncements) in conformity with GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, this SOP amends the principles—based on SOP 78-10 and *Audits of Voluntary Health and Welfare Organizations*, as modified—that those entities apply. For governmental entities that have applied the accounting and financial reporting principles in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements in conformity with GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, this SOP amends the principles—based on *Audits of Colleges and Universities*, as amended and modified—that those entities apply. For other governmental organizations, this SOP amends the Audit and Accounting Guide *Audits of State and Local Governmental Units*.[††]

[††] See footnotes ‡ and || in paragraphs D.3 and D.4, respectively. Also, the AICPA Audit and Accounting Guide *State and Local Governments* supersedes the 1994 AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and subsequent editions of that Guide with conforming changes made by the AICPA staff. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance on the application of this SOP to state and local governments. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34, No. 35, and the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units.*]

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Glossary

Activities. Activities are efforts to accomplish specific objectives. Some activities include producing and distributing materials. For example, if an entity undertakes a mass mailing that includes a letter and a pamphlet, producing and distributing the letter and pamphlet are part of the activity. Other activities may include no materials, such as an annual dinner or a radio commercial.

Compensation or fees. Reciprocal transfers of cash or other assets in exchange for services performed.

Contributions. Contributions are unconditional transfers of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

Costs of joint activities. Costs of joint activities are costs incurred for a joint activity. Costs of joint activities may include joint costs and costs other than joint costs. Costs other than joint costs are costs that are identifiable with a particular function, such as fund raising, program, management and general, and cost of sales. For example, some costs incurred for printing, paper, professional fees, and salaries to produce donor cards are not joint costs, although they may be incurred in connection with conducting joint activities.

Fund-raising activities. Fund-raising activities are activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others.

Help accomplish the entity's mission. Actions that help accomplish the entity's mission are actions that either benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or benefit society (by addressing societal problems).

Joint activity. A joint activity is an activity that is part of the fund-raising function and has elements of one or more other functions, such as program, management and general, membership development, or any other functional category used by the entity.

Joint costs. Joint costs are the costs of conducting joint activities that are not identifiable with a particular component of the activity. For example, the cost of postage for a letter that includes both fund-raising and program components is a joint cost. Joint costs may include the costs of salaries, contract labor, consultants, professional fees, paper, printing, postage, event advertising, telephones, airtime, and facility rentals.

Management and general activities. Management and general activities are those that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization's existence. They include oversight, business management, general recordkeeping, budgeting, financing, soliciting revenue from exchange transactions, such as government contracts and related administrative activities, and all management and administration except for direct conduct of program services or fund-raising activities. Disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, and the annual report, among other activities, are management and general activities, as are soliciting funds other than contributions, including exchange transactions (whether program-related or not).

Medium. A medium is a means of mass communication, such as direct mail, direct response advertising, or television.

Membership-development activities. Membership-development activities include soliciting for prospective members and membership dues, membership relations, and similar activities. If there are no significant benefits or duties connected with membership, however, the substance of membership-development activities may, in fact, be fund-raising.

Program activities. Program activities are the activities that result in goods or services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs. For example, a large university may have programs for student instruction, research, and patient care, among others. Similarly, a health and welfare organization may have programs for health and family services, research, disaster relief, and public education, among others.

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Section 10,740

Statement of Position 98-4
Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition

March 31, 1998

NOTE

Statements of Position (SOPs) on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA SOPs that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this SOP if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the SOP should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

SOP 98-4 is amended by SOP 98-9, *Modification of SOP-97-2*, Software Revenue Recognition, *With Respect to Certain Transactions*. The provisions of this SOP that extend the deferral of the application of certain passages of SOP 97-2 are effective December 15, 1998. All other provisions of this SOP are effective for transactions entered into in fiscal years beginning after March 15, 1999. Earlier adoption is permitted as of the beginning of fiscal years or interior periods for which financial statements or information has not been issued. Retroactive application of the provisions of this SOP is prohibited.

Summary

This Statement of Position (SOP) defers for one year the application of the following passages in SOP 97-2 [section 10,700], which limit what is considered vendor-specific objective evidence (VSOE) of the fair value of the various elements in a multiple-element arrangement: (*a*) the second sentences of paragraphs 10, 37, 41, and 57 [section 10,700.10, .37, .41, and .57], (*b*) example 3 in "Multiple-Element Arrangements—Products" (appendix A [section 10,700.146]), and (*c*) example 3 in "Multiple-Element Arrangement—Products and Services" (appendix A [section 10,700.146]). All other provisions of SOP 97-2 [section 10,700] remain in effect.

This SOP applies to all multiple-element software arrangements, as defined in paragraph 9 of SOP 97-2 [section 10,700.09], and is effective as of March 31, 1998. If an enterprise had applied SOP 97-2 [section 10,700] in an earlier period for financial statements or information already issued prior to the promulgation of this SOP, amounts reported in those financial statements or as part of that information may be restated to reflect the deferral of the effective date of the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 [section 10,700.10, .37, .41, and .57] and the related examples.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (*a*) a prospectus for a project to develop a document, (*b*) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (*c*) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing a final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following.

a. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.

b. The proposal will result in an improvement in practice.

c. The AICPA demonstrates the need for the proposal.

d. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Introduction and Background

.01 On October 27, 1997, the AICPA Accounting Standards Executive Committee (AcSEC) issued Statement of Position (SOP) 97-2, *Software Revenue Recognition* [section 10,700].

.02 The first two sentences of paragraph 10 of SOP 97-2 [section 10,700.10] state:

> If an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated within the contract for each element. Vendor-specific objective evidence of fair value is limited to the following:
>
> - The price charged when the same element is sold separately
> - For an element not yet being sold separately, the price established by management having the relevant authority; it must be probable that the price, once established, will not change before the separate introduction of the element into the marketplace

.03 This SOP defers for one year the application of the following passages in SOP 97-2 [section 10,700], which limit what is considered vendor-specific objective evidence (VSOE) of the fair value of the various elements in a multiple-element arrangement: (*a*) the second sentences of paragraphs 10, 37, 41, and 57 [section 10,700.10, .37, .41, and .57], (*b*) example 3 in "Multiple-Element Arrangements—Products" (appendix A [section 10,700.146]), and (*c*) example 3 in "Multiple-Element Arrangements—Products and Services" (appendix A [section 10,700.146]).

Scope

.04 This SOP applies to all multiple-element software arrangements, as defined in paragraph 9 of SOP 97-2 [section 10,700.09]. Such multiple-element arrangements include all software arrangements that provide licenses for multiple software deliverables such as software products, upgrades/enhancements, postcontract customer support (PCS), or services.

Conclusions

.05 The second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 [section 10,700.10, .37, .41, and .57], which limit what is considered VSOE [vendor-specific objective evidence] of the fair value of the various elements in a multiple-element arrangement, and the related examples noted in paragraph .03 of this SOP need not be applied to transactions entered into before fiscal years beginning after March 15, 1999. [As amended, effective for transactions entered into in fiscal years beginning after March 15, 1999, by Statement of Position 98-9.]

.06 All other provisions of SOP 97-2 [section 10,700], including the remainder of paragraph 10 [section 10,700.10], should be applied as stated in SOP 97-2 [section 10,700]. Accordingly, this SOP does not alter the requirements that (*a*) any allocation of the fee in a multiple-element arrangement to the various elements should be based on the fair values of each element, (*b*) those fair values must be supported by VSOE, and (*c*) in instances where there is insufficient VSOE of the fair values of each element to allow for an allocation of revenue to each element, all revenue from the arrangement should be deferred pursuant to paragraph 12 [section 10,700.12] of that SOP.

Effective Date and Transition

.07 This SOP is effective as of March 31, 1998. If an enterprise had applied SOP 97-2 [section 10,700] in an earlier period for financial statements or information already issued prior to the promulgation of this SOP, amounts reported in those financial statements or as part of that information may be restated to reflect the deferral of the effective date of the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 [section 10,700.10, .37, .41, and .57] and the related examples noted in paragraph .03 of this SOP.

The provisions of this Statement need not be applied to immaterial items.

Basis for Conclusions

.08 Paragraph 10 of SOP 97-2 [section 10,700.10] establishes that the fee in a multiple-element arrangement should be allocated to the various elements based on VSOE of fair values. The second sentence of paragraph 10 [section 10,700.10] adds that evidence of VSOE of fair values is limited to the price charged when the same element is sold separately or is to be sold separately.

.09 In developing the “unbundling” guidance in SOP 97-2 [section 10,700], AcSEC emphasized the need for VSOE of each element’s fair value to properly recognize revenue upon delivery of each element. That principle remains unchanged.

.10 AcSEC concluded that the best evidence of the fair value of an element is the price charged for that element when it is sold separately. Some have argued, however, that conclusions with respect to the "best evidence" should not preclude revenue recognition when the fair value of an element can be determined by reference to other vendor-specific objective information.

.11 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information,* states the following in paragraphs 95 and 96.

> Conservatism no longer requires deferring recognition of income beyond the time that adequate evidence of its existence becomes available or justifies recognizing losses before there is adequate evidence that they have been incurred.
>
> The Board emphasizes that any attempt to understate results consistently is likely to raise questions about the reliability and the integrity of information about those results and will probably be self-defeating in the long run. That kind of reporting, however well-intentioned, is not consistent with the desirable characteristics described in this Statement. On the other hand, the Board also emphasizes that imprudent reporting, such as may be reflected, for example, in overly optimistic estimates of realization, is certainly no less inconsistent with those characteristics. Bias in estimating components of earnings, whether overly conservative or unconservative, usually influences the timing of earnings or losses rather than their aggregate amount. As a result, unjustified excesses in either direction may mislead one group of investors to the possible benefit or detriment of others.

.12 Subsequent to the issuance of SOP 97-2 [section 10,700], several examples of multiple-element arrangements were brought to AcSEC's attention in which the application of the limitations on VSOE of fair values in paragraph 10 of SOP 97-2 [section 10,700.10] would not allow "unbundling" and, as a result, may produce an unduly conservative pattern of revenue recognition. Those examples include the following.

- Software is sold only, or substantially always, in combination with PCS or other elements and there is VSOE of the fair value of the PCS or other elements and of the total arrangement. The restrictions in paragraph 10 of SOP 97-2 [section 10,700.10] led some to the conclusion that VSOE of fair value does not exist for the software element because that element is not "sold separately." Pursuant to paragraph 12 of SOP 97-2 [section 10,700.12], revenue for the entire fee, representing the value of both the software and PCS or other elements, would be recognized ratably over the period during which the obligations are discharged, even if the software product has been delivered.

- PCS or other elements are sold only, or substantially always, in combination with software in transactions for which there is VSOE of the fair value of the software and of the total arrangement. Paragraph 10 of SOP 97-2 [section 10,700.10] led some to the conclusion that VSOE of fair value does not exist for the PCS element in such circumstances, because that element is not "sold separately" (nor has a price been established in anticipation of separate introduction of PCS into the marketplace). Revenue for the entire fee would be recognized ratably over the period during which the PCS obligations are discharged, even if the software product has been delivered.

- Multi-year PCS is included in a multiple-element transaction in situations in which PCS renewals are sold only for periods of one year. Paragraph 10 of SOP 97-2 [section 10,700.10] could lead to the conclusion that VSOE does not exist for the multi-year PCS because PCS renewals are "sold separately" only for one-year periods. Pursuant to paragraph 12 of SOP 97-2 [section 10,700.12], revenue for the entire fee would be recognized ratably over the period during which the PCS obligations are discharged.

AcSEC considered the FASB guidance contained above in FASB Concepts Statement No. 2 and certain examples of transactions as presented above. AcSEC concluded that, although the best evidence of fair value of an element is the price charged for that element when it is sold separately, requiring deferral of recognition of revenue related to the delivered element when there is sufficient other VSOE of fair value to support the allocation of the fee to the various elements may be unduly conservative. Therefore, AcSEC concluded that the application of the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 [section 10,700.10, .37, .41, and .57] should be deferred for one year pending reconsideration by AcSEC.

.13 AcSEC notes that the requirement in the first sentence of paragraph 10 of SOP 97-2 [section 10,700.10] remains in effect during this deferral period, that is, revenues from a multiple-element arrangement should be allocated to each element on the basis of its fair value. This allocation principle is consistent with analogous provisions in other areas of accounting literature directed to multiple-element arrangements. Paragraph 99 of SOP 97-2 [section 10,700.99] cites the requirements of FASB Statement No. 45, *Accounting for Franchise Fee Revenue*, as one such example. Another example is the consensus on FASB's Emerging Issues Task Force (EITF) Issue 97-13, *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation*, which requires allocation of third-party consulting costs to different activities based on the relative fair values of the separate activities. A further requirement imposed by the first sentence of paragraph 10 of SOP 97-2 [section 10,700.10] is that the amounts determined to be fair value need to be supported by VSOE. The basis for such a conclusion is set forth in paragraph 100 of SOP 97-2 [section 10,700.100].

.14 There may be situations in which VSOE of the fair value of each element does not exist. Not all vendor-specific "evidence" is sufficiently objective and reliable to support a conclusion as to the fair value of an element. For example, amounts set forth for software products on a published price list may not represent customary sales prices. In the absence of representative selling prices, VSOE may not exist.

.15 It is AcSEC's intention to immediately begin a project to consider whether guidance is needed on any restrictions that should be placed on VSOE of fair value and, if so, what that guidance should be. Deferral of the second sentence of paragraph 10 of SOP 97-2 [section 10,700.10] will allow AcSEC sufficient time to reconsider its conclusions. Positions of AcSEC are determined through committee procedures, due process, and deliberation. Accordingly, this deferral should not be construed as a conclusion that AcSEC will amend SOP 97-2 [section 10,700]. AcSEC intends to complete its deliberations and, if determined appropriate, issue an SOP before the end of 1998.

Effective Date

.16 SOP 97-2 [section 10,700] was issued on October 27, 1997, and is effective for transactions in fiscal years beginning after December 15, 1997. This SOP is being issued before the end of the earliest three-month period for which SOP 97-2 [section 10,700] must be applied. Consequently, it is appropriate for this SOP to be effective upon issuance.

Transition

.17 Paragraph 92 of SOP 97-2 [section 10,700.92] prohibits retroactive application but encourages early application as of the beginning of a fiscal year or interim period for which financial statements or interim information have not been issued. AcSEC believes that permitting entities that may have adopted the SOP early to restate previously issued financial statements or information to reflect simultaneous adoption of SOP 97-2 [section 10,700] and this SOP will improve comparability among reporting entities. AcSEC believes that very few, if any, entities will be affected by the retroactive restatement provisions of this SOP.

.18

Appendix

Response to Comments Received

A.1. On February 11, 1998, AcSEC issued an exposure draft of a proposed Statement of Position (SOP), *Deferral of the Effective Date of Certain Provisions of SOP 97-2*, Software Revenue Recognition, *for Certain Transactions*. The exposure draft proposed deferring the effective date of the provisions of paragraph 10 of SOP 97-2 [section 10,700.10] with respect to what constitutes vendor-specific objective evidence (VSOE) of fair value of the software element in multiple-element arrangements in which—

a. A software element is sold only in combination with postcontract customer support (PCS) or other service element(s) that qualify for separate accounting pursuant to SOP 97-2 [section 10,700], or both.

b. There is VSOE of the fair values of each of the service elements determined pursuant to paragraphs 10, 57, and 65 of SOP 97-2 [section 10,700.10, .57, and .65].

A.2. None of the commentators on that exposure draft objected to deferral of the effective date of paragraph 10 of SOP 97-2 [section 10,700.10] with respect to multiple-element arrangements within the scope proposed in the exposure draft. A significant number of commentators were concerned, however, about the implications of restricting the scope to only certain multiple-element arrangements, and they urged AcSEC to broaden the scope to all multiple-element arrangements.

A.3. As a result of AcSEC's deliberations of the comment letters and examples of arrangements brought to AcSEC's attention, AcSEC—

a. Concluded that, for arrangements for which there is sufficient VSOE of the fair value of each element, even if each element is not sold separately, the basis for deferral of revenue recognition with respect to those elements that otherwise satisfied the criteria for revenue recognition in SOP 97-2 [section 10,700] needs to be reconsidered. Accordingly, AcSEC expanded the deferral to all arrangements discussed in paragraph .04 of this SOP, not just those arrangements described in paragraph A.1. of this SOP.

b. Affirmed the requirement in SOP 97-2 [section 10,700] that any allocation of the fee in a multiple-element arrangement to the various elements should be based on fair values of each element and that such fair values must be supported by VSOE, thus reinforcing the applicability of that requirement to all arrangements.

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Section 10,750

Statement of Position 98-5 Reporting on the Costs of Start-Up Activities

April 3, 1998

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category b of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) provides guidance on the financial reporting of start-up costs and organization costs. It requires costs of start-up activities and organization costs to be expensed as incurred.

The SOP broadly defines start-up activities and provides examples to help entities determine what costs are and are not within the scope of this SOP.

This SOP applies to all nongovernmental entities and, except as stated in the last paragraph, is effective for financial statements for fiscal years beginning after December 15, 1998. Earlier application is encouraged in fiscal years for which annual financial statements previously have not been issued.

Except for certain entities noted in the last paragraph, initial application of this SOP should be reported as the cumulative effect of a change in accounting principle, as described in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*.[*] When adopting this SOP, entities are *not* required to report the pro forma effects of retroactive application.

Entities that report substantially all investments at market value or fair value, issue and redeem shares, units, or ownership interests at net asset value, and have sold their shares, units, or ownership interests to independent third parties before the later of June 30, 1998, or the date that the SOP is issued should adopt the SOP prospectively.

[*] See the Transition section of the Audit and Accounting Guide *Construction Contractors*, for information on FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*, which supersedes APB Opinion No. 20, and is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. [Footnote added, May 2005, to reflect the 2005 conforming changes made to the Audit and Accounting Guide Construction Contractors. Footnote revised, May 2006, to reflect the 2006 conforming changes made to the Audit and Accounting Guide Construction Contractors.]

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Introduction and Background

.01 The Accounting Standards Executive Committee (AcSEC) had on its agenda a series of projects on reporting the costs of activities that are undertaken to create future economic benefits.

.02 The first phase of AcSEC's series of projects resulted in its issuance of Statement of Position (SOP) 93-7, *Reporting on Advertising Costs* (ACC sec. 10,590). It was AcSEC's intention to use SOP 93-7 (ACC sec. 10,590) as a guide in developing guidance for reporting costs of other kinds of activities undertaken to create future economic benefits. This SOP on start-up costs is the next phase.

.03 A review of a number of public-company financial statement disclosures indicates that some entities capitalize start-up costs whereas others expense start-up costs as they are incurred. In addition, entities that capitalize start-up costs use diverse amortization periods. These diverse practices exist within and across industries. AcSEC believes this SOP will significantly reduce these diversities in financial reporting.

.04 AcSEC issued an exposure draft of a proposed SOP, *Reporting on the Costs of Start-Up Activities*, on April 22, 1997. AcSEC received more than eighty comment letters in response to the exposure draft.

Scope

.05 For purposes of this SOP, start-up activities are defined broadly as those one-time activities related to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with a new class of customer[1] or beneficiary, initiating a new process in an existing facility, or commencing some new operation. Start-up activities include activities related to organizing a new entity (commonly referred to as organization costs). This SOP provides guidance on accounting for the costs of start-up activities.

.06 In practice, various terms are used to refer to start-up costs, such as *preopening costs*, *preoperating costs*, *organization costs* and *start-up costs*. For purposes of this SOP, these costs are referred to as start-up costs.

> *Note: As noted in subsequent paragraphs, the accounting for certain costs incurred in conjunction with start-up activities are not covered by this SOP. An entity should not infer that costs outside the scope of this SOP should be capitalized. Such costs should not be capitalized unless they qualify for capitalization under other generally accepted accounting principles.*

.07 For purposes of this SOP, activities related to routine, ongoing efforts to refine, enrich, or otherwise improve upon the qualities of an existing product, service, process,[2] or facility are not start-up activities and are not within the scope of this SOP. In addition, activities related to a merger or acquisition and to ongoing customer acquisition[3] are not start-up activities.

.08 Certain costs that may be incurred in conjunction with start-up activities are not subject to the provisions of this SOP. Such costs should be accounted for in accordance with other existing authoritative accounting literature. For example, the following costs are outside the scope of this SOP:

- Costs of acquiring or constructing long-lived assets and getting them ready for their intended uses (However, the costs of using long-lived assets that are allocated to start-up activities [for example, depreciation of computers] are within the scope of this SOP.)
- Costs of acquiring or producing inventory
- Costs of acquiring intangible assets (However, the costs of using intangible assets that are allocated to start-up activities [for example, amortization of a purchased patent] are within the scope of this SOP.)
- Costs related to internally developed assets (for example, internal-use computer software costs) (However, the costs of using those assets that are allocated to start-up activities are within the scope of this SOP.)
- Costs that are within the scope of Financial Accounting Standards Board (FASB) Statement No. 2, *Accounting for Research and Develop-*

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[1] This SOP does not address the financial reporting of costs incurred related to ongoing customer acquisition, such as policy acquisition costs in Financial Accounting Standards Board (FASB) Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* and loan origination costs in FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. The SOP addresses the more substantive one-time efforts to establish business with an entirely new class of customers (for example, a manufacturer who does all of its business with retailers attempts to sell merchandise directly to the public).

[2] Costs addressed in Emerging Issues Task Force Issue No. 97-13, *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation*, are outside the scope of this SOP.

[3] See footnote 1.

ment Costs, and FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*

- Costs of fund raising incurred by not-for-profit organizations
- Costs of raising capital
- Costs of advertising
- Costs incurred in connection with existing contracts as stated in paragraph 75d of SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (ACC sec. 10,330.75*d*)

.09 Illustrations 1 through 3 in the Appendix [paragraph .44] provide examples of costs that are and are not within the scope of this SOP.

.10 This SOP applies to all nongovernmental entities (including not-for-profit organizations) and it applies to development-stage entities as well as established operating entities.

.11 This SOP amends the following AICPA SOPs and Audit and Accounting Guides that address start-up costs:

a. SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, paragraph 75a (ACC sec. 10,330.75*a*)

b. SOP 88-1, *Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications*, paragraphs 23 and 25 (ACC sec. 10,430.23 and .25)

c. Industry Audit Guide *Audits of Airlines*, paragraphs 3.115 and 3.117

d. Audit and Accounting Guide *Audits of Casinos*, paragraph 2.06

e. Audit and Accounting Guide *Construction Contractors*, paragraph 2.14*a*

f. Audit and Accounting Guide *Audits of Federal Government Contractors*, paragraph 3.09

g. Audit and Accounting Guide *Audits of Investment Companies*, paragraphs 5.14, 8.10, 8.16, 8.17, and appendix K

Conclusions

Accounting for Start-Up Costs

.12 Costs of start-up activities, including organization costs, should be expensed as incurred.

Amendments to Other Guidance

.13 This SOP amends SOP 81-1 (ACC sec. 10,330) by requiring precontract costs that are start-up costs to be expensed as incurred. The following sentence is added to the end of paragraph 75a (ACC sec. 10,330.75*a*):

> Those costs should be expensed as they are incurred if they are within the scope of SOP 98-5, *Reporting on the Costs of Start-Up Activities*.

.14 This SOP amends SOP 88-1 (ACC sec. 10,430) by requiring preoperating costs to be expensed as incurred rather than capitalized. Paragraph 23 (ACC sec. 10,430.23) is amended as follows:

> Preoperating costs related to the integration of new types of aircraft should be expensed as incurred.

In addition, paragraph 25 (ACC sec. 10,430.25) is deleted.

.15 This SOP amends the Industry Audit Guide *Audits of Airlines* by requiring preoperating costs to be expensed as incurred rather than capitalized. Paragraph 3.115 is amended as follows:

> Preoperating costs related to the integration of new types of aircraft should be expensed as incurred.

In addition, paragraph 3.117 is deleted.

.16 This SOP amends the Audit and Accounting Guide *Audits of Casinos* by requiring preopening costs to be expensed as incurred. Paragraph 2.06 is amended to include the following at the end of the first sentence:

> Preopening costs, however, should be charged to expense as incurred.

.17 This SOP amends the Audit and Accounting Guide *Construction Contractors* by requiring precontract costs that are start-up costs to be expensed as incurred. The following sentence is added to the end of paragraph 2.14*a*:

> Those costs should be expensed as they are incurred if they are within the scope of SOP 98-5, *Reporting on the Costs of Start-Up Activities*.

.18 Paragraph 3.09 of the Audit and Accounting Guide *Audits of Federal Government Contractors* refers to paragraph 75 of SOP 81-1 (ACC sec. 10,330.75) as the applicable guidance for accounting for precontract costs. This SOP amends paragraph 3.09 of the Guide as follows:

> Precontract costs should be accounted for in conformity with paragraph 75 of SOP 81-1, as amended by SOP 98-5, *Reporting on the Costs of Start-Up Activities*.

.19 This SOP amends the Audit and Accounting Guide *Audits of Investment Companies* by requiring organization costs to be expensed as they are incurred. The last two sentences of paragraph 8.10 are deleted and replaced by the following:

> Organization costs should be expensed as they are incurred. Entities should adopt the transition provisions of paragraphs 22 and 23 of SOP 98-5, *Reporting on the Costs of Start-Up Activities*.

In addition, paragraphs 8.16 and 8.17 are deleted, and the following footnote is added after the words *deferred organization expense* in paragraph 5.14 and in the Statement of Assets and Liabilities in Appendix K (SOP 93-4, *Foreign Currency Accounting and Financial Statement Presentation for Investment Companies* [ACC sec. 10,570]).

> Organization costs should be expensed as they are incurred. Entities should adopt the transition provisions of paragraphs 22 and 23 of SOP 98-5, *Reporting on the Costs of Start-Up Activities*.

.20 The following sentence is added to the accounting policies footnote for organization costs in the illustrative financial statements in paragraph 9.10 of the Audit and Accounting Guide *Guide for Prospective Financial Information*:

> (Note: SOP 98-5, *Reporting on the Costs of Start-Up Activities*, requires that organization costs be expensed as they are incurred.)

Effective Date and Transition

.21 Except for certain entities noted in paragraph .23, this SOP is effective for financial statements for fiscal years beginning after December 15, 1998. Earlier application is encouraged in fiscal years for which annual financial statements have not been issued. Restatement of previously issued financial statements is not permitted.

.22 Except for certain entities noted in paragraph .23, initial application of this SOP should be reported as the cumulative effect of a change in accounting principle, as described in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*.* When adopting this SOP, entities are *not* required to report the pro forma effects of retroactive application. Entities are required to disclose the effect of adopting this SOP on income before extraordinary items and on net income (and on the related per share amounts) in the period of the change.

.23 Entities that meet all of the following conditions should not report the effect of initial application of this SOP as a cumulative effect of a change in accounting principle: (*a*) the entities' specialized accounting practices include accounting for substantially all investments at market value or fair value; (*b*) the entities' shares, units, or ownership interests are issued and redeemed at net asset value; and (*c*) the entities' shares, units, or ownership interests are sold to independent third parties (for example, parties other than founders, sponsors, and investment advisors) before the later of June 30, 1998, or the date that the SOP is issued. Capitalized costs incurred by these entities prior to initial application of this SOP should not be adjusted to the amounts that would have been expensed as incurred had this SOP been in effect when those costs were incurred. These entities should apply the SOP prospectively for all costs of start-up activities and organization costs incurred at the later of June 30, 1998, or the date that the SOP is issued. For these entities, costs previously deferred that continue to be reported as assets should continue to be amortized over the remaining life of the original amortization period used by the entity, or a shorter period if the expected period of benefit is reduced. The unamortized balance of deferred start-up costs or organization costs and the remaining amortization period should be disclosed.

.24 Except for those entities noted in paragraph .23, initial application of this SOP should be as of the beginning of the fiscal year in which the SOP is first adopted.

The provisions of this Statement need not be applied to immaterial items.

Basis for Conclusions

Scope

.25 AcSEC based its broad definition of start-up activities on the definition used in the 1973 FASB Discussion Memorandum (DM), *Accounting for Research and Development Costs*. That DM defines start-up costs as "those unusual one-time costs incurred in putting a new plant into operation, opening a new sales outlet, initiating a new process in an existing plant, or otherwise commencing some new operation."

* See footnote * in the Summary.

.26 Some respondents to the exposure draft indicated that the definition of start-up activities is imprecise and leads to confusion about what differentiates start-up costs from certain other costs, such as costs incurred to get a long-lived asset ready for its intended use.

.27 AcSEC believes it is not possible to develop a detailed, all-inclusive definition of start-up activities and start-up costs. AcSEC believes the broad definition of start-up activities together with the identification of certain costs that are not start-up costs and the examples provided in the Appendix [paragraph .44] help the reader understand the kinds of activities and costs that may be involved in a start-up situation. Regardless, AcSEC believes that costs previously capitalized as either start-up costs or organization costs should now be expensed as they are incurred.

.28 AcSEC understands that entities may engage in start-up activities to generate revenue or increase efficiencies; AcSEC believes that it is unnecessary to distinguish between the objectives for undertaking start-up activities for purposes of this SOP.

.29 AcSEC recognizes that some entities use the terms *start-up*, *preopening*, *preoperating*, and *organization* interchangeably and that these terms are used inconsistently in practice. AcSEC believes that it is unnecessary to define the terms individually for purposes of this SOP.

.30 AcSEC also recognizes that some entities differentiate between preopening/preoperating costs and start-up costs as follows:

a. Preopening/preoperating costs are incurred before the commencement of operations or production.

b. Start-up costs are incurred after operations have begun, but before normal productive capacity is reached.

AcSEC believes that this distinction is not made consistently in practice. AcSEC also believes that the guidance in this SOP should be followed regardless of the terms used to describe the activities included in the scope.

.31 AcSEC decided that it was not necessary to develop boundaries for when the start-up period begins and ends. The definition of start-up activities is based on the nature of the activities and not the time period in which they occur. AcSEC believes that costs previously capitalized by entities as start-up costs will be expensed as incurred as start-up costs or some other costs, such as general and administrative.

.32 It is not uncommon for start-up activities to occur simultaneously with other activities, such as the acquisition or development of assets. Paragraph .08 provides examples of costs excluded from the scope of this SOP. AcSEC did not attempt to provide an all-inclusive detailed list of such costs because entities have different accounting policies for the kinds of costs capitalized under existing generally accepted accounting principles (for example, property, plant, and equipment). AcSEC believes entities are best capable of identifying those costs.

.33 This SOP applies to start-up activities of development stage entities as well as established operating entities, as those terms are discussed in FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*. Paragraph 10 of FASB Statement No. 7 states, "Generally accepted accounting principles that apply to established operating enterprises shall govern the recognition of revenue by a development stage enterprise and shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred." This SOP sets forth the generally accepted accounting principles for costs of start-up activities and thus applies to both kinds of entities.

.34 A majority of respondents to the exposure draft did not address issues related to organization costs. The majority of those who did address these issues believes that organization costs should not be included in the scope of the SOP. One reason proposed to exclude organization costs from the scope of this SOP was to avoid unnecessary bookkeeping resulting from book/tax differences. AcSEC concluded that organization costs are similar to start-up costs and that it could not justify excluding organization costs from the scope of the SOP. Further, if organization costs were excluded from the scope of the SOP, AcSEC believes that it would have needed to define organization costs to help entities distinguish between start-up and organization costs. AcSEC's definition of organization costs would have been narrower than that contained in the Internal Revenue Code. Therefore, AcSEC concluded that temporary tax differences would result for some entities whether AcSEC included or excluded organization costs from the scope of the document.

Accounting for Start-Up Costs

.35 About half of the respondents to the exposure draft believe that start-up costs should be reported as assets. AcSEC considered requiring capitalization and amortization of the costs of start-up activities, including organization costs. AcSEC believes that entities incur costs related to start-up and organization activities with an expectation that there will be future benefits. However, AcSEC believes that this is also often the case with other costs, such as costs related to research and development activities.

.36 Paragraph 86 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, states, "Consumption of economic benefits during a period may be recognized either directly or by relating it to revenues recognized during the period: . . . " Paragraph 148 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, states, "Other costs are also recognized as expenses in the period in which they are incurred because the period to which they otherwise relate is indeterminable or not worth the effort to determine."

.37 Some AcSEC members believe that start-up costs may meet the definition of an asset. However, they note that some items that meet the definition of an asset are not recognized as assets because of uncertainty. Paragraph 175 of FASB Concepts Statement No. 6 states, "... business enterprises engage in research and development activities, advertise, develop markets, open new branches or divisions, and the like, and spend significant funds to do so. The uncertainty is not about the intent to increase future economic benefits but about whether and, if so, to what extent they succeeded in doing so. Certain expenditures for research and development, advertising, training, start-up and preoperating activities, development stage enterprises, relocation or rearrangement, and goodwill are examples of the kinds of items for which assessments of future economic benefits may be especially uncertain."

.38 Paragraph 24 of APB Opinion 17[†] states, "Costs of developing, maintaining, or restoring intangible assets which are not specifically identifiable,

[†] APB Opinion No. 17, *Intangible Assets*, was superseded by FASB Statement No. 142, *Goodwill and Other Intangible Assets*. [Footnote added, February 2008, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole—such as goodwill—should be deducted from income when incurred." Start-up costs as defined in this SOP meet all three conditions: they are not specifically identifiable, have indeterminate lives, and are inherent in a continuing business and related to an enterprise as a whole.

.39 AcSEC decided that the SOP should not amend paragraph 75d of SOP 81-1 (ACC sec. 10,330.75*d*). AcSEC believes that start-up costs incurred in connection with existing contracts are contract costs related to a specific source of revenue that should be subject to the accounting prescribed in SOP 81-1 (ACC sec. 10,330). Further, AcSEC decided that start-up costs incurred in connection with existing contracts *and* in anticipation of follow-on or future contracts for the same goods and services should also be accounted for as contract costs within the existing contract because those costs are expected to be recovered. AcSEC also believes that it is impracticable to bifurcate incremental learning curve or start-up costs that may be incurred under existing contracts in anticipation of follow-on or future contracts.

Disclosure and Transition

.40 AcSEC considered requiring entities to disclose start-up costs incurred in an accounting period and total start-up costs expected to be incurred over the life of a project. AcSEC decided that, for many entities, the costs of recordkeeping to identify separately start-up costs incurred in an accounting period likely would outweigh the related benefits of disclosing those costs to users of financial statements. AcSEC also believes that it cannot provide an all-inclusive definition of start-up costs, which would ensure comparability between entities. In addition, AcSEC believes that, if an entity discloses total start-up costs expected to be incurred, it is likely to do so outside the financial statements (for example, in Management's Discussion and Analysis for a public company).

.41 Some entities currently report certain costs, such as depreciation incurred in conjunction with start-up activities, as start-up costs. Other entities currently report those costs under captions such as "depreciation." This SOP does not require entities to report those costs as start-up costs.

.42 AcSEC decided that entities that report substantially all investments at market value or fair value, issue and redeem shares, units, or ownership interests at net asset value, and have sold their shares, units, or ownership interests to independent third parties before the later of June 30, 1998, or the date that the SOP is issued should adopt the SOP prospectively. Examples of such entities include open-end mutual funds, regardless of their load features, because open-end mutual funds issue and redeem shares at net asset value (however, closed-end funds would not be examples because those funds may trade at a premium or discount in relation to net asset value). Before operations begin, these entities often incur start-up or organization costs. The expectation is that all shareholders will bear the costs as amortization gradually decreases asset value. Alternatively, the sponsors could pay the start-up or organization costs and get reimbursed through fees charged to the entity that would be borne by the shareholders. AcSEC believes that existing shareholders would experience negative economic consequences if previously capitalized costs were required to be expensed immediately, thereby causing an immediate decrease in net asset value per share. AcSEC believes that it has made a practical decision to ensure that the adoption of the SOP does not cause economic harm to existing shareholders in entities that report substantially all investments at market value or fair value and issue and redeem shares, units, or ownership interests at net asset value.

Other Authoritative Literature

.43 AcSEC considered the following other authoritative literature in its deliberations of financial reporting of start-up costs. However, the guidance in the following literature is *not* affected by the provisions of this SOP: (*a*) FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, and the related AICPA Audit and Accounting Guide *Audits of Entities With Oil and Gas Producing Activities*; (*b*) FASB Statement No. 34, *Capitalization of Interest Cost*; (*c*) FASB Statement No. 50, *Financial Reporting in the Record and Music Industry*; (*d*) FASB Statement No. 51, *Financial Reporting by Cable Television Companies*; (*e*) FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*; (*f*) FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*; (*g*) FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*; and (*h*) FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

.44

Appendix

Illustrations

The Illustrations provide examples that should not be interpreted to be all-inclusive. Accounting for certain costs incurred in conjunction with start-up activities are not covered by this SOP. An entity should not infer that costs outside the scope of this SOP should be capitalized. Such costs should not be capitalized unless they qualify for capitalization under other generally accepted accounting principles.

Illustration 1

Scenario—A major U.S. beverage company (the Company) begins construction of a new plant in China. This represents the Company's initial entry into the Chinese market. As part of the overall strategy, the Company plans to introduce into China, on a locally produced basis, the Company's major U.S. beverage brands. Following are some of the costs that might be incurred in conjunction with start-up activities that are subject to the provisions of this SOP:

- Travel costs, employee salary-related costs, and consulting costs related to feasibility studies, accounting, legal, tax, and governmental affairs
- Training of local employees related to production, maintenance, computer systems, engineering, finance, and operations
- Recruiting, organization, and training related to establishing a distribution network
- Nonrecurring operating losses
- Depreciation, if any, of new computer data terminals and other communication devices

The following costs incurred in conjunction with start-up activities are outside the scope of this SOP (as noted in paragraphs .07 and .08):

- Costs of long-lived asset additions, such as the new plant, production equipment, and packaging lines
- Internal-use computer software systems development costs
- Costs that are capitalizable as inventory
- Deferred financing costs

Illustration 2

Scenario—A retail chain is constructing and opening two new stores. One will open in a territory in which the entity already has three stores operating. The other will open in a territory new to the entity. (Costs related to both openings are treated the same for purposes of this SOP.) All of the stores provide the same products and services. Following are some of the costs that might be incurred in conjunction with start-up activities that are subject to the provisions of this SOP:

- Salary-related expenses for new employees
- Salary-related expenses for the management store opening team
- Training costs and meals for newly hired employees
- Hotel charges, meals, and transportation for the opening team
- Security, property taxes, insurance, and utilities costs incurred after construction is completed
- Depreciation, if any, of new computer data terminals and other communication devices
- Nonrecurring operating losses

The following costs incurred in conjunction with start-up activities are outside the scope of this SOP (as noted in paragraphs .07 and .08):

- Store advertising costs
- Coupon giveaways
- Costs of uniforms
- Costs of furniture and cash registers
- Costs to obtain licenses, if any
- Security, property taxes, insurance, and utilities costs related to construction activities
- Deferred financing costs

Illustration 3

Scenario—A not-for-profit organization that has provided meals to the homeless is opening a shelter to house the homeless. The organization will rent the facility. This will be the organization's first shelter and it will conduct a fund-raising campaign to raise money to start up the shelter. The organization will lease space for the shelter and will incur capital expenditures for leasehold improvements and furniture. The organization expects that it will require three months to set up the space for the shelter. The organization will hire a security firm to secure the premises during the three-month period in which the shelter is built. Following are some of the costs that might be incurred in conjunction with start-up activities that are subject to the provisions of this SOP:

- Employee salary-related costs related to needs and feasibility studies
- Staff recruiting and training
- Rent, security, insurance, and utilities
- Consultant fees for developing policies and procedures for operating the shelter
- Amortization and depreciation, if any, of leasehold improvements and furniture
- Costs of social workers

The following costs incurred in conjunction with start-up activities are outside the scope of this SOP (as noted in paragraphs .07 and .08):

- Costs of fund-raising
- Costs of leasehold improvements and furniture
- Architect fees for the leasehold improvements
- Advertising costs to publicize the shelter

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The task force and staff gratefully acknowledge the contributions made to the development of this Statement of Position by Kevin G. Varty.

[The next page is 80,545.]

Section 10,760

Statement of Position 98-7 Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk

October 19, 1998

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the area of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. It applies to all entities and all insurance and reinsurance contracts that do not transfer insurance risk, except for long-duration life and health insurance contracts. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to in this SOP as deposit accounting. The SOP does not address when deposit accounting should be applied.

This SOP specifies the following.

- Insurance and reinsurance contracts for which the deposit method is appropriate should be classified as one of the following, which are those that—
  - — Transfer only significant timing risk.
  - — Transfer only significant underwriting risk.
  - — Transfer neither significant timing nor underwriting risk.
  - — Have an indeterminate risk.

- At inception, a deposit asset or liability should be recognized for insurance and reinsurance contracts accounted for under deposit accounting and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract.
- Insurance and reinsurance contracts that transfer neither significant timing nor underwriting risk, and insurance and reinsurance contracts that transfer only significant timing risk, should be accounted for using the interest method. Changes in estimates of the timing or amounts of recoveries should be accounted for by recalculating the effective yield. The asset or liability should then be adjusted to the amount that would have existed had the new effective yield been applied since the inception of the contract. The revenue and expense recorded for such contracts shall be included in interest income or interest expense.
- Insurance or reinsurance contracts that transfer only significant underwriting risk should be accounted for by measuring the deposit based on the unexpired portion of the coverage provided until losses are incurred that will be reimbursed under the contracts. Once a loss is incurred that will be reimbursed under this kind of contract, then the deposit should be measured by the present value of the expected future cash flows arising from the contract, plus the remaining unexpired portion of the coverage provided. Changes in the recorded amount of the deposit, other than the unexpired portion of the coverage provided, should be included in the income statement of the insured as an offset against the loss recorded by the insured that will be reimbursed under the contract and in an insurer's income statement as an incurred loss. The reduction in the deposit related to the unexpired portion of the coverage provided should be recorded by the insured and the insurer who are insurance enterprises as an adjustment to incurred losses. If the insured is an enterprise other than an insurance enterprise, then the reduction in the deposit related to the unexpired portion of the coverage provided should be recorded as an expense.
- For insurance and reinsurance contracts with indeterminate risk, the guidance in SOP 92-5, *Accounting for Foreign Property and Liability Reinsurance* [section 10,520] as to the open-year method, should be followed. The open-year method should not, however, be used to defer losses that otherwise would be recognized pursuant to Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. Under the open-year method, the effects of the contracts are not included in the determination of net income until sufficient information becomes available to reasonably estimate and allocate premiums. The open-year method requires that these effects be aggregated in the balance sheet. When sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified into one of the other three categories as an insurance or reinsurance contract that transfers neither significant timing nor underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly.

This SOP is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier adoption encouraged. Restatement of previously issued annual financial statements is not permitted. Initial application of this SOP is as of the beginning of an entity's fiscal year (that is, if the SOP were adopted before the effective date and during an interim period, all prior interim periods are required to be restated). The effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle, in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Introduction

.01 "Insurance provides indemnification against loss or liability from specified events and circumstances that may occur or be discovered during a specified period. In exchange for a payment from the policyholder (a premium), an insurance enterprise agrees to pay the policyholder if specified events occur or are discovered. Similarly, the insurance enterprise may obtain indemnification against claims associated with contracts it has written by entering into a reinsurance contract with another enterprise."[1] Insurance and reinsurance contracts may be structured in various ways. The premium paid by the policyholder may represent a payment for the transfer of **insurance risk** or it may represent a deposit.[2]

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[1] The source is paragraph 1 of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*.

[2] Terms defined in the Glossary [paragraph .39] are set in boldface the first time they appear in this SOP.

.02 Paragraph 44 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, states the following, in part.

> To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or ceding company.

.03 FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* established certain conditions for determining whether a reinsurance contract indemnifies against loss or liability relating to insurance risk. Although existing accounting literature does not provide similar criteria to evaluate whether an insurance contract indemnifies against loss or liability, generally accepted accounting principles (GAAP) require a determination of whether insurance risk has been transferred (as discussed in paragraph .02 above). This SOP neither addresses *when* deposit accounting should be applied nor provides criteria to make this determination. Such guidance is provided on a case-by-case basis in the applicable pronouncements.

.04 As stated above, FASB Statement Nos. 5 and 113 and Emerging Issues Task Force (EITF) Issue Nos. 93-14, *Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises*, and 93-6, *Accounting for Multiple-Year Retrospectively Rated Reinsurance Contracts by Ceding and Assuming Enterprises*, each require that the deposit method of accounting be applied when parties enter into insurance or reinsurance contracts that do not transfer insurance risk. Nevertheless, the existing accounting pronouncements do not describe what is meant by deposit accounting in those circumstances or how it should be applied.

.05 The consensus decisions in FASB EITF Issue Nos. 93-14 and 93-6 provide further guidance on when deposit accounting should be applied to reinsurance and insurance contracts.

Applicability and Scope

.06 This SOP provides guidance on how to apply the deposit method of accounting when it is required for insurance and reinsurance contracts that do not transfer insurance risk. These contracts may be prospective or retroactive in nature. This SOP applies to all entities that have entered into the following kinds of insurance and reinsurance contracts:

a. Short-duration insurance and reinsurance contracts that do not transfer insurance risk as described in paragraph 44 of FASB Statement No. 5 and, for reinsurance contracts, as described in paragraphs 8 through 11 and 18(a) of FASB Statement No. 113 and EITF Issue No. 93-6.

b. Multiple-year insurance and reinsurance contracts that do not transfer insurance risk or for which insurance risk transfer is not determinable. (EITF Issue Nos. 93-14 and 93-6 prescribe the deposit method of accounting for multiple-year retrospectively rated insurance and reinsurance contracts, respectively, that do not transfer insurance risk.)

However, 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*, and FASB Statement No. 113 explicitly provide that long-duration life and health insurance contracts that do not indemnify against mortality or morbidity risk should be accounted for as investment contracts as defined and described in FASB Statement No. 97. Therefore, such contracts are not covered by this SOP.

.07 This SOP does not address or change existing requirements as to when deposit accounting should be applied. Appendix A [paragraph .37], "Illustrations of Application of Conclusions," herein, provides examples that illustrate the application of certain provisions of this SOP. The illustrations are intended as examples only; it should not be construed that any aspect of the illustrations establishes or changes requirements as to when deposit accounting should be applied. The conclusions in this SOP apply to both the insured and the insurer in an insurance contract. The conclusions in this SOP also apply to the **ceding** and **assuming entity** in a reinsurance contract.

Kinds of Contracts

.08 The transfer of insurance risk requires transferring both **timing risk** and **underwriting risk**. Therefore, four possible categories for deposit arrangements have been identified as follows.

a. *An insurance or reinsurance contract that transfers only significant timing risk*. For an insurance or reinsurance contract to be considered to have transferred significant timing risk, the timing of the loss reimbursement under the contract must be based on the timing of the loss event.[3] An insurance or reinsurance contract that transfers only significant timing risk limits the amount of underwriting risk to which the insurer or reinsurer is subject and is commonly entered into by the insured or ceding entity to provide liquidity. These limitations may result in an insufficient transfer of insurance risk. For example, insurance and reinsurance contracts that provide for **experience adjustments** may indicate that a sufficient amount of underwriting risk has not been transferred. The recovery of the amount of the initial deposit for a contract that transfers only significant timing risk is not substantially dependent on future loss experience of the insured.

b. *An insurance or reinsurance contract that transfers only significant underwriting risk*. For an insurance or reinsurance contract to be considered to have transferred significant underwriting risk, the probability of a significant variation in the amount of payments under the insurance or reinsurance contract must be more than remote. Such variation must also result from variation in the insured's losses, and it must be at least reasonably possible that the insurer will realize a significant loss from the transaction. An insurance or reinsurance contract that transfers only significant underwriting risk may be entered into to lessen the overall economic risks

[3] With respect to insurance contracts, the timing of the loss reimbursement under the contract would be based on the timing of the payment with respect to the loss event. For reinsurance contracts, the timing of the loss reimbursement under the contract would be based on the timing of payment by the insured (reinsured) of the underlying loss, as well as when recovery is expected from the reinsurer.

associated with the contract and permit a greater amount of coverage than would otherwise be obtainable for a comparable premium. Features in insurance or reinsurance contracts that transfer only significant underwriting risk limit the uncertainties about the timing of the receipt and payment of cash flow, thus, limiting the amount of timing risk assumed by the insurer. A delayed reimbursement of losses by the insurer is a possible indication that timing risk has not been transferred.[4] Unlike insurance and reinsurance contracts that transfer only significant timing risk, the recovery of the amount of the initial deposit for an insurance or reinsurance contract that transfers only significant underwriting risk is substantially dependent on the future loss experience of the insured. Depending on such experience, the initial deposit may be recovered or the recovery may be significantly more or less than the original deposit.

c. *An insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk.* Insurance and reinsurance contracts that transfer neither significant timing nor significant underwriting risk are expected to be rare.

d. *An insurance or reinsurance contract with an indeterminate risk.* These insurance and reinsurance contracts have uncertain terms, or there is insufficient information to reasonably estimate and allocate premiums in proportion to the protection provided. For example, certain insurance and reinsurance contracts allow the insured to obtain some degree of coverage for multiple years without exposing the insurer to a defined level of insurance risk each year. Uncertainties surrounding these insurance and reinsurance contracts are analogous to those often associated with foreign property and liability reinsurance as addressed in SOP 92-5 [section 10,520].

For short-duration reinsurance contracts, FASB Statement No. 113 requires that two conditions be met in order to account for that contract as reinsurance. The first condition is that the contract must transfer significant insurance risk to the reinsurer. The second condition is that the contract must subject the reinsurer to the reasonable possibility of realizing a significant loss from the transaction, unless substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. If a short-duration reinsurance contract does not meet the second condition but transfers significant insurance risk, then the accounting for contracts that transfer only significant underwriting risk should be followed (see paragraphs .13 through .15 in this SOP).

Conclusions

Initial Measurement

.09 At inception, a deposit asset or liability should be recognized for insurance and reinsurance contracts accounted for under deposit accounting

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[4] FASB Statement No. 113, paragraph 9, states, in part, "A reinsurer shall not be considered to have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. Contractual provisions that delay timely reimbursement to the ceding enterprise would prevent this condition from being met."

and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. Accounting for such fees should be based on the terms of the contract. Deposit assets and liabilities should be reported on a gross basis, unless the right of offset exists as defined in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*. The accounting by the insured and insurer are symmetrical, except as noted in paragraph .15 of this SOP.

Subsequent Measurement

Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk and Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Underwriting Risk

.10 For insurance and reinsurance contracts that transfer only significant timing risk or that transfer neither significant timing nor significant underwriting risk, the amount of the deposit asset or liability should be adjusted at subsequent reporting dates by calculating the effective yield on the deposit to reflect actual payments to date and expected future payments (as discussed in paragraph .11 below), with a corresponding credit or charge to interest income or expense. This approach is consistent with the interest method described in Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.*

.11 The calculation of the effective yield should use the estimated amount and timing of cash flows. Consistent with paragraph 19 of FASB Statement No. 91, if a change in the actual or estimated timing or amount of cash flows occurs, the effective yield should be recalculated to reflect the revised actual or estimated cash flows. The deposit should be adjusted to the amount that would have existed at the balance-sheet date had the new effective yield been applied since the inception of the insurance or reinsurance contract. Changes in the carrying amount of the deposit should be reported as interest income or interest expense.

.12 Significant changes in the expected amounts of aggregate cash flows are expected to occur infrequently because of the nature of these kinds of contracts. Should a significant change occur in the total amount of actual or estimated cash flows, the enterprise should determine whether the change indicates that the contract does include significant underwriting risk and therefore should be converted to the accounting for contracts that transfer only significant underwriting risk. (See paragraphs .13 through .15 for the accounting guidance for insurance and reinsurance contracts that transfer only significant underwriting risk.) In addition, a contract that transfers only significant timing risk, which subsequently is determined also to transfer significant underwriting risk, cannot be accounted for under insurance or reinsurance accounting when the revised determination is made.

Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk

.13 Until such time as a loss is incurred that will be reimbursed under an insurance or reinsurance contract that transfers only significant underwriting risk, the deposit should be measured based on the unexpired portion of the coverage provided. Once a loss is incurred that will be reimbursed under such a contract, then the deposit should be measured by the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the coverage provided.

.14 Changes in the recorded amount of the deposit, other than the unexpired portion of the coverage provided, arising from an insurance or reinsurance contract that transfers only significant underwriting risk should be recorded in an insured's income statement as an offset against the loss recorded by the insured that will be reimbursed under the insurance or reinsurance contract and in an insurer's income statement as an incurred loss. Insurance enterprises should record the reduction in the deposit related to the unexpired portion of the coverage provided as an adjustment to incurred losses. Insurance enterprises should disclose the amounts related to those deposit contracts that are reported in incurred losses in their statement of earnings. (See paragraph .19.) If the insured is an enterprise other than an insurance enterprise, the reduction in the deposit related to the unexpired portion of the coverage provided should be recorded as an expense.

.15 For the insured or ceding enterprise, the discount rate used to determine the deposit asset should be the current rate on United States government obligations with similar cash-flow characteristics, adjusted for default risk. Consideration of the default risk, if any, should be based on the assessment of the creditworthiness of the insurer. For the insurer or assuming enterprise, the discount rate used to determine the deposit liability should be the current rate on United States government obligations with similar cash-flow characteristics. These rates should be established at the date of each loss incurred and used for the remaining life of the contract and should not be changed. If numerous losses occur, the use of average rates is permitted because establishing individual rates might require detailed recordkeeping and computations that could be burdensome and unnecessary to produce reasonable approximations of the results.

Insurance and Reinsurance Contracts With Indeterminate Risk

.16 Uncertainties surrounding insurance and reinsurance contracts with indeterminate risk are analogous to those often associated with foreign property and liability reinsurance as addressed in SOP 92-5 [section 10,520]. As a result, the guidance in SOP 92-5 [section 10,520], regarding the open-year method, should be followed. The open-year method should not, however, be used to defer losses that otherwise would be recognized pursuant to FASB Statement No. 5.

.17 Under the open-year method, the effects of the contracts are not included in the determination of net income until sufficient information becomes available to reasonably estimate and allocate premiums. The open-year method requires that these effects be aggregated in the balance sheet. If sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified into one of the three categories as an insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly. The change in deposit assets or liabilities that result if sufficient information becomes available is treated as a change in accounting estimate in accordance with APB Opinion 20, *Accounting Changes.*

Disclosures

.18 Entities should disclose a description of the contracts accounted for as deposits and the separate amounts of total deposit assets and total deposit liabilities reported in the statement of financial position.

.19 Insurance enterprises should disclose the following information regarding the changes in the recorded amount of the deposit arising from an insurance or reinsurance contract that transfers only significant underwriting risk:

a. The present values of initial expected recoveries that will be reimbursed under the insurance or reinsurance contracts that have been recorded as an adjustment to incurred losses

b. Any adjustment of amounts initially recognized for expected recoveries (The individual components of the adjustment (meaning, interest accrual, the present value of additional expected recoveries, and the present value of reductions in expected recoveries) should be disclosed separately.)

c. The amortization expense attributable to the expiration of coverage provided under the contract

Effective Date and Transition

.20 This SOP is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier adoption encouraged. Previously issued annual financial statements should not be restated. The initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date and during an interim period, all prior interim periods should be restated). The effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle (in accordance with the provisions of APB Opinion 20).

The provisions of this Statement need not be applied to immaterial items.

Basis for Conclusions

.21 Because of questions raised about the application of the deposit method of accounting to insurance and reinsurance contracts that do not indemnify against loss or liability and the scarcity of guidance concerning the accounting for such contracts, AcSEC believes that guidance is needed for all entities that enter into insurance and reinsurance contracts that are to be accounted for as deposits under FASB Statement Nos. 5, 60, and 113 and EITF Issue Nos. 93-6 and 93-14. Long-duration life and health insurance and reinsurance contracts that do not indemnify against mortality and morbidity risk are not covered under this SOP because FASB Statement Nos. 97 and 113 provide sufficient guidance on accounting for these kinds of insurance and reinsurance contracts.

.22 Paragraph 44 of FASB Statement No. 5 states the following.

> To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium paid

> less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or ceding company. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding company is a deposit, it shall be accounted for as such.[5]

That guidance also is incorporated in paragraph 18(a) of FASB Statement No.113.

.23 The consensus in EITF Issue No. 93-6 states, the following, in part.

> The Task Force reached a consensus that in order to be accounted for as reinsurance, a contract that reinsures risk arising from short-duration insurance contracts must meet all of the following conditions: (1) the contract must qualify as a short-duration contract under paragraph 7(a) of Statement 60, (2) the contract must not contain features that prevent the risk transfer criteria in paragraphs 8 through 13 of Statement 113 from being reasonably applied (and those criteria must be met), and (3) the ultimate premium expected to be paid or received under the contract must be reasonably estimable and allocable in proportion to the reinsurance protection provided as required by paragraph 14(a) and (b) of Statement 60 and paragraph 21 of Statement 113. If any of these conditions are not met, a deposit method of accounting should be applied by the ceding and assuming enterprises.

The consensus in EITF No. 93-14 states, the following, in part.

> The Task Force reached a consensus that in order to be accounted for as insurance, an insurance contract must indemnify the insured as required by paragraph 44 of Statement 5. For those contracts that do not provide indemnification, the premium paid, less the amount of the premium to be retained by the insurer, should be accounted for as a deposit by the insured.

Initial Measurement

.24 This SOP states that, at inception, insurance and reinsurance contracts accounted for under deposit accounting should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. The provisions of paragraph 44 of FASB Statement No. 5 and paragraph 18a of FASB Statement No. 113 state that "for those contracts that do not provide indemnification, the premium paid, less the amount of the premium to be retained by the insurer, should be accounted for as a deposit by the insured." AcSEC believes that it may be difficult, if not impossible, to reasonably determine the amount of the premium to be retained by the insurer when initially measuring the deposit unless it is explicitly identified in the contract because the implicit rate of interest in the contract reflects a combination of considerations including prevailing market rates, uncertainty regarding amounts and timing of cash flows, as well as ranges of possible margins that may be retained by the insurer. The accounting provided in this SOP is similar to accounting for prepaid insurance.

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[5] FASB Statement No. 113 amended FASB Statement No. 5 to include the following footnote at the end of paragraph 44: "Paragraphs 8 to 13 of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, identify conditions that are required for a reinsurance contract to indemnify the ceding enterprise against loss or liability and to be accounted for as reinsurance. Any transaction between enterprises to which FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, applies must meet those conditions to be accounted for as reinsurance."

Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk and Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Significant Underwriting Risk

.25 AcSEC concluded that the revenue and expense associated with insurance and reinsurance contracts that transfer only significant timing risk, and with insurance and reinsurance contracts that transfer neither significant timing nor significant underwriting risk are attributable primarily to the time value of money. Accordingly, AcSEC concluded that the interest method described in FASB Statement No. 91 is the appropriate model to apply to these kinds of insurance and reinsurance contracts. AcSEC also concluded that changes in actual or estimates of timing and, where applicable, the amount of cash flows under such insurance and reinsurance contracts should be accounted for consistent with paragraph 19 of FASB Statement No. 91 by recalculating the effective yield for the entire contract.

Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk

.26 This SOP requires that deposits under insurance and reinsurance contracts that transfer only significant underwriting risk be measured based on the unexpired portion of the coverage provided until such time as a loss is incurred that will be reimbursed under the contract. Once a loss is incurred that will be reimbursed under the insurance or reinsurance contract that transfers only significant underwriting risk, the deposit is to be measured by the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the original deposit for the coverage provided.

.27 AcSEC considered a variety of discount rates and concluded that the deposit should be measured by the present value of expected future cash flows discounted at the current risk-free rate available in the market, adjusted for default risk associated with the insurer's creditworthiness in the case of a deposit asset. AcSEC also discussed whether this rate should continue to be used in subsequent periods (often referred to as the *lock-in concept*) or whether the rate should change throughout the remaining life of the contract. AcSEC concluded that the rate should be established at the date of each loss incurred and used until the expected cash flows associated with the loss are collected. AcSEC believes that changes that occur are only changes in the estimate of cash flows and, therefore, the rate should not change. In those circumstances in which there is more than one loss, there will be different rates for each of the loss occurrences. If numerous losses occur, establishing these rates might require detailed recordkeeping and computations that could be burdensome as well as unnecessary to produce reasonable approximations of the results. Therefore, the use of average rates is permitted.

.28 For insurance and reinsurance contracts that transfer insurance risk (meaning contracts that transfer both underwriting and timing risk), the purchaser (who is in a comparable position to the insured or ceding entity) pays a fixed or determinable amount and receives a right to an uncertain future return. Estimated recoveries under such contracts generally are recorded at undiscounted amounts. For insurance and reinsurance contracts that transfer only significant underwriting risk, the deposit is measured by the present value of the expected future cash flows. AcSEC believes that this difference in measurement—between insurance and reinsurance contracts that transfer insurance risk and those that transfer only significant underwriting risk—appropriately reflects the dissimilarities in these contracts, principally the failure of contracts that transfer only significant underwriting risk to match the timing of the recoveries to the timing of the payments of the loss.

.29 When an asset or liability is measured by discounting expected future cash flows, the present value of such asset or liability will increase from one reporting period to the next as a result of the passage of time (assuming that the actual or expected timing and amount of cash flows remain constant). Nevertheless, the present value of a deposit under an insurance or reinsurance contract that transfers only significant underwriting risk may change from one reporting period to the next as a result of not only the passage of time but also the changes in actual or estimated timing and amount of cash flows.

.30 AcSEC considered whether the change in the present value of the cash flows should be recognized entirely as interest related, entirely as underwriting related (offsetting the recorded loss under the insurance or reinsurance contract), or partly as interest related and partly underwriting related. AcSEC concluded that the entire change should be recognized in the income statement as an offset to the loss recorded by the insured that will be reimbursed under the insurance or reinsurance contract that transfers only significant underwriting risk. With regard to insurance enterprises and because of the significance of amounts recorded as incurred losses by these enterprises, AcSEC believes that disclosure of the components of the deposit that are recorded in incurred losses is appropriate. AcSEC noted that, if the *amount* of expected future cash flows under the deposit contract changes, the reporting entity will report both a change in the deposit and a corresponding change related to the underlying loss accrual; AcSEC concluded that both of those changes should be recognized in a similar manner. Additionally, because this kind of contract transfers significant underwriting risk, AcSEC considered it inappropriate to recognize the entire change in the present value of the cash flows as interest related. AcSEC also concluded that the costs of accounting separately for the interest-related component of the change in the present value of the cash flows outweighed the benefits of such separate accounting. AcSEC noted the following areas in which the interest-related component of a change in the present value of an asset or liability is recognized as an operating item rather than as interest related:

a. Accounting for long-duration insurance liabilities and changes in cash surrender value of life insurance contracts

b. Accounting for pension and other post-retirement benefit expenses

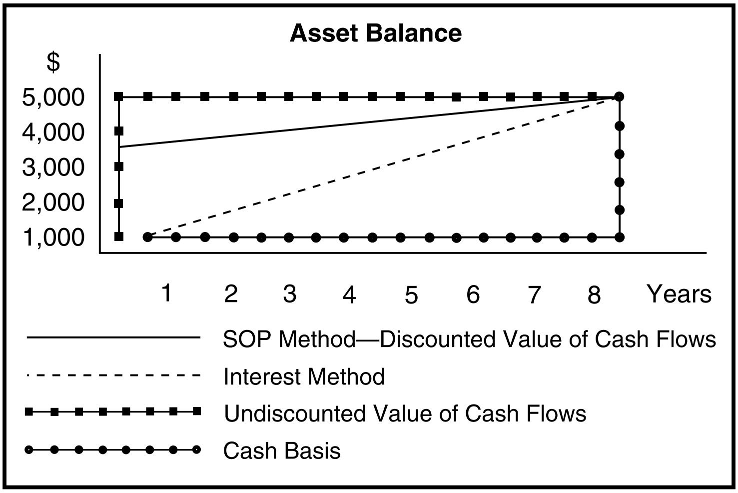
c. Accounting generally used when insurance claim liabilities are measured on a discounted basis

d. Accounting for a change in the present value of an impaired loan

.31 AcSEC considered a variety of possible ways to apply deposit accounting to insurance and reinsurance contracts that transfer only significant underwriting risk. The following graph, which is based on the example in Appendix A [paragraph .37], "Illustrations of Application of Conclusions," paragraphs A.6 through A.9, illustrates the effects of four alternative methods of accounting for insurance and reinsurance contracts that transfer only significant underwriting risk that were considered by AcSEC. In this example, the insured or ceding entity pays an initial premium of $1,000 and expects to recover $5,000 at the end of Year 8 based on an actual loss incurred by the insured. A delayed reimbursement clause mitigates timing risk.[6]

.32 AcSEC eliminated from consideration the cash basis and the undiscounted value of cash flows methods because they fail to properly reflect the time value of money, the receivable or payable under the contract, or both.

.33 AcSEC concluded that the interest method fails to recognize that the $5,000 incurred loss is a discrete event that has been recorded under the contract in Year 1 giving rise to the ultimate recovery of $5,000 in Year 8.



Insurance and Reinsurance Contracts With Indeterminate Risk

.34 In insurance and reinsurance contracts with indeterminate risk, there are uncertain terms, or there is insufficient information to reasonably estimate and allocate premiums in proportion to the protection provided. Paragraph 15 of SOP 92-5 [section 10,520.15] provides that, in circumstances in which a foreign ceding entity cannot provide the information required by the assuming entity to estimate both the ultimate premiums and the appropriate periods of recognition, the open-year method should be used.

.35 AcSEC concluded that uncertainties surrounding these insurance and reinsurance contracts are analogous to those often associated with foreign property and liability reinsurance as addressed in SOP 92-5 [section 10,520]. As a result, the guidance in SOP 92-5 [section 10,520] as to the open-year method should be followed.

.36 If sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified into one of three categories as an insurance or reinsurance contract that transfers neither significant timing nor underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly. FASB Statement No. 113 provides that the determination of whether a contract transfers risk should be evaluated at the inception of the contract. There are no provisions in FASB Statement No. 113 that provide for subsequent reevaluation of

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[6] The table only presents the recovery under the contract and does not depict the underlying loss associated with the contract.

a contract. Therefore, AcSEC concluded that when sufficient information becomes available to reasonably estimate and allocate premiums, the accounting for an insurance or reinsurance contract, with indeterminate risk at its inception, should be reclassified as an insurance or reinsurance contract that does one of the following:

1. Transfers neither significant timing nor significant underwriting risk
2. Transfers only significant timing risk
3. Transfers only significant underwriting risk

As appropriate, the reclassified contract should be accounted for accordingly using deposit accounting as described in this SOP.

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Appendix A

Illustrations of Application of Conclusions

A.1. The following examples illustrate the application of the conclusions in this SOP. The illustrations are intended as examples only; it should not be construed that any aspect of the illustrations establishes or changes requirements as to when deposit accounting should be applied. Rather, the examples illustrate how deposit accounting is to be applied when it is determined that it should be applied under other accounting literature. These examples illustrate the accounting by the insured. The accounting by the insurer would be symmetrical, except as noted in paragraph .15 of this SOP.

Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Significant Underwriting Risk

A.2. This example illustrates the accounting by the insured for an insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk. The facts are as shown in the following table.

Premium	$1,000
Coverage period	1 year
Expected recoveries	$250 at the end of each year for five years
Implicit interest rate	8 percent[*]

[*] Present value of $250 per year for five years at 8 percent = $1,000.

A.3. At contract inception, the insured records a $1,000 asset. Changes in the amount or timing of cash flows are not anticipated. As they are received, cash recoveries reduce the carrying amount of the deposit, and the carrying amount of the deposit is increased at each reporting date by the amount of the interest earned during the period. The example assumes that the enterprise is reporting related financial information as of the end of each year, as shown in the following table.

Description	*8-Percent Interest Income*	*Cash Recoveries*	*Deposit Balance*
Initial payment			$1,000
Year 1	$ 80		1,080
End of Year 1		$ (250)	830
Year 2	66		896
End of Year 2		(250)	646
Year 3	52		698
End of Year 3		(250)	448
Year 4	36		484
End of Year 4		(250)	234
Year 5	16		250
End of Year 5		(250)	0
Totals	$250	$(1,250)	$ 0

Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk

A.4. This example illustrates the accounting by the insured for an insurance or reinsurance contract that transfers only significant timing risk. The facts are as shown in the following table.

Premium	$1,000
Coverage period	1 year
Initial expected recoveries	$225 per year (at end of year) for five years
Initial implicit rate	4 percent(†)

(†) Present value of $225 per year for five years at 4 percent = $1,000.

This implicit rate often will be less than the current risk-free rate because of the uncertainties as to the timing of cash flows in the insurance or reinsurance contract.

A.5. At contract inception, the insured records a $1,000 asset. Though the total amount ($1,125) is likely to be paid, changes in estimates of the timing of cash flows are expected. At each subsequent reporting date, the amount of the deposit would be increased by the amount of interest earned during the period, calculated using the estimated future cash flows to determine the then-current implicit discount rate (this is consistent with the retrospective approach in applying the interest method). At the end of Year 2, the timing of anticipated recoveries under the insurance or reinsurance contract is revised. A reevaluation of the implicit interest rate produces a rate of 3.63 percent and an asset of $640 at the end of the year. Given the change in the expected timing of cash flows at the end of Year 2, the carrying amount of the asset would be calculated as shown in the following table.

Description	*Interest Income*	*Cash Recoveries*	*Deposit Balance*
Initial payment			$1,000
Year 1 (4 percent)(‡)	$ 40		1,040
End of Year 1		$ (225)	815
Year 2 (4 percent)	33		848
End of Year 2		(200)	648
Yield adjustment	(8)		640
Year 3 (3.63 percent)	23		663
End of Year 3		(175)	488
Year 4 (3.63 percent)	18		506
End of Year 4		(175)	331
Year 5 (3.63 percent)	12		343
End of Year 5		(175)	168
Year 6 (3.63 percent)	7		175
End of Year 6		(175)	0
Totals	$125	$(1,125)	$ 0

(‡) Implicit rate at the inception of the insurance or reinsurance contract.

Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk

A.6. This example illustrates the accounting by the insured for an insurance or reinsurance contract that transfers only significant underwriting risk. The facts are as shown in the following table.

Initial Premium	$1,000
Coverage period	1 year
Expected recoveries	Could aggregate up to $10,000 with none paid prior to Year 8 regardless of when the insured incurs or pays a loss

A.7. A delayed reimbursement clause, which provides that the full amount will be paid to the insured or ceding entity at the end of Year 8, mitigates timing risk. A $5,000 loss is incurred at the end of Year 1 and is expected to be recovered at the end of Year 8. The risk-free rate of interest in Year 1 for the period from the loss to the expected payment date, adjusted for default risk, is 6 percent. (For the insurer, the risk-free rate would be used but it would not be adjusted for default risk.) At the end of Year 3, the estimated loss is increased from $5,000 to $6,000.

A.8. At contract inception, the insured records a $1,000 asset. The $1,000 amount is amortized over the coverage period of one year. If the $5,000 loss is incurred, the insured increases the amount of the asset by the present value of the $5,000. (Note that the insured has recorded the entire $5,000 loss from the underlying event in the same period.) At each subsequent reporting date, the portion of the carrying amount of the asset attributable to the incurred loss would be recalculated by discounting the estimated future cash flows.

A.9. The carrying amount of the asset would be calculated as shown in the following table.

Description	*Amortization*	*Offset to Recorded Losses*	*Cash Recoveries at End of Year*	*Deposit Balance*
Initial payment				$1,000
Amortization	$1,000			0
Year 1		$3,325[||]		3,325[#]
Year 2		200		3,525
Year 3		211		3,736
Adjustment		**747**		4,483[**]
Year 4		270		4,753
Year 5		284		5,037
Year 6		303		5,340
Year 7		320		5,660
Year 8		340	$6,000	0
Totals	$1,000	$6,000	$6,000	$ 0

[||] The loss occurred on the last day of the year.

[#] The present value of $5,000 received after seven years discounted at 6 percent. At the end of Year 1, there is no remaining deposit applicable to the unexpired portion of the coverage because it is a one-year contract.

[**] The present value of $6,000 received after five years discounted at 6 percent.

Conversion From a Contract That Transfers Neither Significant Timing Risk Nor Significant Underwriting Risk or a Contract That Transfers Only Significant Timing Risk to a Contract That Transfers Significant Underwriting Risk

A.10. The following illustration builds on the examples in paragraphs A.4 and A.5. It uses the same assumptions and facts as that example for the first two years; however, at the end of Year 3, the estimated recovery is increased from $1,125 to $1,950 (with the remaining recovery to be $450 per year for the remaining three years). For purposes of this example, assume the magnitude of the change in the estimated recovery is such that a determination should be reached that the contract does include significant underwriting risk. The risk-free rate of interest at Year 1 is 6 percent adjusted for default risk. In addition, this rate would be utilized when appropriate for the life of the contract.

Description	*Interest Income*	*Offset to Recorded Losses*	*Cash Recoveries at End of Year*	*Deposit Balance*
Initial payment				$1,000
Year 1 (4 percent)	$40		$ (225)	815
Year 2 (4 percent)	25[(††)]		(200)	640
Year 3 (3.63 percent)	23		(175)	488
Adjustment		$715[(‡‡)]		1,203[(‖‖)]
Year 4 (6 percent)		72	(450)	825
Year 5 (6 percent)		50	(450)	425
Year 6 (6 percent)		25	(450)	0
Totals	$88	$862	$(1,950)	$ 0

(††) The interest income adjustment at 4 percent of $33 less the yield adjustment of $8 equals $25.

(‡‡) At the end of Year 3, there is a change in the estimated recovery to $1950. The payment of the remaining losses will occur over three years, in Years 4, 5, and 6.

(‖‖) The present value of $450 per year for three years discounted at 6 percent (the risk-free rate at the time of the loss adjusted for default risk).

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Appendix B

Discussion of Comments Received on the Exposure Draft

B.1. An exposure draft of a proposed Statement of Position, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*, was issued for public comment on June 30, 1997, and distributed to a variety of interested parties to encourage comment by those who would be affected by the proposal. Twenty-three comment letters were received in response on the exposure draft. The most significant and pervasive comments received were in the following areas:

a. Scope

b. Kinds of contracts

c. Risk transfer criteria for direct insurance contracts

d. Recognition of fees to be retained by the insurer or reinsurer

e. Discount rate

f. Accounting for contracts that transfer only significant underwriting risk

Scope

B.2. The guidance regarding scope in the exposure draft caused some confusion. Several respondents requested clarification about the kinds of insurance contracts that would be covered by the SOP. AcSEC clarified the guidance to explain that the SOP applies to contracts that do not transfer insurance risk, except for those contracts which Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards Nos. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* and 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, provide explicit guidance.

Kinds of Contracts

B.3. Several comment letters expressed concern about the complexity of the various contract types. AcSEC continues to believe that the various deposit categories are appropriate and adequately capture the majority of potential kinds of contracts.

B.4. For short-duration reinsurance contracts, FASB Statement No. 113 requires that two conditions be met in order to account for that contract as reinsurance. The first condition is that the contract must transfer significant insurance risk to the reinsurer. The SOP provides guidance on accounting for contracts that fail to transfer one or both of these risks, which must be transferred for a contract to be considered to have transferred significant insurance risk. FASB Statement No. 113 also provides a second condition that must be met for a contract to receive reinsurance accounting. The second condition is that the contract must subject the reinsurer to the reasonable possibility of realizing a significant loss from the transaction, unless substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. The exposure draft did not specifically identify this situation. The SOP has been changed to state that for short-duration reinsurance contracts that do not meet the second condition, but that do transfer significant insurance risk, the accounting for these reinsurance contracts should be the same as the accounting for contracts that transfer only significant underwriting risk. AcSEC believes that for short-duration reinsurance contracts to satisfy the requirements of paragraph 9a of FASB Statement No. 113, there is an expectation that there is variability in the amount and timing of expected cash flows. Therefore, the accounting for contracts that transfer only significant underwriting risk would be appropriate.

Risk Transfer Criteria for Direct Insurance Contracts

B.5. Several comment letters expressed concern that the risk transfer criteria from FASB Statement No. 113 were being applied to direct insurance contracts. Paragraph 44 of FASB Statement No. 5, *Accounting for Contingencies*, and FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, do not specifically state risk transfer criteria in the same manner as does FASB Statement No. 113. The SOP's objective is to address how to account for contracts that do not transfer insurance risk and consequently must be accounted for as deposit accounting. The SOP is not intended to provide a method to determine whether risk transfer exists.

Recognition of Fees to Be Retained by the Insurer or Reinsurer

B.6. Several comments were received on the initial measurement of the deposit asset or liability relating to the recognition of fees to be retained by the insurer or reinsurer. AcSEC continues to believe that such fees should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, based upon the terms and conditions of the contract. AcSEC believes that a reasonable determination of premiums or fees is ordinarily not possible at the inception of the contract. Each contract should be evaluated based on its relevant terms and conditions.

Discount Rate

B.7. The use of a risk-free interest rate locked in at the loss event was addressed in several comment letters. Several respondents believe that this method is inconsistent with other accounting literature and believe the rate does not fully recognize the current market value of the deposit. AcSEC believes that the method chosen is consistent with other recent literature issued. The SOP has been changed to explicitly document that AcSEC believes that changes that occur are only changes in the estimate of expected cash flows resulting from the previous loss event and, therefore, the rate should not change. It is not AcSEC's intention to measure the deposit amount on a fair-value basis.

Accounting for Contracts That Transfer Only Significant Underwriting Risk

B.8. The accounting in the SOP prescribes that recoveries for contracts that transfer only significant underwriting risk to be recognized through underwriting income. Some respondents believe that the accounting is inconsistent with FASB Statement No. 113. Other respondents believe that these kinds of contracts should receive reinsurance accounting under FASB Statement No. 113 when a recovery under the contract occurs. Some changes in the balance of the amount recoverable are related to underwriting activities and it is, therefore, reasonable to include that activity in the underwriting account. AcSEC believes that bifurcation or a financial approach that would allocate underwriting and interest components would be preferable; however, current insurance company GAAP does not permit that approach. Therefore, AcSEC continues to believe that the accounting described in the SOP is appropriate.

Glossary

.39

assuming entity (or enterprise). The party that receives a reinsurance premium in a reinsurance transaction. The assuming enterprise (or reinsurer) accepts an obligation to reimburse a ceding enterprise under the terms of the reinsurance contract.

ceding entity (or enterprise). The party that pays a reinsurance premium in a reinsurance transaction. The ceding enterprise receives the right to reimbursement from the assuming enterprise under the terms of the reinsurance contract.

experience adjustment. A provision in an insurance or reinsurance contract that modifies the premium, coverage, commission, or a combination of the three, in whole or in part, based on experience under the contract.

insurance risk. The risk arising from uncertainties about both underwriting risk and timing risk. Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous; the possibility of adverse events occurring is outside the control of the insured.

timing risk. The risk arising from uncertainties about the timing of the receipt and payments of the net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract.

underwriting risk. The risk arising from uncertainties about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract.

Accounting Standards Executive Committee (1997–1998)

Insurance Companies Committee (1997–1998)

Deposit Accounting Task Force

AICPA Staff

The AICPA gratefully acknowledges the contributions made to the development of this Statement of Position by George O'Shaughnessy and Thomas Genrich.

[The next page is 80,575.]

Section 10,770

Statement of Position 98-9 *Modification of SOP 97-2,* Software Revenue Recognition, *With Respect to Certain Transactions*

December 22, 1998

NOTE

Statements of Position on accounting issues present the conclusions of at least two thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) amends paragraphs 11 and 12 of SOP 97-2, *Software Revenue Recognition* [section 10,700.11 and .12], to require recognition of revenue using the “residual method” when (1) there is vendor-specific objective evidence of the fair values of *all* undelivered elements in a multiple-element arrangement that is not accounted for using long-term contract accounting, (2) vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement, and (3) all revenue-recognition criteria in SOP 97-2 [section 10,700] other than the requirement for vendor-specific objective evidence of the fair value of each delivered element of the arrangement are satisfied. Under the residual method, the arrangement fee is recognized as follows: (1) the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is deferred and subsequently recognized in accordance with the relevant sections of SOP 97-2 [section 10,700] and (2) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

Effective December 15, 1998, this SOP amends SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2,* Software Revenue Recognition [section 10,740], to extend the deferral of the application of certain passages of SOP 97-2 [section 10,700] provided by SOP 98-4 [section 10,740] through fiscal years beginning on or before March 15, 1999.

All other provisions of this SOP are effective for transactions entered into in fiscal years beginning after March 15, 1999. Earlier adoption is permitted as of the beginning of fiscal years or interim periods for which financial statements or information has not been issued. Retroactive application of the provisions of this SOP is prohibited.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing a final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Introduction and Background

.01 On October 27, 1997, the AICPA Accounting Standards Executive Committee (AcSEC) issued Statement of Position (SOP) 97-2, *Software Revenue Recognition* [section 10,700].

.02 Paragraph 10 of SOP 97-2 [section 10,700.10] states that, if an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value. Vendor-specific objective evidence of fair value is limited to the following:

a. The price charged when the same element is sold separately

b. For an element not yet being sold separately, the price established by management having the relevant authority (it must be probable that the price, once established, will not change before the separate introduction of the element into the marketplace)

.03 Paragraph 12 of SOP 97-2 [section 10,700.12] requires deferral of all revenue from multiple-element arrangements that are not accounted for using long-term contract accounting if sufficient vendor-specific objective evidence does not exist for the allocation of revenue to the various elements of the arrangement.

.04 This SOP amends that guidance to require recognition of revenue in accordance with the "residual" method in the limited circumstances described in paragraph .05 of this SOP.

Scope

.05 This SOP applies only to multiple-element arrangements in which (*a*) a software element or other delivered element is sold *only* in combination with one or more other elements that qualify for separate accounting pursuant to SOP 97-2 [section 10,700], (*b*) vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements, and (*c*) there is vendor-specific objective evidence of the fair value of each of the undelivered elements determined pursuant to paragraphs 10, 37, 57, and 66 of SOP 97-2 [section 10,700.10, .37, .57, and .66].

Conclusions

.06 The following changes are made to SOP 97-2 [section 10,700].

a. The following sentence is added to the end of paragraph 11 of SOP 97-2 [section 10,700.11].

 Moreover, to the extent that a discount exists, the residual method described in paragraph 12 [of SOP 97-2] attributes that discount entirely to the delivered elements.

b. The following is added to the end of paragraph 12 of SOP 97-2 [section 10,700.12].

 - There may be instances in which there is vendor-specific objective evidence of the fair values of *all* undelivered elements in an arrangement but vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement. In such instances, the fee should be recognized using the residual method, provided that (*a*) all other applicable revenue recognition criteria in this SOP [SOP 97-2] are met and (*b*) the fair value of all of the undelivered elements is less than the arrangement fee. Under the residual method, the arrangement fee is recognized as follows: (*a*) the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is deferred and (*b*) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

c. The following example is added to appendix A of SOP 97-2 [section 10,700.146], following "Multiple Element Arrangements—Products and Services—Example 3."

Multiple Element Arrangements—Products and Services—Example 4

Facts

A vendor sells software product A for $950. The license arrangement for product A always includes one year of "free" PCS. The annual renewal price of PCS is $150.

Revenue Recognition

Assuming that, apart from the lack of vendor-specific objective evidence of the fair value of the delivered software element, all applicable revenue recognition criteria in this SOP [SOP 97-2] are met, revenue in the amount of $150 should be deferred and recognized in income over the one-year PCS service period. Revenue of $800 should be allocated to the software element and recognized upon delivery of the software.

Discussion

Vendor-specific objective evidence of the fair value of the software does not exist because the software is never sold separately. Consequently, sufficient vendor-specific objective evidence of fair value does not exist for the allocation of revenue to the various elements based on their relative fair values. Paragraph 12 of this SOP [SOP 97-2] states, however, that the residual method should be used when there is vendor-specific objective evidence of the fair values of *all* undelivered elements; all other applicable revenue recognition criteria in this SOP [SOP 97-2] are met; and the fair value of all of the undelivered elements is less than the total arrangement fee.

If there had been vendor-specific objective evidence of the fair value of the delivered software but not of the undelivered PCS, the entire arrangement fee would be deferred and recognized ratably over the contractual PCS period in accordance with paragraphs 12 and 58 [of SOP 97-2].

.07 Paragraph 5 of SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2*, Software Revenue Recognition [section 10,740.05], is replaced with the following.

> The second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2, which limit what is considered VSOE [vendor-specific objective evidence] of the fair value of the various elements in a multiple-element arrangement, and the related examples noted in paragraph 3 of this SOP [SOP 98-4] need not be applied to transactions entered into before fiscal years beginning after March 15, 1999.

.08 All provisions of SOP 97-2 [section 10,700] for software transactions outside the scope of this SOP and all other provisions of SOP 97-2 [section 10,700] for transactions within the scope of this SOP should be applied as stated in SOP 97-2 [section 10,700].

Effective Date and Transition

.09 The provisions of this SOP that extend the deferral of the application of certain passages of SOP 97-2 [section 10,700] are effective December 15, 1998. All other provisions of this SOP are effective for transactions entered into in fiscal years beginning after March 15, 1999. Earlier adoption is permitted as of the beginning of fiscal years or interim periods for which financial statements or information has not been issued. Retroactive application of the provisions of this SOP is prohibited.

The provisions of this Statement need not be applied to immaterial items.

Background Information and Basis for Conclusions

.10 SOP 97-2, *Software Revenue Recognition* [section 10,700], was issued on October 27, 1997 and became effective for transactions entered into in fiscal years beginning after December 15, 1997, with earlier application encouraged.

.11 Paragraph 10 of SOP 97-2 [section 10,700.10] provides that, if a software arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value. Paragraph 12 of SOP 97-2 [section 10,700.12] provides that, if sufficient vendor-specific objective evidence of fair value does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement should be deferred.

.12 Paragraph 10 of SOP 97-2 [section 10,700.10] establishes only two conditions that constitute vendor-specific objective evidence of fair value. Neither of those conditions allows for the determination of the fair value of an element of a multiple-element arrangement that is never sold separately. A consequence of not having separate sales of one or more elements under SOP 97-2 [section 10,700], as issued, is that all revenue from such an arrangement would be deferred in accordance with paragraph 12 of SOP 97-2 [section 10,700.12].

.13 In developing the "unbundling" guidance in SOP 97-2 [section 10,700], AcSEC deliberated the need for verifiable fair values of each of the elements. AcSEC did not support permitting allocation of the sales price of the package of elements to the individual elements using differential measurement, in which an amount to allocate to an element for which there is no separate vendor-specific objective evidence of fair value is inferred by reference to the fair values of elements for which there is vendor-specific objective evidence of fair value and the fair value of the total arrangement.[1] AcSEC was concerned that, under differential measurement, any difference between the fair values of the individual elements when sold separately and the fair value of the elements when sold as a package (that is, a discount) would be allocated entirely to undelivered elements, possibly resulting in a significant overstatement of reported revenue in the period in which the software is delivered.

.14 In arriving at its conclusion in SOP 97-2 [section 10,700], AcSEC did not deliberate situations in which software or other delivered elements would *always* be sold with one or more services or other undelivered elements that qualify for separate accounting. In such situations, there could be vendor-specific objective evidence of the fair value of the undelivered elements when sold separately (for example, by reference to renewal PCS or to the price for user training that is sold separately). Application of the conclusions in paragraph 10 of SOP 97-2 [section 10,700.10], however, would have resulted in a determination that there was not vendor-specific objective evidence of the fair value of the delivered element (for example, software). The provisions in paragraph 12 of SOP 97-2 [section 10,700.12] would have required the initial deferral of all revenue from such arrangements.

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[1] Differential measurement encompasses the residual method described in this SOP.

.15 Subsequent to the issuance of SOP 97-2 [section 10,700], some AcSEC members came to believe that it is inappropriate to defer all revenue from the arrangement in such situations, because the use of the residual method would result in allocation of any discount entirely to the delivered element. Thus, there would be no potential for overstatement of revenue at the time of initial delivery of the software element. Indeed, it had been argued that recognizing no revenue from the delivered software element in such circumstances would inappropriately understate reported income.

.16 AcSEC considered this matter in light of paragraphs 95 and 96 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*. Those paragraphs state the following.

> Conservatism no longer requires deferring recognition of income beyond the time that adequate evidence of its existence becomes available or justifies recognizing losses before there is adequate evidence that they have been incurred.
>
> The Board emphasizes that any attempt to understate results consistently is likely to raise questions about the reliability and the integrity of information about those results and will probably be self-defeating in the long run. That kind of reporting, however well-intentioned, is not consistent with the desirable characteristics described in this Statement. On the other hand, the Board also emphasizes that imprudent reporting, such as may be reflected, for example, in overly optimistic estimates of realization, is certainly no less inconsistent with those characteristics. Bias in estimating components of earnings, whether overly conservative or unconservative, usually influences the timing of earnings or losses rather than their aggregate amount. As a result, unjustified excesses in either direction may mislead one group of investors to the possible benefit or detriment of others.

.17 On February 11, 1998, AcSEC issued an exposure draft of a proposed SOP, *Deferral of the Effective Date of Certain Provisions of SOP 97-2*, Software Revenue Recognition, *for Certain Transactions*. The exposure draft proposed deferring the effective date of the provisions of paragraph 10 of SOP 97-2 [section 10,700.10] with respect to what constitutes vendor-specific objective evidence of fair value of the software element in multiple-element arrangements in which—

a. A software element is sold only in combination with PCS or other service elements that qualify for separate accounting pursuant to SOP 97-2 [section 10,700], or both.

b. There is vendor-specific objective evidence of the fair value of each of the service elements determined pursuant to paragraphs 10, 57, and 65 of SOP 97-2 [section 10,700.10, .57, and .65].

.18 None of the commentators on that exposure draft objected to deferral of the effective date of paragraph 10 of SOP 97-2 [section 10,700.10] with respect to multiple-element arrangements within the scope proposed in the exposure draft. A significant number of commentators were concerned, however, about the implications of restricting the scope to only certain multiple-element arrangements, and they urged AcSEC to broaden the scope to all multiple-element arrangements.

.19 As a result of AcSEC's deliberations of the comment letters on the February 11, 1998, exposure draft and examples of arrangements brought to AcSEC's attention, AcSEC —

a. Concluded that, for arrangements for which there is sufficient vendor-specific objective evidence of the fair value of each element, even if each element is not sold separately, the basis for deferral of revenue recognition with respect to those elements that otherwise satisfied the criteria for revenue recognition in SOP 97-2 [section 10,700] needed to be reconsidered. Accordingly, AcSEC expanded the deferral to encompass all multiple-element software arrangements.

b. Affirmed the requirement in SOP 97-2 [section 10,700] that any allocation of the fee in a multiple-element arrangement to the various elements should be based on fair values of each element and that such fair values must be supported by vendor-specific objective evidence, thus reinforcing the applicability of that requirement to all arrangements.

These conclusions were set forth in SOP 98-4*, Deferral of the Effective Date of a Provision of SOP 97-2,* Software Revenue Recognition [section 10,740].

.20 On July 31, 1998, AcSEC issued an exposure draft of an SOP, *Modification of the Limitations on Evidence of Fair Value in Software Arrangements (A proposed amendment to SOP 97-2,* Software Revenue Recognition). That exposure draft proposed rescinding the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 [section 10,700.10, .37, .41, and .57]. Further, the exposure draft proposed that vendor-specific objective evidence of the fair value of any one element of an arrangement could be inferred by reference to vendor-specific objective evidence of the fair value of the remaining elements in the arrangement and vendor-specific objective evidence of the fair value of the total arrangement. An example in the exposure draft suggested that such vendor-specific objective evidence of the fair value of the total arrangement, which could differ from the arrangement fee, might be provided by sufficiently consistent pricing for the total arrangement in sales to other customers.

.21 Under AcSEC's July 31, 1998, proposal, any difference between the fair value of the total arrangement and the arrangement fee (the discount) for the particular transaction would be allocated to each element in the arrangement based on each element's fair value without regard to the discount, in accordance with paragraph 11 of SOP 97-2 [section 10,700.11].

.22 AcSEC received twenty comment letters on the exposure draft. Although none of the commentators opposed modification of the evidentiary requirements of the second sentence of paragraph 10 of SOP 97-2 [section 10,700.10], approximately half of the commentators requested further guidance on some aspect of what would constitute vendor-specific objective evidence of fair value and on some aspect of what might constitute "consistent pricing." Five respondents requested reconsideration of the acceptability of methods, perhaps in addition to the exposure draft method, that would permit recognition of a "minimum" amount of revenue when vendor-specific objective evidence of fair value does not exist for each element in an arrangement or for the total arrangement.

.23 The Software Revenue Recognition Working Group, which had been advising AcSEC during this process continued to support the position in the exposure draft. However, AcSEC was troubled by the significant number of comment letters requesting more guidance on the terms "consistent pricing" and "vendor-specific objective evidence." In addition, certain comment letters explained that determining vendor-specific objective evidence of fair value of total arrangements is difficult because, in many cases, each sale represents an independent negotiation. AcSEC believes that, because of the wide variety of facts and circumstances that influence individual transactions, not all of which can be anticipated, it cannot further define the term consistent pricing without making arbitrary decisions and drafting a multitude of rules. AcSEC believes that promulgating such specificity and arbitrary rules would be unwise. AcSEC was further troubled by the concept that there could be a fair value for a multiple-element arrangement that differs from the price paid for the total arrangement, which is negotiated between independent parties.

.24 AcSEC concluded, based on the information obtained during AcSEC's due process, that the approach proposed in the July 31, 1998, exposure draft was not operational for multiple-element software arrangements. This conclusion, combined with concerns about the potential for a disproportionate allocation of any discount on an arrangement to undelivered elements (possibly resulting in an overstatement of revenue reported in the period of initial delivery of the software), caused AcSEC to conclude that it should retain the limitations on evidence of fair value in SOP 97-2 [section 10,700]. AcSEC did agree, however, to provide for the use of the residual method in circumstances where there is vendor-specific objective evidence of the fair value of all the undelivered elements in an arrangement but there is not vendor-specific objective evidence of the fair value of one or more delivered elements.

.25 AcSEC notes that the residual method is not an acceptable alternative to allocation based on relative fair values when there is vendor-specific objective evidence of the fair value of each element in a multiple-element arrangement. AcSEC acknowledges that the residual method represents an exception to the revenue-recognition model in SOP 97-2 [section 10,700] that the arrangement fee should be allocated on the basis of relative fair values. AcSEC believes, however, that, in the particular circumstances discussed in this SOP, recognition of some revenue for a delivered element is more appropriate than deferral of all revenue.

Effective Date and Transition

.26 AcSEC initially agreed that this SOP should be effective for transactions entered into in fiscal years beginning after December 15, 1998, the date on which the deferral of certain passages of SOP 97-2 [section 10,700] that is provided by SOP 98-4 [section 10,740] would have expired. However, several subsequent letters from the software industry stated that some software companies would have difficulty implementing this SOP (and the provisions of SOP 97-2 [section 10,700] that had been deferred for one year by SOP 98-4 [section 10,740]) by that date. In response, AcSEC agreed to change the effective date of this SOP to make it apply to transactions entered into in fiscal years beginning after March 15, 1999. Moreover, in order to avoid the need for two accounting changes, AcSEC agreed to amend SOP 98-4 [section 10,740] to extend the deferral period through fiscal years beginning on or before March 15, 1999. AcSEC believes that this additional three-month period is sufficient to permit companies to implement both this SOP and the passages of SOP 97-2 [section 10,700] that had been deferred by SOP 98-4 [section 10,740].

.27 The transition provisions of both SOP 97-2 [section 10,700] and SOP 98-4 [section 10,740] are transaction based. It is, therefore, appropriate for this SOP to be applied on a prospective basis to transactions entered into in fiscal years beginning after March 15, 1999.

.28 The guidance that was deferred by SOP 98-4 [section 10,740] was to have been applied prospectively. As this SOP reinstates the guidance in SOP 97-2 [section 10,700] while adding one narrow exception, it is appropriate for this SOP to provide also for prospective application.

.29 Some entities may have adopted SOP 97-2 [section 10,700] before its December 15, 1997, effective date and, upon the issuance of SOP 98-4 [section 10,740], may have chosen not to restate their financial statements to reflect the deferral of the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 [section 10,700.10, .37, .41, and .57], as was permitted. Any differences in reported revenue pursuant to SOP 97-2 [section 10,700] from the revenue that would have been reported under SOP 97-2 [section 10,700] as amended by this SOP will reverse as the revenue recognition criteria are met for the undelivered elements of these arrangements. This is consistent with the transition methodology incorporated in SOP 97-2 [section 10,700]. AcSEC believes that it is therefore unnecessary to permit retroactive application of this SOP by any entities.

Due Process

.30 The exposure draft that preceded this SOP proposed rescinding the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 [section 10,700.10, .37, .41, and .57]. Further, the exposure draft proposed that vendor-specific objective evidence of the fair value of any one element of an arrangement could be inferred by reference to vendor-specific objective evidence of the fair value of the remaining elements in the arrangement and vendor-specific objective evidence of the fair value of the total arrangement. An example in the exposure draft suggested that such vendor-specific objective evidence of the fair value of the total arrangement, which could differ from the arrangement fee, might be provided by sufficiently consistent pricing for the total arrangement in sales to other customers.

.31 The July 31, 1998, exposure draft did not propose the use of the residual method that is required by this SOP. However, the comment letters on the exposure draft clearly identified perceived weaknesses in the proposed approach. The comment letters also included recommendations to adopt the residual method in addition to the proposed approach that AcSEC ultimately rejected. Moreover, AcSEC received and considered comments on the scope of the February 11, 1998, exposure draft, which was similar to the scope of this SOP. AcSEC concluded that it could reach an informed decision based on the comments received on the two exposure drafts, without issuing a revised exposure draft for public comment.

Accounting Standards Executive Committee (1998–1999)

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Section 10,780

Statement of Position 99-2 Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans

July 28, 1999

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) would amend chapters 2 and 4 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide). This SOP specifies the accounting for and disclosure of 401(h) features of defined benefit pension plans, by both defined benefit pension plans and health and welfare benefit plans.

The SOP requires—

a. Defined benefit pension plans to record the aggregate amount of net assets held in a 401(h) account related to health and welfare plan obligations for retirees as both assets and liabilities on the face of the statement of net assets available for pension benefits in order to arrive at net assets available for pension benefits

b. 401(h) account assets used to fund health benefits, and the changes in those assets, to be reported in the financial statements of the health and welfare benefit plan. Benefit obligations related to the 401(h) account are also required to be reflected in the health and welfare plan financial statements

c. Defined benefit pension plans to disclose the fact that the 401(h) account assets are available only to pay retirees' health benefits

d. Health and welfare benefit plans to disclose in the notes to the financial statements the fact that retiree health benefits are funded partially through a 401(h) account of the defined benefit pension plan.

This SOP is effective for financial statements for plan years beginning after December 15, 1998. Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this SOP should be made retroactively by restatement of financial statements for prior periods.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.

2. The proposal will result in an improvement in practice.

3. The AICPA demonstrates the need for the proposal.

4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearing the FASB will propose suggestions, many of which are included in the documents.

Introduction

.01 Some defined benefit pension plans provide a postretirement medical-benefit component in addition to the normal retirement benefits of the plan, pursuant to Section 401(h) of the Internal Revenue Code (IRC). Employers may fund a portion of their postretirement medical-benefit obligations related to their health and welfare benefit plans through a health benefit account (401(h) account) in their defined benefit pension plans, subject to certain restrictions and limitations.

.02 Funding can be accomplished through a qualified transfer of excess pension plan assets (as defined in Section 420 of the IRC) or through additional contributions to the 401(h) account by the employer, employees, or both. Any assets transferred to a 401(h) account in a qualified transfer of excess pension plan assets (and any income allocable thereto) must be used only to pay qualified current retiree health benefits for the taxable year of the transfer (whether directly or through reimbursement). Any assets transferred to the 401(h) account to pay retiree medical expenses in a qualified transfer of excess pension plan assets (and any income allocable thereto) that are not used during the year must be transferred out of the account to the transferor plan and treated as an employer reversion for purposes of a 20 percent excise tax on reversions. The IRC allows employers to allocate up to 25 percent of total contributions to the plan, subject to certain limitations, to the 401(h) account. If the full amount of these contributions is not used during the year, they may be accumulated for future retiree medical expenses in the 401(h) account. The deductibility of employer contributions to a 401(h) account is subject to separate limitations and, therefore, such contributions have no effect on the amount of deductible contributions an employer can make to fund pension benefits under the plan. The earnings on the 401(h) account are ignored for minimum funding purposes. Additionally, under the IRC, qualified transfers are not treated as prohibited transactions for purposes of Section 4975.

.03 The plan sponsor has discretion in making contributions to the 401(h) account. A pension or annuity plan may provide for payment of medical benefits for retired employees, their spouses, and their dependents if all of the following conditions are met.

a. Benefits are subordinate (as defined in section 401(h) of the IRC) to the retirement benefits provided by the plan.

b. A separate account is established and maintained for such benefits.

c. The employer's contributions to the separate account are reasonable and ascertainable.

d. It is impossible, at any time prior to the satisfaction of all obligations under the plan to provide such benefits, for any part of the corpus or income of the separate account to be (within the taxable year or thereafter) used for or diverted to any purpose other than the providing of such benefits.

e. Notwithstanding the provisions of certain IRC sections, upon satisfaction of all obligations under the plan to provide such benefits, any amount remaining in the separate account must, under the terms of the plan, be returned to the employer.

f. In the case of an employee who is a key employee, (as defined in Section 416(i)), a separate account is established and maintained for such benefits payable to such employee (and the spouse and dependents) and such benefits (to the extent attributable to plan years beginning after March 31, 1984, for which the employee is a key employee) are payable only to such employee (and the spouse and dependents) from that separate account.

.04 The 401(h) assets may be used only to pay current retiree health benefits, which are obligations of a separate health and welfare benefit plan or health benefit arrangement. They may not be used to satisfy pension obligations. Although the assets may be invested together with assets that are available to pay pension benefits, a separate accounting must be maintained for all qualified transfers, contributions, distributions and/or expenses, and income earned thereon.

.05 Financial Accounting Standards Board (FASB) Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, and the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide) provide guidance to preparers and auditors of financial statements of defined benefit pension plans. Neither document addresses accounting for and reporting of 401(h) features of those plans.

Scope

.06 Paragraphs .08 through .10 and paragraphs .13 and .14 of this SOP apply to all defined benefit pension plans that contain a 401(h) feature.

.07 Paragraphs .11, .12, .15, and .16 of this SOP apply to health and welfare benefit plans if a portion or all of the benefits under such plans are funded through a 401(h) feature in a defined benefit pension plan.

Conclusions

Accounting and Reporting

Defined Benefit Pension Plans

.08 Because the 401(h) net assets may not be used to satisfy pension obligations, the total of net assets available for pension benefits must not include assets held in the 401(h) account related to obligations of the health and welfare benefit plan. The 401(h) account assets less liabilities (net assets of the 401(h) account) are required to be shown in defined benefit pension plan financial statements as a single line item on the face of the statements (as illustrated in appendix B [paragraph .22]). Those net assets related to the 401(h) account also must be deducted before arriving at the total of net assets available for pension benefits. In deducting those net assets, the amount relating to 401(h) features should be presented as a separate line item in the liabilities section of the statement of net assets available for pension benefits. The financial statement caption should clearly denote that the net assets held in the 401(h) account relate to obligations of the health and welfare plan or arrangement. The statement of changes in net assets should show only the changes in net assets of the pension plan and not any of the components of the changes in the net assets in the 401(h) account. The only amounts that should be reported in the statement of changes in net assets are qualified transfers to the 401(h) account and/or any unused or unspent amounts (including allocated income) in the 401(h) account at the end of the year that were qualified transfers of excess pension plan assets that should have been but were not transferred back to the defined benefit pension plan.

.09 Information regarding accumulated plan benefits should relate only to pension obligations. Even in situations in which separate financial statements are not prepared for the health and welfare benefit plan, obligations related to retiree health benefits should not be reported in the statement of accumulated plan benefits of the defined benefit pension plan financial statements.

.10 Illustrative financial statements for a defined benefit pension plan with a 401(h) feature are presented in appendix B [paragraph .22].

Health and Welfare Benefit Plans

.11 The 401(h) account assets used to fund health benefits, and the changes in those assets, should be reported in the financial statements of the health and welfare benefit plan. The 401(h) account assets and liabilities and changes in them can be shown in the health and welfare benefit plan financial statements in one of two ways. An entity can present that information either as a single line item on the face of the statements (as illustrated in appendix C [paragraph .23] or included in individual line items with separate disclosure in the footnotes about the 401(h) amounts included in those individual line items. If the assets and liabilities are shown as a single line item in the statement of net assets, the changes in net assets also should be shown as a single line item in the statement of changes in net assets. If the assets and liabilities are included in individual asset and liability line items in the statement of net assets, the changes in individual 401(h) amounts should be included in the changes in the individual line items in the statement of changes in net assets, with separate disclosure in the footnotes about the 401(h) amounts included in those individual line items. The notes to the financial statements should disclose the significant components of net assets and changes in net assets of the 401(h) account. The 401(h) obligations are reported in the health and welfare benefit plan's statement of benefit obligations as required by SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans* [section 10,530]. Likewise, the health and welfare benefit plan's statement of changes in benefit obligations should include claims paid through the 401(h) account.

.12 Illustrative financial statements of a health and welfare benefit plan funded through a 401(h) account in a separate defined benefit pension plan are presented in appendix C [paragraph .23].

Disclosures

Defined Benefit Pension Plans

.13 Defined benefit pension plans should disclose in the notes to the financial statements the nature of the assets related to the 401(h) account, and the fact that the assets are available only to pay retiree health benefits.

.14 The Employee Retirement Income Security Act of 1974 (ERISA) requires that the 401(h) assets be reported as assets of the defined benefit pension plan in regulatory filings with the U.S. government. Paragraph 12.27 of the Guide notes that ERISA requires a plan's financial statements to include a note explaining differences between amounts reported in the financial statements and the amounts reported in the Form 5500 Annual Return/Report. Because ERISA requires 401(h) accounts to be reported as assets of the pension plan, a reconciliation of the net assets reported in the financial statements to those reported in Form 5500 is required. The reconciliation should be accompanied by a discussion of the 401(h) account, explaining clearly that the assets in the 401(h) account are not available to pay pension benefits.

Health and Welfare Benefit Plans

.15 Health and welfare benefit plans should disclose in the notes to the financial statements the fact that retiree health benefits are funded partially through a 401(h) account of the defined benefit pension plan. Those plans also should disclose the fact that the assets in the 401(h) account are available only to pay retiree health benefits. The notes to the financial statements should disclose the significant components of net assets and changes in net assets of the 401(h) account.

.16 As noted in paragraph .14 above, ERISA requires that the 401(h) assets be reported as assets of the defined benefit pension plan and not as assets of the health and welfare benefit plan in regulatory filings with the U.S. government. Paragraph 12.27 of the Guide notes that ERISA requires a plan's financial statements to include a note explaining differences between amounts reported in the financial statements and the amounts reported in the Form 5500. Because ERISA requires 401(h) accounts to be reported as assets of the pension plan, a reconciliation of the net assets reported in the financial statements to those reported in the Form 5500 is required for the health and welfare benefit plan.

Amendments to the Guide

.17 The following is added to chapter 2, "Accounting and Reporting by Defined Benefit Pension Plans," of the Guide as paragraphs 2.36 through 2.44 under the section "Additional Financial Statement Disclosures." The existing Guide paragraphs 2.36 through 2.42 will be renumbered to paragraphs 2.43 through 2.51 as a result of these amendments.

> **2.36** *401(h) Accounts.* Some defined benefit pension plans provide a postretirement medical-benefit component in addition to the normal retirement benefits of the plan, pursuant to Section 401(h) of the Internal Revenue Code (IRC). Employers may fund a portion of their postretirement medical-benefit obligations related to their health and welfare benefit plans through a health benefit account (401(h) account) in their defined benefit pension plans, subject to certain restrictions and limitations. Funding can be accomplished through a qualified transfer of excess pension plan assets or through additional contributions. Any assets transferred to a 401(h) account in a qualified transfer of excess pension plan assets (and any income allocable thereto) must be used only to pay qualified current retiree health benefits for the taxable year of the transfer (whether directly or through reimbursement). Any assets transferred to a 401(h) account in a qualified transfer of excess pension plan assets (and any income allocable thereto) that are not used in the year must be transferred out of the account to the pension plan.
>
> **2.37** The IRC allows employers to allocate up to 25 percent of total contributions to the plan, subject to certain limitations, to the 401(h) account. If the full amount of these contributions is not used during the year, they may be accumulated for future retiree medical expenses in the 401(h) account. The deductibility of employer contributions to a 401(h) account is subject to separate limitations and, therefore, such contributions have no effect on the amount of deductible contributions an employer can make to fund pension benefits under the plan. The earnings on the 401(h) account are ignored for minimum funding purposes. Additionally, under the IRC, qualified transfers are not treated as prohibited transactions for purposes of Section 4975.
>
> **2.38** The plan sponsor has discretion in making contributions to the 401(h) account. A pension or annuity plan may provide for payment of medical benefits for retired employees, their spouses, and their dependents if all of the following conditions are met.
>
> *a.* Benefits are subordinate (as defined in Section 401(h) of the IRC) to the retirement benefits provided by the plan.
>
> *b.* A separate account is established and maintained for such benefits.

c. The employer's contributions to the separate account are reasonable and ascertainable.

d. It is impossible, at any time prior to the satisfaction of all obligations under the plan to provide such benefits, for any part of the corpus or income of the separate account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits.

e. Notwithstanding the provisions of certain IRC sections, upon satisfaction of all obligations under the plan to provide such benefits, any amount remaining in the separate account must, under the terms of the plan, be returned to the employer.

f. In the case of an employee who is a key employee (as defined in Section 416(i)), a separate account is established and maintained for such benefits which are payable to such employee (and the spouse and dependents), and such benefits (to the extent attributable to plan years beginning after March 31, 1984, for which the employee is a key employee) are payable only to that employee (and the spouse and dependents) from the separate account.

2.39 The 401(h) assets may be used only to pay current retiree health benefits, which generally are obligations of a separate health and welfare benefit plan or health benefit arrangement. They may not be used to satisfy pension obligations. Although the assets may be invested together with assets that are available to pay pension benefits, a separate accounting must be maintained for all qualified transfers, contributions, distributions and/or expenses, and income earned thereon.

2.40 Because the 401(h) net assets may not be used to satisfy pension obligations, the total of net assets available for pension benefits must not include net assets held in the 401(h) account related to obligations of the health and welfare benefit plan. The 401(h) account assets less liabilities (net assets of the 401(h) account) are required to be shown in defined benefit pension plan financial statements as a single line item on the face of the statements (as illustrated in appendix B of SOP 99-2). Those net assets related to the 401(h) account also must be deducted before arriving at the total of net assets available for pension benefits. In deducting those net assets, the amount related to the 401(h) features should be presented as a separate line item in the liabilities section of the statement of net assets available for pension benefits. The financial statement caption should clearly denote that the net assets held in the 401(h) account relate to obligations of the health and welfare benefit plan or arrangement. The statement of changes in net assets should show only the changes in net assets of the pension plan and not any of the components of the changes in the net assets in the 401(h) account. The only amounts that should be reported in the statement of changes in net assets are qualified transfers to the 401(h) account and/or any unused or unspent amounts (including allocated income) in the 401(h) account at the end of the year that were qualified transfers of excess pension plan assets that should have been, but were not, transferred back to the defined benefit pension plan.

2.41 Information regarding accumulated plan benefits should relate only to pension obligations. Even in situations in which separate financial statements are not prepared for the health and welfare benefit plan, obligations related to retiree health benefits should not be reported in the statement of accumulated plan benefits of the defined benefit pension plan financial statements.

2.42 Defined benefit pension plans should disclose in the notes to the financial statements the fact that the 401(h) account assets are available only to pay retiree health benefits.

.18 The following is added to chapter 4, "Accounting and Reporting by Health and Welfare Benefit Plans," of the Guide as paragraphs 4.54 and 4.55 under the section "Postretirement Benefit Obligations." The existing Guide paragraphs 4.54 through 4.55 are renumbered to paragraphs 4.56 through 4.57 as a result of these amendments.

4.54 Certain retiree health benefits may be funded through a 401(h) account in a defined benefit pension plan, pursuant to Section 401(h) of the Internal Revenue Code (IRC). Refer to paragraphs 2.36 through 2.42 of this Guide for a detailed discussion of 401(h) accounts. The 401(h) account assets and liabilities used to fund retiree health benefits, and the changes in those assets and liabilities, should be reported in the financial statements of the health and welfare benefit plan. The 401(h) account assets used to fund health benefits, and the changes in those assets, should be reported in the financial statements of the health and welfare benefit plan. The 401(h) account assets and liabilities and changes in them can be shown in the health and welfare benefit plan financial statements in one of two ways. An entity can present that information either as a single line item on the face of the statements or included in individual line items with separate disclosure in the footnotes about the 401(h) amounts included in those individual line items. If the assets and liabilities are shown as a single line item in the statement of net assets, the changes in net assets also should be shown as a single line item in the statement of changes in net assets. If the assets and liabilities are included in individual asset and liability line items in the statement of net assets, the changes in individual 401(h) amounts should be included in the changes in the individual line items in the statement of changes in net assets, with separate disclosure in the footnotes about the 401(h) amounts included in those individual line items. The notes to the financial statements should disclose the significant components of net assets and changes in net assets of the 401(h) account. The 401(h) obligations are reported in the health and welfare benefit plan's statement of benefit obligations. Likewise, the health and welfare benefit plan's statement of changes in benefit obligations should include claims paid through the 401(h) account.

4.55 If retiree health benefit obligations are funded partially through a 401(h) account of the defined benefit pension plan, the plan should also disclose the fact that the assets are available only to pay retiree health benefits. The notes to the financial statements should disclose the significant components of net assets and changes in net assets of the 401(h) account. Additionally, the notes should include a reconciliation of amounts reported in the financial statements to the amounts reported in the Form 5500 (see paragraph 12.27).

.19 The illustrative financial statements examples in appendix B [paragraph .22] of this SOP are added to the Guide as exhibits D-9 through D-11.

The illustrative financial statements examples in appendix C [paragraph .23] of this SOP are added to the Guide as exhibits F-9 through F-13.

Effective Date and Transition

.20 This SOP is effective for financial statements for plan years beginning after December 15, 1998. Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this SOP should be made retroactively by restatement of financial statements for prior periods. If financial statements for prior periods are not presented, the financial statements for the year in which this SOP is first applied should disclose the effect of any restatement on the beginning balance of net assets.

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Appendix A

Background Information and Basis for Conclusions

A.1. Practice in the area of accounting and reporting for 401(h) features of defined benefit pension plans was diverse. Some defined benefit pension plans reported all defined benefit and 401(h) account assets together in the statement of net assets available for benefits, and disclosed information about the 401(h) account in the notes to the defined benefit pension plan and health and welfare benefit plan financial statements. Others displayed the assets separately in multicolumnar format in the defined benefit pension plan financial statements, with note disclosures in the defined benefit plan and health and welfare benefit plan financial statements. The content of note disclosures varied significantly. Still others did not include the 401(h) assets in the defined benefit pension plan financial statements at all. Instead, the assets were reported in the financial statements of the related health and welfare benefit plan.

A.2. 401(h) account assets are used to pay benefits promised by a separate health and welfare benefit plan. Payments for retiree health benefits are made directly from the 401(h) account to the participant or his or her designee or as reimbursements to the sponsoring company. The pension plan basically is a funding vehicle for payment of those benefits. The AICPA Accounting Standards Executive Committees (AcSEC) believes the reporting of those 401(h) assets should be similar to financial statement reporting of separate accounts of life insurance companies, where the assets in the separate accounts are shown as a single line item described as "assets held in separate accounts." The same amount also is shown as a liability captioned "liabilities related to the separate accounts." The Industry Audit Guide *Audits of Stock Life Insurance Companies* states in the glossary that "separate accounts constitute a separate operation under which the assets fund the liabilities to variable annuity contractholders, pension funds, and others."

A.3. In substance, those 401(h) assets are assets of the health and welfare benefit plan because they will be used to pay retiree health benefits promised by that plan. Paragraph 25 of FASB Statement of Financial Accounting Concepts Statement No. 6, *Elements of Financial Statements*, defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." FASB Concepts Statement No. 6 further states in paragraph 172 that "Future economic benefit is the essence of an asset. An asset has the capacity to serve the entity by being exchanged for something else of value to the entity, by being used to produce something of value to the entity, or by being used to settle its liabilities."

A.4. This document was exposed for public comment for a period of ninety days. Some respondents to the exposure draft questioned the need for a detailed disclosure of 401(h) net assets in a defined benefit pension plans financial statements. The 401(h) assets legally are assets of the defined benefit pension plan. In addition, the Employee Retirement Income Security Act of 1974 (ERISA) requires that for regulatory filings with the U.S. government, 401(h) assets be reported in the financial statements of the defined benefit pension plan. Accordingly, AcSEC believes the legal status of the assets should be reflected in the defined benefit pension plan's statement of net assets available for benefits.

A.5. Because the 401(h) account assets are available only to pay retiree health and welfare benefits, it would be misleading to report them as assets in the statement of net assets available for plan benefits in a defined benefit pension plan without also reporting the same amounts as obligations in the liabilities section of the statement of net assets available for pension benefits. AcSEC also believes the net amount of 401(h) assets held in the pension plan should be included in the net assets of the health and welfare benefit plan and the changes in those net assets should be reflected in the statement of changes in net assets available for benefits, with note disclosure of the nature of the 401(h) account assets and activity.

A.6. Some respondents commented that the 401(h) account assets should only be displayed as a single line item on the face of the benefit plan's financial statements and not included in the individual asset and liability line items with a separate footnote disclosure. AcSEC considered two alternative presentations of the 401(h) account net assets in defined benefit pension plan financial statements—either single line item treatment on the face of the financial statements (single line presentation) or including the individual asset and liability line items with other defined benefit plan assets and liabilities and disclosing in the footnotes the 401(h) amounts included in those individual line items (broad presentation). Because those 401(h) assets are not available to defined benefit pension plan participants for the payment of benefits, AcSEC believes the broad presentation method may confuse the users of defined benefit pension plan financial statements. Therefore, AcSEC agreed to the single line presentation method of reporting 401(h) account assets and liabilities in defined benefit pension plan financial statements.

A.7. In health and welfare benefit plans, the proceeds from 401(h) account assets can be used only to pay retiree health and welfare benefits. They are not available to pay benefits for active employees. Legal title to such assets is held by the defined benefit pension plan. Therefore, some believe the single line presentation is most appropriate. Others believe such factors do not prevent the broad presentation which they believe is more useful. Because paragraph .11 of this SOP requires disclosure regarding the significant components of net assets and changes in net assets of the 401(h) account, AcSEC concluded it did not need to resolve this issue at this time and agreed to allow health and welfare benefit plans the option of reporting either the single line presentation or the broad presentation of the 401(h) account assets in the health and welfare benefit plan's financial statements.

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Appendix B

Illustrative Defined Benefit Pension Plan Financial Statements and Related 401(h) Account Disclosures

B.1. This appendix illustrates certain applications of the provisions of this SOP that apply for the annual financial statements of a hypothetical defined benefit pension plan that has been amended to include a 401(h) account. It does not illustrate other provisions of this SOP that might apply in circumstances other than those assumed in this illustration. It also does not illustrate all disclosures required for a fair presentation in conformity with generally accepted accounting principles (GAAP). The formats presented and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations.

B.2. Although GAAP does not require comparative financial statements, Employee Retirement Income Security Act (ERISA) requires a comparative statement of net assets available for benefits. The illustrative financial statements are intended to comply with the requirements of ERISA.

B.3. ERISA and the Department of Labor (DOL) regulations require that certain information be included in supplemental schedules, which are not required under GAAP, and reported on by the independent auditor. See appendix A of *Audits of Employee Benefit Plans* for a further discussion of the ERISA and DOL requirements.

Example 1
C&H Company Pension Plan
Statement of Net Assets Available for Pension Benefits

	December 31,	
	20X1	*20X0*
Assets		
Investments, at fair value (Note A):		
Plan interest in C&H Master Trust	$2,000,000	$1,660,000
C&H Company common stock	600,000	800,000
Investment contract with insurance company	850,000	800,000
Corporate bonds and debentures	3,000,000	3,170,000
U.S. government securities	300,000	200,000
Mortgages	480,000	460,000
Money market fund	270,000	240,000
Total investments	7,500,000	7,330,000
Net assets held in 401(h) account (Note H)	1,072,000	966,000
Receivables:		
Employer's contribution	20,000	10,000
Securities sold	310,000	175,000
Accrued interest and dividends	70,000	70,000
Total receivables	400,000	255,000
Cash	180,000	80,000
Total assets	9,152,000	8,631,000
Liabilities		
Due to broker for securities purchased	—	400,000
Accounts payable	70,000	60,000
Accrued expenses	70,000	25,000
Amounts related to obligation of 401(h) account	1,072,000	966,000
Total liabilities	1,212,000	1,451,000
Net assets available for pension benefits	$7,940,000	$7,180,000

The accompanying notes are an integral part of the financial statements.

Example 2
C&H Company Pension Plan
Statement of Changes in Net Assets Available for Pension Benefits

	For the Year Ended December 31, 20X1
Investment income:	
Net appreciation in fair value of investments	$ 233,000
Interest	293,000
Dividends	4,000
	530,000
Less investment expenses	30,000
	500,000
Plan interest in C&H Master Trust investment income (Note F)	117,000
	617,000
Contributions (Note C):	
Employer	740,000
Employees	450,000
	1,190,000
Total additions	1,807,000
Benefits paid directly to participants	740,000
Purchases of annuity contracts (Note G)	257,000
	997,000
Administrative expenses	50,000
Total deductions	1,047,000
Net increase	760,000
Net assets available for pension benefits:	
Beginning of year	7,180,000
End of year	$7,940,000

The accompanying notes are an integral part of the financial statements.

Notes to Financial Statements

A. 401 (h) Account

Effective January 1, 19X0, the Plan was amended to include a medical-benefit component in addition to the normal retirement benefits to fund a portion of the postretirement obligations for retirees and their beneficiaries in accordance with Section 401(h) of the Internal Revenue Code (IRC). A separate account has been established and maintained in the Plan for the net assets related to the medical-benefit component (401(h) account). In accordance with IRC Section 401(h), the Plan's investments in the 401(h) account may not be used for, or diverted to, any purpose other than providing health benefits for retirees and their beneficiaries. Any assets transferred to the 401(h) account from the defined benefit pension plan in a qualified transfer of excess pension plan assets (and any income allocable thereto) that are not used during the plan year must be transferred out of the account to the pension plan. The related obligations for health benefits are not included in this Plan's obligations in the statement of accumulated plan benefits but are reflected as obligations in the financial statements of the health and welfare benefit plan. Plan participants do not contribute to the 401(h) account. Employer contributions or qualified transfers to the 401(h) account are determined annually and are at the discretion of the Plan Sponsor. Certain of the Plan's net assets are restricted to fund a portion of postretirement health benefits for retirees and their beneficiaries in accordance with IRC Section 401(h).

H. Reconciliation of Financial Statements to Form 5500[1]

The following is a reconciliation of net assets available for pension benefits per the financial statements to the Form 5500:

	December 31,	
	20X1	*20X0*
Net assets available for pension benefits per the financial statements	$7,940,000	$7,180,000
Net assets held in 401(h) account included as assets in Form 5500	1,072,000	966,000
Net assets available for benefits per the Form 5500	$9,012,000	$8,146,000

The net assets of the 401(h) account included in Form 5500 are not available to pay pension benefits but can be used only to pay retiree health benefits.

[1] The reconciliation of amounts reported in the plan's financial statements to amounts reported in Form 5500 is required by ERISA.

The following is a reconciliation of the changes in net assets per the financial statements to the Form 5500:

	For the Year Ended December 31, 20X1		
	Amounts per Financial Statements	*401(h) Account*	*Amounts per Form 5500*
Net appreciation in fair value of investments	$233,000	$10,800	$243,800
Interest income	293,000	80,200	373,200
Employer contributions	740,000	40,000	780,000
Benefits paid to retirees	740,000	10,000	750,000
Administrative expenses	50,000	15,000	65,000

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Appendix C

Illustrative Health and Welfare Benefit Plan Financial Statements and Related 401(h) Account Disclosures—Single Line Presentation Approach

C.1. This appendix illustrates certain applications of the provisions of this SOP that apply to the financial statements of a health and welfare benefit plan that includes retiree health benefits that are funded partially through a 401(h) account in the plan sponsor's defined benefit pension plan. It illustrates the single line approach to presenting information about the 401(h) account permitted by paragraph .11 of this SOP. It does not illustrate other provisions of this SOP that might apply in circumstances other than those assumed in this illustration. It also does not illustrate all disclosures required for a fair presentation in conformity with generally accepted accounting principles (GAAP). The formats presented and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations.

C.2. Although GAAP does not require comparative financial statements, the Employee Retirement Income Security Act (ERISA) requires a comparative statement of net assets available for benefits. The illustrative financial statements are intended to comply with the requirements of ERISA.

C.3. ERISA and the Department of Labor (DOL) regulations require that certain information be included in supplemental schedules, which are not required under GAAP, and reported on by the independent auditor. See appendix A of *Audits of Employee Benefit Plans* for a further discussion of the ERISA and DOL requirements.

Example 1
C&H Company Welfare Benefit Plan
Statement of Net Assets Available for Plan Benefits

	December 31,	
	20X1	*20X0*
Assets		
Investments, at fair value:		
U.S. government securities	$5,000,000	$4,000,000
Corporate bonds and debentures	2,000,000	1,600,000
Common stock	1,000,000	600,000
Total investments	8,000,000	6,200,000
Net assets held in C&H Company defined benefit plan—restricted for 401(h) account (Notes A and E)	1,072,000	966,000
Receivables		
Employer contribution	500,000	430,000
Employee contributions	100,000	80,000
Accrued interest and dividends	50,000	40,000
Total receivables	650,000	550,000
Cash	110,000	115,000
Total assets	9,832,000	7,831,000
Liabilities		
Due to broker for securities purchased	250,000	240,000
Accounts payable for administrative expenses	25,000	25,000
Total liabilities	275,000	265,000
Net assets available for plan benefits	$9,557,000	$7,566,000

The accompanying notes are an integral part of the financial statements.

Example 2
C&H Company Welfare Benefit Plan
Statement of Changes in Net Assets Available for Plan Benefits

	For the Year Ended December 31, 20X1
Additions	
Contributions	
Employer contributions	$15,000,000
Employee contributions	3,000,000
Total contributions	18,000,000
Investment income	
Net appreciation in fair value of investments	300,000
Interest	500,000
Dividends	50,000
Total investment income	850,000
Less investment expense	15,000
Net investment income	835,000
Net increase in 401(h) account (Note E)	106,000
Total additions	18,941,000
Deductions	
Benefits paid directly to participants:	
Health care	16,000,000
Disability and death	770,000
Total benefits paid	16,770,000
Administrative expenses	180,000
Total deductions	16,950,000
Net increase during the year	1,991,000
Net assets available for benefits:	
Beginning of year	7,566,000
End of year	$ 9,557,000

The accompanying notes are an integral part of the financial statements.

Example 3
C&H Welfare Benefit Plan
Statement of Benefit Obligations

	For the Year Ended December 31, 20X1	*For the Year Ended December 31, 20X0*
Amounts currently payable to or for participants, beneficiaries, and dependents		
Health claims payable	$ 1,100,000	$ 975,000
Death and disability benefits payable	100,000	75,000
Total amounts currently payable	1,200,000	1,050,000
Other obligations for current benefit coverage, at present value of estimated amounts		
Claims incurred but not reported	425,000	390,000
Long-term disability benefits	925,000	610,000
Total other obligations for current benefit coverage	1,350,000	1,000,000
Total obligations other than postretirement benefit obligations	2,550,000	2,050,000
Postretirement benefit obligations		
Current retirees	3,900,000	3,500,000
Other participants fully eligible for benefits	2,100,000	2,000,000
Other participants not yet fully eligible for benefits	5,000,000	4,165,000
Total postretirement benefit obligations	11,000,000	9,665,000
Total benefit obligations	$13,550,000	$11,715,000

The accompanying notes are an integral part of the financial statements.

Example 4
C&H Company Welfare Benefit Plan
Statement of Changes in Benefit Obligations

	For the Year Ended December 31, 20X1
Amounts currently payable to or for participants, beneficiaries, and dependents	
Balance, beginning of year	$ 1,050,000
Claims reported and approved for payment	16,930,000
Claims paid (including disability)	(16,770,000)
Claims paid through 401(h) account (Note E)	(10,000)
Balance, end of year	1,200,000
Other obligations for current benefit coverage, at present value of estimated amounts	
Balance, beginning of year	1,000,000
Net change during year:	
Long-term disability benefits	315,000
Other	35,000
Balance, end of year	1,350,000
Total obligations other than postretirement benefit obligations	2,550,000
Postretirement benefit obligations	
Balance, beginning of year	9,665,000
Increase (decrease) during the year attributable to:	
Benefits earned and other changes	1,250,000
Plan amendment	(175,000)
Changes in actuarial assumptions	260,000
Balance, end of year	11,000,000
Total benefit obligations, end of year	$13,550,000

The accompanying notes are an integral part of the financial statements.

Notes to Financial Statements

A. 401(h) Account

Effective January 1, 19X0, the [*Company's defined benefit pension plan*] was amended to include a medical-benefit component in addition to normal retirement benefits to fund a portion of the postretirement obligations for retirees and their beneficiaries in accordance with Section 401(h) of the Internal Revenue Code (IRC). A separate account has been established and maintained in the [*defined benefit pension plan*] for such contributions. In accordance with IRC Section 401(h), the Plan's investments in the 401(h) account may not be used for, or diverted to, any purpose other than providing health benefits for retirees and their beneficiaries. The related obligations for health benefits are not included in the [*defined benefit pension plan's*] obligations in the statement of accumulated plan benefits but are reported as obligations in the financial statements of the [*health and welfare benefit plan*].

E. 401(h) Account

A portion of the Plan's obligations are funded through contributions to the Company's [*defined benefit pension plan*] in accordance with IRC Section 401(h). The following table presents the components of the net assets available for such obligations and the related changes in net assets available.

Net Assets Available for Postretirement Health and Welfare Benefits in 401(h) Account

	December 31,	
	20X1	*20X0*
Investments at fair value:		
U.S. government securities	$ 14,000	$150,000
Money market fund	900,000	800,000
	1,040,000	950,000
Cash	20,000	10,000
Employer's contribution receivable[2]	20,000	15,000
Accrued interest	7,000	6,000
Total assets	1,087,000	981,000
Accrued administrative expenses	(15,000)	(15,000)
Net assets available	$1,072,000	$966,000

[2] A receivable from the employer must meet the requirements of paragraph 10 of FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*.

Changes in Net Assets in 401(h) Account

	For the Year Ended December 31, 20X1
Net appreciation in fair value of investments:	
U.S. government securities	$ 10,800
Interest	80,200
	91,000
Employer contributions	40,000
Health and welfare benefits paid to retirees	(10,000)
Administrative expenses	(15,000)
Net increase in net assets available	$106,000

H. Reconciliation of Financial Statements to Form 5500[3]

The following is a reconciliation of net assets available for benefits per the financial statements to the Form 5500:

Net assets available for benefits per the financial statements	$ 9,557,000
Claims payable	(1,200,000)
Net assets held in defined benefit plan-401(h) account	(1,072,000)
Net assets available for benefits per Form 5500	$ 7,285,000

The following is a reconciliation of claims paid per the financial statements to the Form 5500:

Claims paid per the financial statements	$16,770,000
Add: Amounts payable at December 31, 20X1	1,200,000
Less: Amounts payable at December 31, 20X0	(1,050,000)
Claims paid per Form 5500	$16,920,000

[3] The reconciliation of amounts reported in plan financial statements to amounts reported in Form 5500 is required by ERISA.

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401(h) Account SOP Task Force

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The Employee Benefit Plans Committee gratefully acknowledges the contributions of the Office of Chief Accountant, Pension and Welfare Benefits Administration of the U. S. Department of Labor.

[The next page is 80,641.]

Section 10,790

Statement of Position 99-3 Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters

September 15, 1999

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) amends chapters 3 and 4 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide). This SOP amends SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined Contribution Plans* [section 10,620], and SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans* [section 10,530]. This SOP simplifies disclosures for certain investments and supersedes AICPA Practice Bulletin 12, *Reporting Separate Investment Fund Option Information of Defined-Contribution Pension Plans*.

This SOP—

- Amends paragraph 3.20 of the Guide to eliminate the previous requirement for a defined contribution plan to present plan investments by general type for participant-directed investments in the statement of net assets available for benefits.
- Amends paragraph 3.35(*k*) and supersedes paragraph 3.35(*l*) of the Guide and supersedes Practice Bulletin 12 to eliminate the requirement for a defined contribution plan to disclose participant-directed investment programs and to eliminate the requirement to disclose the total number of units and the net asset value per unit during the period, and at the end of the period, by defined contribution pension plans that assign units to participants.

- Amends paragraph 3.35(*g*) of the Guide to require a defined contribution plan to identify nonparticipant-directed investments that represent 5 percent or more of net assets available for benefits.
- Amends paragraphs 3.35(*p*) and 4.57 of the Guide, paragraph 53 of SOP 92-6 [section 10,530.58], and paragraph 15 of SOP 94-4 [section 10,620.15] to eliminate the requirement for defined contribution plans, including both health and welfare benefit plans and pension plans, to disclose benefit-responsive investment contracts by investment fund option.
- Replaces exhibits E-1 through E-5 in the Guide.

This SOP is effective for financial statements for plan years ending after December 15, 1999. Earlier application is encouraged for fiscal years for which annual financial statements have not been issued. If the previously required "by-fund" disclosures are eliminated, the reclassification of comparative amounts in financial statements for earlier periods is required.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, the clearance of the proposed project and proposed documents by the FASB reflect suggested changes to the proposed items.

Introduction

.01 The primary objective of a **defined contribution plan's**[1] financial statements is to provide information that is useful in assessing the plan's present and future ability to pay benefits. This objective is consistent with the

[1] Terms defined in the glossary [paragraph .34] are set in boldface type the first time they appear in this SOP.

objectives of a pension plan's financial statements as stated in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*. The primary users of a defined contribution plan's financial statements are the plan sponsor(s), plan participants, and the following governmental regulators: the U.S. Department of Labor (DOL), the Internal Revenue Service (IRS), and the Securities and Exchange Commission (SEC). For employee benefit plans that are subject to the Employee Retirement Income Security Act (ERISA), many of the disclosures in a plan's financial statements are provided in order to comply with certain regulatory requirements. For substantially all plans, the financial statement information is reported to the regulatory agencies on Form 5500, Annual Return/Report of Employee Benefit Plans, which includes financial statements and supplemental schedules (for example, plan investments and reportable transactions).

.02 Paragraph 3.35(*k*) of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide) established requirements for separately reporting information about participant-directed **investment fund options** within defined contribution plans. AICPA Practice Bulletin 12, *Reporting Separate Investment Fund Option Information of Defined-Contribution Pension Plans*, clarified the reporting requirements set forth in paragraph 3.35(*k*). Plans that provide participant-directed investment programs were required to disclose amounts relating to each such program as a separate fund, either in columnar form in the financial statements or in the related disclosures, or through separate financial statements for each investment fund option.

.03 Statement of Position (SOP) 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined Contribution Plans*, paragraph 15 [section 10,620.15]; paragraphs 3.35(*p*) and 4.57 of the Guide; and SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans* (SOP 92-6 [section 10,530], as amended by SOP 94-4 [section 10,620][2]), paragraph 53 [section 10,530.58], required defined contribution pension and **health and welfare benefit plans** to disclose the following information relating to **benefit-responsive investment contracts** in the aggregate by investment fund option:

- The average yield for each period for which a statement of net assets available for benefits is presented
- The crediting interest rate as of the date of each statement of net assets available for benefits presented
- The amount of valuation reserves recorded to adjust contract amounts
- The fair values of benefit-responsive investment contracts reported at contract value, in accordance with FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended

.04 Paragraph 3.35(*l*) of the Guide required defined contribution pension plans that assign units to participants to disclose "the total number of units and the net asset value per unit during the period (for example, monthly or quarterly, depending on the plan's provisions for calculating the unit values) and at the end of the period."

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[2] The original paragraph 53 of SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans* [section 10,530.58], has been renumbered to paragraph 58 by the issuance of SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans* [section 10,620].

.05 Paragraph 3.20 of the Guide required defined contribution plans to present plan investments in the statement of net assets available for benefits by general type.

.06 Paragraph 3.35(*g*) of the Guide requires identification of investments that represent 5 percent or more of the net assets available for benefits.

Scope

.07 Paragraphs .08 through .12 of this SOP apply to all defined contribution plans with participant-directed investment programs. Paragraphs .13 and .14 of this SOP apply to all defined contribution health and welfare benefit plans with benefit-responsive investment contracts.

Conclusions

Defined Contribution Plans

Presentation in Defined Contribution Plan Financial Statements of Information About Investments, Participant-Directed Investment Programs, and Units of Participation

.08 A defined contribution plan that provides participant-directed investment programs is no longer required to disclose amounts relating to those individual programs as a separate fund in the financial statements in columnar form, or in the related disclosures, or by separate financial statements for each program as required by Practice Bulletin 12. However, if a defined contribution plan provides for both participant-directed and nonparticipant-directed[3] investment programs, the plan should disclose information in the financial statements about the net assets and significant components of the changes in net assets relating to the nonparticipant-directed program with such reasonable detail, either in the financial statements or the accompanying notes, as is necessary to identify the types of investments and changes therein.

.09 Defined contribution plans are not required to present participant-directed plan investments in the statement of net assets available for benefits by general type as required by paragraph 3.20 of the Guide. Participant-directed plan investments may be shown in the aggregate, as a one-line item, in the statement of net assets available for benefits. The presentation of nonparticipant-directed investments in the statement of net assets available for benefits or in the notes should be detailed by general type, such as registered investment companies (also known as mutual funds), government securities, short-term securities, corporate bonds, common stocks, mortgages, loans to participants, and real estate. The presentation should indicate whether the fair values of the investments have been measured by quoted market prices in an active market or were determined otherwise.

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[3] If a plan offers a program that is both participant- and nonparticipant-directed, and if the participant-directed and nonparticipant-directed amounts cannot be separately determined, the plan will be deemed to be nonparticipant-directed for purposes of this disclosure. For example, an employer-sponsored plan offers six investment fund options, one of which is a stock fund that includes only the employer's stock. Employees at their discretion may invest their contributions in any or all of the six options. However, the employer's contribution to the plan (for example, the company match) is automatically invested in the employer's stock fund. The stock fund is considered to be nonparticipant-directed for purposes of this disclosure if the employee and the employer amounts cannot be separately determined.

.10 In addition to the current requirement to identify those investments that represent 5 percent or more of net assets available for benefits, defined contribution plans should specifically identify those investments that represent 5 percent or more of net assets available for benefits that are nonparticipant-directed.

.11 Defined contribution plans no longer need to disclose, by investment fund option, the information on benefit-responsive investment contracts as required by paragraph 15 of SOP 94-4 [section 10,620.15], paragraphs 3.35(*p*) and 4.57 of the Guide, and paragraph 53[4] of SOP 92-6 [section 10,530.58]. However, the disclosures set forth in SOP 94-4, paragraph 15 [section 10,620.15]; the Guide, paragraphs 3.35(*p*) and 4.57 (bullet 17); and SOP 92-6, paragraph 53 [section 10,530.58] (as amended by SOP 94-4 [section 10,620][4]), are still required in the aggregate.

.12 Defined contribution plans (participant-directed and nonparticipant-directed) that assign units to participants are not required to disclose the total number of units and the net asset value per unit during the period, and at the end of the period as required by Guide paragraph 3.35(*l*).

Defined Contribution Health and Welfare Benefit Plans

.13 Defined contribution health and welfare benefit plans no longer need to disclose the information on benefit-responsive investment contracts by investment fund option, as required by paragraph 15 of SOP 94-4 [section 10,620.15], paragraphs 3.35(*p*) and 4.57 of the Guide, and paragraph 53[4] of SOP 92-6 [section 10,530.58]. However, the disclosures set forth in SOP 94-4, paragraph 15 [section 10,620.15]; the Guide, paragraphs 3.35(*p*) and 4.57 (bullet 17); and SOP 92-6, paragraph 53 [section 10,530.58] (as amended by SOP 94-4 [section 10,620][4]), are still required in the aggregate.

.14 In addition to the disclosures listed in paragraph .13, defined contribution health and welfare benefit plans should specifically identify those investments that represent 5 percent or more of net assets available for benefits.

Amendments to the Guide

.15 In paragraph 3.09 and footnote 6, the phrase “when they are due” is deleted.

.16 In paragraphs 3.11 and 4.20, the phrase “when due” is deleted.

.17 Paragraph 3.20 is replaced with the following.

> Participant-directed plan investments may be shown in the aggregate, as a one-line item, in the statement of net assets available for benefits. The presentation of nonparticipant-directed investments in the statement of net assets available for benefits or in the notes should be detailed by general type, such as registered investment companies (also known as mutual funds), government securities, short-term securities, corporate bonds, common stocks, mortgages, loans to participants, and real estate. The presentation should indicate whether the fair values of the investments have been measured by quoted market prices in an active market or were determined otherwise.

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[4] The original paragraph 53 of SOP 92-6 [section 10,530.58] has been renumbered to paragraph 58 by the issuance of SOP 94-4 [section 10,620].

.18 In paragraph 3.35(*g*), the following is added after the first sentence:

> If any of those investments are nonparticipant-directed, they should be identified as such.

.19 Paragraph 3.35(*k*) is replaced with the following:

> If a defined contribution plan provides for participant-directed and nonparticipant-directed investment programs, the plan should disclose information in the financial statements about the net assets and significant components of the changes in net assets relating to the nonparticipant-directed program with such reasonable detail, either in the financial statements or accompanying notes, as is necessary to identify the types of investments and changes therein.
>
> A plan provides for participant-directed investment programs if it allows participants to choose among various investment alternatives. The available alternatives are usually pooled fund vehicles, such as registered investment companies or commingled funds of banks, that provide varying kinds of investments—for example, equity funds and fixed income funds. The participant may select among the various available alternatives and periodically change that selection.

.20 Paragraph 3.35(*l*) is eliminated.

.21 In paragraph 3.35(*p*), the phrase "by investment option" is deleted.

.22 In the seventeenth bullet of paragraph 4.57, the phrase "by investment option" is deleted.

.23 Exhibits E-1 through E-5 in the Guide are superseded by the illustrative financial statements and disclosures in appendix B [paragraph .33] of this SOP.

.24 The terms "benefit-responsive investment contract" and "investment fund option," as defined in the glossary [paragraph .34] of this SOP, are added to the glossary of the Guide.

Amendments to SOP 94-4 [section 10,620]

.25 In paragraph 15 [section 10,620.15], the phrase "by investment option" is deleted.

.26 In paragraph 17(*g*)(*o*) [section 10,620.17(*g*)(*o*)], the phrase "by investment option" is deleted.

.27 In paragraph 17(*l*)(*i*) [section 10,620.17(*l*)(*i*)], the phrase "by investment option" is deleted.

.28 In the first bullet of paragraph 18(*e*) [section 10,620.18(*e*)], the phrase "by investment option" is deleted.

Amendment to SOP 92-6 [section 10,530]

.29 In the sixteenth bullet of paragraph 53 [section 10,530.58][5] (which was added by SOP 94-4 [section 10,620]), the phrase "by investment option" is deleted.

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[5] The original paragraph 53 of SOP 92-6 [section 10,530.58] has been renumbered to paragraph 58 by the issuance of SOP 94-4 [section 10,620].

Practice Bulletin 12

.30 This SOP supersedes AICPA Practice Bulletin 12, *Reporting Separate Investment Fund Option Information of Defined-Contribution Pension Plans*.

Effective Date and Transition

.31 This SOP is effective for financial statements for plan years ending after December 15, 1999. Earlier application is encouraged for fiscal years for which annual financial statements have not been issued. If the previously required "by-fund" disclosures are eliminated, the reclassification of comparative amounts in financial statements for earlier periods is required.

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Appendix A

Background Information and Basis for Conclusions

A.1. The Accounting Standards Executive Committee (AcSEC) considered whether the disclosures required by paragraph 3.35(*k*) of the Guide should be made by a defined contribution plan for its participant-directed investment programs. Paragraph 3.35(*k*) of the Guide, as clarified by Practice Bulletin 12, required all plans that provide participant-directed investment fund options to disclose the options separately and show in the financial statements amounts relating to each individual investment fund option, either in columnar format on the face of the financial statements, in the related notes to the financial statements, or in separate financial statements for each option. Practice Bulletin 12 clarified that paragraph 3.35(*k*) requires plans to disclose information about the net assets and significant components of changes in net assets for each participant-directed investment fund option.

A.2. Since the issuance of Practice Bulletin 12, there has been an increase in the number of investment programs offered to participants of defined contribution plans. At the same time, financial information about many investment fund options has become widely available, often with more frequency than the issuance of plan financial statements. For example, certain daily business publications and information services, such as Bloomberg Pricing Service and Interactive Data Corporation, provide financial information about investment fund options. In addition, financial information is publicly available for many investment fund options throughout the year, including upon request from fund distributors and the Securities and Exchange Commission (SEC). In each instance, participants and other interested parties are provided with financial information that is similar in many respects to the information required to be disclosed under paragraph 3.35(*k*) of the Guide. In addition, plan participants receive information about the plan in the form of at least annual (often quarterly) individual single-employer account statements and summary annual reports. Also, plan administrators and the trustees regularly provide plan participants with information on the investment fund options, such as prospectuses on mutual funds, or provide copies of the individual account statements on a quarterly basis.

A.3. The primary objective of a defined contribution plan's financial statements is to provide information that is useful in assessing the plan's present and future ability to pay benefits. That objective is fulfilled, in part, when the plan's financial statements provide information that is relevant and timely and the benefit of doing so justifies the cost. In view of the fact that plan participants now have available from other sources financial information about many participant-directed investment fund options, in many cases more timely and frequently than plan financial statements (for example, daily valuations), AcSEC believes that the benefit of plans presenting certain disclosures required by Guide paragraphs 3.35(*k*) and 3.35(*l*) for defined contribution plans is diminished. Furthermore, the periodic per unit net asset value disclosure is not a meaningful disclosure in the current plan investment environment because of the increased frequency of measuring unit values (that is, daily valuations), and plan participants generally receive more timely investment information from their individual participant statements. AcSEC believes that continuing to require those disclosures under these circumstances would impose an increasing compliance burden on plans, the cost of which would grow increasingly difficult to justify as more investment programs are offered to participants. Consequently, AcSEC has concluded that certain disclosures required by paragraphs 3.35(*k*) and 3.35(*l*) should not be required for defined contribution plans. Paragraph 3.35(*k*) is amended to reflect this conclusion and to reflect certain other disclosure requirements carried forward from Practice Bulletin 12, which is superseded by this SOP. Paragraph 3.35(*l*) is eliminated from the Guide.

A.4. The U. S. Department of Labor (DOL) is a primary user of a defined contribution plan's financial statements, and many of the disclosures in a plan's financial statements are provided in order to comply with certain regulatory requirements. Although this SOP eliminates the Guide paragraph 3.35(*k*) requirement to disclose amounts relating to individual participant-directed investment programs, it still requires that information about nonparticipant-directed investment programs in the aggregate be disclosed. This SOP also amends paragraph 3.20 of the Guide to require a defined contribution plan to present in the financial statements or accompanying notes plan investments by general type for only nonparticipant-directed investments. In addition, this SOP adds to the existing Guide paragraph 3.35(*g*) requirements to identify those investments that represent 5 percent or more of net assets available for benefits that are nonparticipant-directed. The DOL has advised that disclosure of information about nonparticipant-directed investment programs in the aggregate is useful in its regulation of defined contribution plans. In addition, AcSEC believes disclosure of such information is useful in providing information about plan resources and how the plan trustee's stewardship responsibility for those resources has been discharged.

A.5. SOP 94-4, paragraph 15 [section 10,620.15], and the Guide, paragraphs 3.35(*p*) and 4.57, required defined contribution plans to disclose certain aggregate information about benefit-responsive investment contracts by investment option. Furthermore, SOP 94-4, paragraph 15 [section 10,620.15]; the Guide, paragraph 4.57; and SOP 92-6, paragraph 53 [section 10,530.58] (as amended by SOP 94-4 [section 10,620]), required defined contribution health and welfare plans to disclose certain aggregate information about fully benefit-responsive investment contracts by investment option. AcSEC believes that disclosure of this information by investment option should not be required, and elimination of this disclosure is consistent with the elimination of certain Guide paragraph 3.35(*k*) disclosures. However, disclosure of this information in the aggregate is still required. Consequently, SOP 94-4, paragraph 15 [section 10,620.15]; paragraphs 3.35(*p*) and 4.57 of the Guide; and SOP 92-6, paragraph 53 [section 10,530.58], are amended.

A.6. This document was exposed for public comment for a period of sixty days. Certain respondents to the exposure draft believed that paragraph 3.20 of the Guide should not be amended. Paragraph 3.20 of the Guide required defined contribution plans to present plan investments detailed by general type in the statement of net assets available for benefits. AcSEC believes including participant-directed investments by general type in the financial statements for a defined contribution plan does not provide useful information in assessing the plan's present and future ability to pay benefits, nor does AcSEC believe it provides useful information to evaluate the trustee's stewardship responsibilities over those assets. Consequently, AcSEC has concluded that a defined contribution plan may present participant-directed plan investments in the aggregate, as a one-line item, on the statement of net assets available for benefits without detailing them by general type.[6] In addition, as mentioned in paragraph A.4, AcSEC believes the disclosure of nonparticipant-directed investment information by general type is useful in providing information about plan resources and how the plan trustee's stewardship responsibility for those resources has been discharged.

A.7. AcSEC decided to permit, but not require, early application of this SOP in plan financial statements for a fiscal year for which annual financial statements have not been issued. AcSEC believes that requiring entities that may adopt the SOP early to reclassify amounts in the financial statements when by-fund disclosures are eliminated will improve comparability.

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[6] Form 5500, item 31, requires investments to be detailed by general type.

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Appendix B

Illustrative Financial Statements and Disclosures of a Defined Contribution Plan With Participant-Directed and Nonparticipant-Directed Investment Programs

B.1. This Appendix illustrates certain applications of the provisions of this SOP that apply to the annual financial statements of a defined contribution plan with participant-directed and nonparticipant-directed investments. These illustrative financial statements and disclosures supersede exhibits E-l through E-5 in the Guide.

XYZ Company 401(k) Plan
Statements of Net Assets Available for Benefits

	December 31,	
	20X1	*20X0*
Assets:		
Investments (See Note C)	$9,177,000	$7,995,000
Receivables:		
Employer contribution	14,000	10,000
Participant contributions	52,000	50,000
Total receivables	66,000	60,000
Total assets	9,243,000	8,055,000
Liabilities:		
Accounts payable	10,000	20,000
Accrued expenses	15,000	—
Total liabilities	25,000	20,000
Net assets available for benefits	$9,218,000	$8,035,000

See accompanying notes to the financial statements.

XYZ Company 401(k) Plan
Statement of Changes in Net Assets Available for Benefits

	Year Ended December 31, 20X1
Additions:	
Additions to net assets attributed to:	
Investment income:	
Net appreciation in fair value of investments (see Note C)	$ 279,000
Interest	439,000
Dividends	165,000
	883,000
Less investment expenses	(50,000)
	833,000
Contributions:	
Participant	900,000
Employer	699,000
	1,599,000
Total additions	2,432,000
Deductions:	
Deductions from net assets attributed to:	
Benefits paid to participants	1,144,000
Administrative expenses (see Note F)	105,000
Total deductions	1,249,000
Net increase	1,183,000
Net assets available for benefits:	
Beginning of year	8,035,000
End of year	$9,218,000

See accompanying notes to the financial statements.

Notes to Financial Statements

A. Description of Plan

The following description of the XYZ Company ("Company") 401(k) Plan (Plan) provides only general information. Participants should refer to the Plan agreement for a more complete description of the Plan's provisions.

1. *General.* The Plan is a defined contribution plan covering all full-time employees of the Company who have one year of service and are age twenty-one or older. It is subject to the provisions of the Employee Retirement Income Security Act (ERISA).
2. *Contributions.* Each year, participants may contribute up to 12 percent of pretax annual compensation, as defined in the Plan. Participants may also contribute amounts representing distributions from other qualified defined benefit or defined contribution plans. Participants direct the investment of their contributions into various investment options offered by the Plan. The Plan currently offers two mutual funds and an insurance investment contract as investment options for participants. The Company contributes 25 percent of the first 6 percent of base compensation that a participant contributes to the Plan. The matching Company contribution is invested directly in XYZ Company common stock. Additional profit sharing amounts may be contributed at the option of the Company's board of directors and are invested in a portfolio of investments as directed by the Company. Contributions are subject to certain limitations.
3. *Participant Accounts.* Each participant's account is credited with the participant's contribution and allocations of (*a*) the Company's contribution and (*b*) Plan earnings, and charged with an allocation of administrative expenses. Allocations are based on participant earnings or account balances, as defined. The benefit to which a participant is entitled is the benefit that can be provided from the participant's vested account.
4. *Vesting.* Participants are vested immediately in their contributions plus actual earnings thereon. Vesting in the Company's contribution portion of their accounts is based on years of continuous service. A participant is 100 percent vested after five years of credited service.
5. *Participant Loans.* Participants may borrow from their fund accounts a minimum of $1,000 up to a maximum of $50,000 or 50 percent of their account balance, whichever is less. The loans are secured by the balance in the participant's account and bear interest at rates that range from 6 percent to 10 percent, which are commensurate with local prevailing rates as determined quarterly by the Plan administrator.
6. *Payment of Benefits.* On termination of service due to death, disability, or retirement, a participant may elect to receive either a lump-sum amount equal to the value of the participant's vested interest in his or her account, or annual installments over a ten-year period. For termination of service for other reasons, a participant may receive the value of the vested interest in his or her account as a lump-sum distribution.

B. Summary of Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and changes therein, and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Investment Valuation and Income Recognition

The Plan's investments are stated at fair value except for its benefit-responsive investment contract, which is valued at contract value (Note E). Quoted market prices are used to value investments. Shares of mutual funds are valued at the net asset value of shares held by the Plan at year end.

Purchases and sales of securities are recorded on a trade-date basis. Dividends are recorded on the ex-dividend date.

C. Investments

The following presents investments that represent 5 percent or more of the Plan's net assets.

	December 31,	
	20X1	*20X0*
XYZ Company common stock, 400,000 and 390,000 shares, respectively	$ 470,000*	$ 420,000*
ABC Corporation common stock, 390,000 and 380,000 shares, respectively	490,000*	450,000*
Prosperity Investments Common Stock Fund, 226,250 and 200,000 shares, respectively	2,262,500*	2,000,000*
Prosperity Investments Balanced Fund, 40,000 and 210,000 shares, respectively	1,422,000	2,100,000
Investment Contract with National Insurance Company, #2012A, matures 12/31/X5 (Note E)	1,500,000	650,000

* Nonparticipant-directed

During 20X1, the Plan's investments (including gains and losses on investments bought and sold, as well as held during the year) appreciated in value by $279,000 as follows:

Mutual funds	$229,000
Common stock	30,000
Corporate bond	30,000
U.S. Government Securities	(10,000)
	$279,000

D. Nonparticipant-Directed Investments

Information about the net assets and the significant components of the changes in net assets relating to the nonparticipant-directed investments is as follows:

	December 31,	
	20X1	*20X0*
Net Assets:		
Common stock	$ 960,000	$ 870,000
Mutual funds	2,262,500	2,000,000
Corporate bonds	307,500	255,000
U.S. Government Securities	225,000	120,000
	$3,755,000	$3,245,000

	Year Ended December 31, 20X1
Changes in Net Assets:	
Contributions	$ 699,000
Dividends	165,000
Net appreciation	60,000
Benefits paid to participants	(280,000)
Transfers to participant-directed investments	(134,000)
	$ 510,000

E. Investment Contract with Insurance Company

In 20X0, the Plan entered into a benefit-responsive investment contract with National Insurance Company (National). National maintains the contributions in a general account. The account is credited with earnings on the underlying investments and charged for participant withdrawals and administrative expenses. The contract is included in the financial statements at contract value as reported to the Plan by National. Contract value represents contributions made under the contract, plus earnings, less participant withdrawals and administrative expenses. Participants may ordinarily direct the withdrawal or transfer of all or a portion of their investment at contract value.

There are no reserves against contract value for credit risk of the contract issuer or otherwise. The average yield and crediting interest rates were approximately 8 percent for 20X1 and 20X0. The crediting interest rate is based on a formula agreed upon with the issuer, but may not be less than 4 percent. Such interest rates are reviewed on a quarterly basis for resetting.

F. Related-Party Transactions

Certain Plan investments are shares of mutual funds managed by Prosperity Investments. Prosperity Investments is the trustee as defined by the Plan and, therefore, these transactions qualify as party-in-interest transactions. Fees paid by the Plan for the investment management services amounted to $105,000 for the year ended December 31, 20X1.

G. Plan Termination

Although it has not expressed any intent to do so, the Company has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions of ERISA. In the event of Plan termination, participants would become 100 percent vested in their employer contributions.

H. Tax Status

The Internal Revenue Service has determined and informed the Company by a letter dated August 30, 1986, that the Plan and related trust are designed in accordance with applicable sections of the Internal Revenue Code (IRC). Although the Plan has been amended since receiving the determination letter, the Plan administrator and the Plan's tax counsel believe that the Plan is designed and is currently being operated in compliance with the applicable requirements of the IRC.

.34

Glossary

Defined contribution plan. A plan that provides an individual account for each participant and provides benefits that are based on (*a*) amounts contributed to the participant's account by the employer or employee, (*b*) investment experience, and (*c*) any forfeitures allocated to the account, less any administrative expenses charged to the plan.

Benefit-responsive investment contract. A contract between an insurance company, a bank, a financial institution, or any financially responsible entity and a plan that provides for a stated return on principal invested over a specified period and that permits withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan. Participant withdrawals from the plan are required to be at contract value.

Health and welfare benefit plan. A plan that provides the following:

1. Medical, dental, visual, psychiatric, or long-term health care; severance benefits; life insurance; accidental death or dismemberment benefits

2. Unemployment, disability, vacation or holiday benefits

3. Apprenticeships, tuition assistance, day-care, housing subsidies, or legal services benefits

Investment fund option. An investment alternative provided to a participant in a defined contribution plan. The alternatives are usually pooled fund vehicles, such as registered investment companies (meaning, mutual funds), commingled funds of banks, or insurance company pooled separate accounts providing varying kinds of investments, for example, equity funds and fixed income funds. The participant may select from among the various available alternatives and periodically change that selection.

Accounting Standards Executive Committee (1998-1999)

Employee Benefit Plans Committee (1998-1999)

AICPA Staff

The Employee Benefit Plans Committee gratefully acknowledges the contributions of Michele M. Weldon, former committee member; Linda Delahanty, technical manager, AICPA Accounting & Auditing Publications; and The Office of Chief Accountant, Pension and Welfare Benefits Administration of the U.S. Department of Labor.

[The next page is 80,671.]

Section 10,800

Statement of Position 00-2 Accounting by Producers or Distributors of Films

June 12, 2000

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) provides guidance on generally accepted accounting principles for all kinds of films, except where specifically noted, and is applicable to all producers or distributors that own or hold rights to distribute or exploit films. For purposes of this SOP, films are defined as feature films, television specials, television series, or similar products (including animated films and television programming) that are sold, licensed, or exhibited, whether produced on film, video tape, digital or other video recording format. The SOP requires, among other things, the following.

- An entity should recognize revenue from a sale or licensing arrangement of a film when all of the following conditions are met.
  - Persuasive evidence of a sale or licensing arrangement with a customer exists.
  - The film is complete and, in accordance with the terms of the arrangement, has been delivered or is available for immediate and unconditional delivery.
  - The license period of the arrangement has begun and the customer can begin its exploitation, exhibition, or sale.
  - The arrangement fee is fixed or determinable.
  - Collection of the arrangement fee is reasonably assured.

  If an entity does not meet any one of the preceding conditions, the entity should defer recognizing revenue until all of the conditions are met.

- If a licensing arrangement covering a single film provides that an entity will receive a flat fee, then the amount of that fee is considered fixed and determinable. In such instances, the entity should recognize the entire amount of the license fee as revenue when it has met all of the other revenue recognition conditions.
- An entity's arrangement fee may be based on a percentage or share of a customer's revenue from the exhibition or other exploitation of a film. In such instances, and when the entity meets all of the other revenue recognition conditions, the entity should recognize revenue as the customer exhibits or exploits the film.
- In certain licensing arrangements that provide for variable fees, a customer guarantees and pays or agrees to pay an entity a nonrefundable minimum amount that is applied against the variable fees on a film or films that are not cross-collateralized. In such arrangements, the amount of the nonrefundable minimum guarantee is considered fixed and determinable, and the entity should recognize the minimum guarantee as revenue when it has met all of the other revenue recognition conditions.
- If a licensing arrangement provides for a nonrefundable minimum guarantee that is applied against variable fees from a group of films on a cross-collateralized basis, the amount of the minimum guarantee applicable to each film cannot be objectively determined. Consequently, the entity should recognize revenue as the customer exhibits or exploits the film. If, at the end of the license period, a portion of the nonrefundable minimum guarantee remains unearned, an entity should recognize the remaining guarantee as revenue by allocating it to the individual films based on their relative performance under the arrangement.
- The costs of producing a film and bringing that film to market consist of film costs, participation costs, exploitation costs, and manufacturing costs.
- An entity should report film costs as a separate asset on its balance sheet.
- An entity should amortize film costs and accrue (expense) participation costs using the individual-film-forecast-computation method, which amortizes or accrues (expenses) such costs in the same ratio that current period actual revenue (numerator) bears to estimated remaining unrecognized ultimate revenue as of the beginning of the current fiscal year (denominator). An entity should begin amortization of capitalized film costs and accrual (expensing) of participation costs when a film is released and it begins to recognize revenue from that film.
- Ultimate revenue to be included in the denominator of the individual-film-forecast-computation method fraction is subject to the limitations set forth in this SOP.
- If an event or change in circumstance indicates that an entity should assess whether the fair value of a film is less than its unamortized film costs, the entity should determine the fair value of the film (the determination of which is affected by estimated future exploitation costs still to be incurred) and write off to the income statement the amount by which the unamortized capitalized costs exceeds the film's fair value. An entity should not subsequently restore any amounts written off in previous fiscal years.

- An entity should account for advertising costs in accordance with the provisions of SOP 93-7, *Reporting on Advertising Costs* [section 10,590]. All other exploitation costs, including marketing costs, should be expensed as incurred.
- An entity should charge manufacturing and/or duplication costs of products for sale, such as videocassettes and digital video discs, to expense on a unit-specific basis when the related product revenue is recognized.
- This SOP is effective for financial statements for fiscal years beginning after December 15, 2000. Earlier application is encouraged. The cumulative effect of changes in accounting principles caused by adopting the provisions of this SOP should be included in the determination of net income in conformity with paragraph 20 of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*. Disclosure of pro forma effects of retroactive application (APB Opinion 20, paragraph 21) is not required. An entity should not restate previously issued annual financial statements.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Introduction and Background

.01 In 1981, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*. FASB Statement No. 53 extracted specialized accounting and reporting principles and practices from the American Institute of Certified Public Accountants (AICPA) Industry Accounting

Guide *Accounting for Motion Picture Films*, and AICPA Statement of Position (SOP) 79-4, *Accounting for Motion Picture Films*, and established financial accounting and reporting standards for **producers** or **distributors** of films.[1]

.02 Since FASB issued FASB Statement No. 53, extensive changes have occurred in the film industry. Through 1981, the majority of a film's **revenue** resulted from distribution to movie theaters and free television. Since that time, numerous additional forms of exploitation (such as home video, satellite and cable television, and pay-per-view television) have come into existence, and international revenue has increased in significance. Concurrent with these changes, significant variations in the application of FASB Statement No. 53 have arisen.

.03 In 1995, in response to concerns raised by constituents, the FASB requested that the AcSEC of the AICPA develop an SOP providing guidance on the accounting and financial reporting requirements for producers or distributors of films. In September 1998, the FASB concluded that it would rescind FASB Statement No. 53 when AcSEC completed its project. An **entity** that previously was subject to the requirements of FASB Statement No. 53 should follow the guidance in this SOP. This SOP and FASB Statement No. 139, *Rescission of FASB Statement No. 53 and Amendments to FASB Statements No. 63, 89, and 121*, are simultaneously effective for fiscal years beginning after December 15, 2000.

.04 AcSEC issued an exposure draft of a proposed SOP, *Accounting by Producers and Distributors of Films*, on October 16, 1998. AcSEC received twenty-eight comment letters in response to the exposure draft. See the section entitled "Basis for Conclusions" for a discussion of AcSEC's response to the comment letters received.

Scope

.05 The guidance in this SOP applies to all kinds of films, except where specifically noted below, and is applicable to all producers or distributors that own or hold rights to distribute or exploit films. For purposes of this SOP, films are defined as feature films, television specials, television series, or similar products (including animated films and television programming) that are sold, licensed, or exhibited, whether produced on film, video tape, digital, or other video recording format. This SOP does not apply to the following:

a. Activities or transactions within the scope of FASB Statement No. 50, *Financial Reporting in the Record and Music Industry* (For example, accounting for the creation and distribution of recorded music products is within the scope of FASB Statement No. 50, whereas accounting for the cost of acquiring music rights for use in a film is within the scope of this SOP.)

b. Activities or transactions within the scope of FASB Statement No. 51, *Financial Reporting by Cable Television Companies*

c. Activities or transactions within the scope of FASB Statement No. 63, *Financial Reporting by Broadcasters*

d. Activities or transactions within the scope of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*

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[1] Terms defined in the glossary [paragraph .134] are set in boldface type the first time they appear in this SOP.

e. Activities or transactions within the scope of SOP 97-2, *Software Revenue Recognition* [section 10,700]

f. Products within the scope of Emerging Issues Task Force (EITF) Issue No. 96-6, "Accounting for the Film and Software Costs Associated with Developing Entertainment and Educational Software Products"

Conclusions

Revenue Recognition—Basic Principles

.06 A licensing arrangement for a single film or multiple films involves the transfer of a single right or a group of rights. An entity may license films to customers such as distributors, theaters, exhibitors, or other licensees on either an exclusive or nonexclusive basis in a particular **market** and **territory**. The terms of licensing arrangements may vary significantly from contract to contract. In common licensing arrangements, the license fee may be fixed in amount (flat fee) or may be based on a percentage of the customer's revenue (variable fee). When based on a percentage of a customer's revenue, an arrangement may include a **nonrefundable minimum guarantee**, which may be paid in advance or over a license period. The terms of a licensing arrangement may allow a producer to exercise direct control over the distribution of a film, or may transfer that control to a distributor, exhibitor, or other licensee.

.07 An entity should recognize revenue from a **sale** or licensing arrangement of a film when all of the following conditions are met.

a. Persuasive evidence of a sale or licensing arrangement with a customer exists.

b. The film is complete and, in accordance with the terms of the arrangement, has been delivered or is available for immediate and unconditional delivery.

c. The license period of the arrangement has begun and the customer can begin its exploitation, exhibition, or sale.

d. The arrangement fee is fixed or determinable.

e. Collection of the arrangement fee is reasonably assured.

If an entity does not meet any one of the preceding conditions, the entity should defer recognizing revenue until all of the conditions are met.

.08 If an entity recognizes a receivable in its balance sheet for advances presently due pursuant to an arrangement for any form of distribution, exhibition, or exploitation prior to the date of revenue recognition, or an entity receives cash payments under such an arrangement prior to revenue recognition, it should also recognize an equivalent liability for deferred revenue until the entity meets all of the conditions of paragraph .07. If an entity sells or otherwise transfers to a third party that receivable, the liability for deferred revenue established pursuant to the preceding sentence should not be reduced, and revenue for the film should not be recognized, until the conditions of paragraph .07 are met. Amounts scheduled to be received in the future pursuant to an arrangement for any form of distribution, exploitation, or exhibition should not be recognized as a receivable prior to the time those amounts are presently due or have been recognized as revenue pursuant to paragraph .07, if earlier.

Revenue Recognition—Details

Persuasive Evidence of an Arrangement

.09 Persuasive evidence of a licensing arrangement is provided solely by a contract or other legally enforceable documentation that sets forth, at a minimum, the license period, the film or films affected, the rights transferred, and the consideration to be exchanged. An entity should not recognize revenue if factors raise significant doubt as to the obligation or ability of either party to perform under the terms of an arrangement.

.10 An entity should have forms of verifiable evidence, such as a contract, a purchase order, or an online authorization, to document the mutual understanding of an arrangement. That evidence should include correspondence received from the customer that details the mutual understanding of the arrangement between the customer and the entity, or evidence that the customer has acted in accordance with such arrangement.

Delivery

.11 In a licensing arrangement that requires the physical delivery of a product to a customer, an entity should not recognize revenue until such delivery is complete. If a licensing arrangement is silent about delivery, physical delivery is required in order to recognize revenue.

.12 Certain licensing arrangements may not require immediate or direct physical delivery of a film to a customer. In lieu of immediate delivery, an arrangement may provide the customer with immediate and unconditional access to a film print held by the entity or authorization for the customer to order a film laboratory to make the film immediately and unconditionally available for the customer's use (a lab access letter). In such cases, if the film is complete and available for immediate delivery, the entity has met the conditions of paragraph .07(*b*).

.13 If a licensing arrangement requires an entity to make significant changes to a film after its initial availability to a customer, the arrangement does not meet the delivery condition in paragraph .07(*b*). In such instances, the entity should not recognize revenue until it makes those significant changes and meets all of the conditions of paragraph .07. Significant changes are defined as those changes that are additive to a film; that is, an arrangement requires an entity to create new or additional content after the film is initially available to the customer. For example, reshooting a scene or creating additional special effects are significant changes. Mere insertion or addition of preexisting film footage, addition of dubbing or subtitles (which by definition is done to existing footage), removal of offensive language, reformatting a film to fit a broadcaster's screen dimensions, and adjustments to allow for the insertion of commercials are all examples of changes to a film that are not significant and do not preclude revenue recognition prior to their completion. The costs incurred for significant changes should be added to **film costs** and subsequently charged to expense when an entity recognizes the related revenue; the costs expected to be incurred for insignificant changes should be accrued and charged to expense if an entity begins to recognize revenue from the arrangement before incurring those costs.

Availability

.14 Certain arrangements restrict a customer from beginning its initial exploitation, exhibition, or sale of a film. For example, the imposition of a street date (the initial date when home video products may be sold or displayed for rental) defines the period in time when a customer's exploitation rights begin. In such instances, an entity should not recognize related revenue until the restriction has expired. Additionally, if conflicting agreements impose restrictions on the initial exploitation, exhibition, or sale of a film by a customer in a particular territory or market, an entity should not recognize revenue until the restrictions lapse and it meets all of the other conditions of paragraph .07.

Fixed or Determinable Fee

.15 ***Flat Fees***. If a licensing arrangement covering a single film provides that an entity will receive a flat fee, then the amount of that fee is considered fixed and determinable. In such instances, the entity should recognize the entire amount of the license fee as revenue when it has met all of the other conditions of paragraph .07.

.16 If a licensing arrangement provides for a flat fee payable with respect to multiple films (including films not yet produced or completed), an entity should allocate the amount of the fee to each individual film, by market and territory based on relative fair values of the rights to exploit each film under the licensing arrangement. An entity should base the allocations to a film or films not yet produced or completed on the amounts refundable if the entity does not ultimately complete and deliver the films to the customer. The entity should allocate the remaining flat fee to completed films based on the relative fair values of the rights to exploit those films pursuant to the licensing arrangement. Once made, those allocations should not be subject to later adjustment. An entity should recognize amounts allocated to individual films as revenue when it meets all of the conditions of paragraph .07 with respect to each individual film by market and territory. If an entity cannot determine relative fair values of the rights to exploit those films, then the fee is not fixed or determinable and the entity should not recognize revenue until it can make such a determination and it meets all of the conditions of paragraph .07.

.17 Paragraph 7 of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*,* provides a hierarchy of methods for determining fair value. Because quoted market prices (the most preferred method) are usually not available, an entity should estimate the fair value of the rights to exploit an individual film that is part of a multiple film arrangement (as discussed in paragraph .16) by using the best information available in the circumstances with the objective of measuring the amount the entity believes it would have received had it entered into a license arrangement that grants the same rights to the film separately rather than as part of the multiple film arrangement. A discounted cash flows model is often used to estimate fair value. Paragraphs 39 to 71 of FASB Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, provide guidance on the traditional and expected cash flow approaches to present value measurements. An entity's estimates of cash flows used in determining the fair value of the rights to exploit an individual film that is part of a multiple film arrangement should be consistent with the rights granted for that film under the multiple film arrangement (for example, the length of the license period, and any limitations on the method, timing, or frequency of exploitation).

.18 ***Variable Fees***. An entity's arrangement fee may be based on a percentage or share of a customer's revenue from the exhibition or other exploitation

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* FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, supersedes FASB Statement No. 121. [Footnote added, October 2002, to reflect conforming changes necessary due to the issuance of FASB Statement No. 144.]

of a film. In such instances, and when the entity meets all of the conditions of paragraph .07, the entity should recognize revenue as the customer exhibits or exploits the film.

.19 ***Nonrefundable Minimum Guarantees***. In certain licensing arrangements that provide for variable fees, a customer guarantees and pays or agrees to pay an entity a nonrefundable minimum amount that is applied against the variable fees on a film or films that are not **cross-collateralized**. In such arrangements, the amount of the nonrefundable minimum guarantee is considered fixed and determinable, and the entity should recognize the minimum guarantee as revenue when it has met all of the other conditions of paragraph .07.

.20 If a licensing arrangement provides for a nonrefundable minimum guarantee that is applied against variable fees from a group of films on a cross-collateralized basis, the amount of the minimum guarantee applicable to each film cannot be objectively determined. Consequently, the entity should recognize revenue in such arrangements in accordance with the provisions of paragraph .18. If, at the end of the license period, a portion of the nonrefundable minimum guarantee remains unearned, an entity should recognize the remaining guarantee as revenue by allocating it to the individual films based on their relative performance under the arrangement.

Barter Revenue

.21 An entity sometimes licenses programming to television stations in exchange for a specified amount of advertising time on those stations. These exchanges qualify as nonmonetary exchanges and an entity should account for these kinds of exchanges in accordance with Accounting Principles Board Opinion (APB) No. 29, *Accounting for Nonmonetary Exchanges*, as interpreted by EITF Issue No. 93-11, "Accounting for Barter Transactions Involving Barter Credits."

Modifications of Arrangements

.22 If, at any time during a licensing arrangement, an entity and its customer agree to extend an existing arrangement (and all of the provisions in paragraph .07 are met), the accounting for the consideration received for the extension depends on whether the consideration is a flat fee or a variable fee. If the consideration is a flat fee, the entity should account for the consideration upon the execution of the extension in accordance with the provisions of paragraphs .15 and .16 of this SOP. If the consideration is a variable fee, the entity should follow the guidance set forth in paragraph .18. If the consideration is a minimum guarantee, the entity should follow the guidance set forth in paragraphs .19 and .20.

.23 If, at any time during a licensing arrangement, the parties agree to change the provisions of the licensing arrangement, other than by extending the license period (as discussed in paragraph .22), the entity should consider the revised arrangement as a new arrangement and account for it in accordance with the provisions of this SOP. At the time the old arrangement is terminated, the entity should accrue and expense associated costs or reverse previously reported revenue for refunds and concessions (an example of which is agreeing to a below market rate license fee), to terminate the old arrangement. For example, if an original arrangement was a fixed fee and the new arrangement is a smaller fixed fee with a variable component, the entity should reduce revenue for the current period for the excess of the original fixed fee previously reported as revenue over the new fixed fee and earned variable component to date. It should also adjust accumulated film cost amortization and accrued participation costs attributable to that excess. In addition, the entity should account for the new arrangement fee in accordance with this SOP.

Returns and Price Concessions

.24 The contract provisions of an arrangement and an entity's policies and past actions related to granting concessions or accepting product returns can determine whether a fee is fixed or determinable. For an arrangement that includes a right-of-return provision or if an entity's past practices allow for returns, an entity must meet all of the conditions in FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*, in order for it to recognize revenue. Those conditions include a requirement that the entity can reasonably estimate the amount of future returns.

.25 An example of how contractual provisions or an entity's customary business practices related to granting price concessions can affect the determination of revenue recognition is as follows. In the home video business, customers may be granted price concessions on previously purchased and unsold product if an entity subsequently reduces its wholesale prices (commonly referred to as price protection). In such cases, an entity should provide appropriate allowances at the date of revenue recognition. If an entity is unable to reasonably and reliably estimate future price concessions, or if significant uncertainties exist regarding an entity's ability to maintain its prices, the corresponding revenue is not fixed or determinable. Consequently, the entity should not recognize revenue until it can make reasonable and reliable estimates of the effects of future price changes.

Licensing of Film-Related Products

.26 An entity should not recognize revenue from licensing arrangements to market film-related products until it releases the corresponding film.

Present Value

.27 Revenue recognized in connection with a licensing arrangement should represent the present value of the license fee as of the date that an entity first recognizes the revenue, computed in accordance with APB Opinion 21, *Interest on Receivables and Payables*.

Costs and Expenses

.28 The costs of producing a film and bringing that film to market consist of film costs, **participation costs**, **exploitation costs**, and manufacturing costs.

Film Costs—Capitalization

.29 An entity should report film costs as a separate asset on its balance sheet. An entity should account for interest costs related to the production of a film in accordance with the provisions in FASB Statement No. 34, *Capitalization of Interest Cost*.

.30 Production overhead, a component of film costs, includes allocable costs of individuals or departments with exclusive or significant responsibility for the production of films. Production overhead should not include administrative and general expenses, the costs of certain overall deals, as discussed in paragraph .31, or charges for losses on properties sold or abandoned, as discussed in paragraph .32.

.31 An entity may enter into an arrangement known as an *overall deal*, whereby it compensates a producer or other creative individual for the exclusive or preferential use of that party's creative services. An entity should charge the costs of overall deals that cannot be identified with specific projects to expense as they are incurred over the related period of time. An entity should record a reasonable proportion of costs of overall deals as specific project film costs to the extent those costs are directly related to the acquisition, adaptation, or development of specific projects. If related to properties as discussed in paragraph .32, an entity should include such amounts in the cost of properties subject to the periodic review. An entity should not allocate to specific project film costs amounts that it had previously expensed.

.32 Film costs ordinarily include expenditures for properties (such as film rights to books or stage plays, or original screenplays) that generally must be adapted to serve as the basis for the production of a particular film. An entity will add the cost of adaptation or development to the cost of the particular property. An entity should periodically review properties in development to determine whether they will ultimately be used in the production of a film. When an entity determines that a property will not be used (disposed of), it should recognize any loss by a charge to the income statement. It should be presumed that an entity will dispose of a property (whether by sale or abandonment) if it has not been **set for production** within three years from the time of the first capitalized transaction. An entity should measure the loss as the amount by which the carrying amount of the project exceeds its fair value. Amounts written off should not be subsequently reestablished as assets. Unless management, having the authority to approve the action, has committed to a plan to sell such property, the rebuttable presumption is that the entity will abandon the property and, as such, its fair value should be zero.

.33 For an episodic television series, the following additional guidance for film costs applies. Ultimate revenue for an episodic television series can include estimates from the initial market and secondary markets, as discussed in paragraph .39(*b*).[2] Until an entity can establish estimates of secondary market revenue in accordance with paragraph .39(*b*), capitalized costs for each episode produced should not exceed an amount equal to the amount of revenue contracted for that episode. An entity should expense as incurred film costs in excess of this limitation on an episode-by-episode basis, and an entity should not restore such amounts as film cost assets in subsequent periods. An entity should expense all capitalized costs (including set costs) for each episode as it recognizes the related revenue for each episode. Once an entity can establish estimates of secondary market revenue in accordance with paragraph .39(*b*), the entity should capitalize subsequent film costs. An entity should amortize such capitalized film costs in accordance with the provisions in paragraphs .34 through .37, and it should evaluate such costs for impairment in accordance with paragraph .44.

Film Costs Amortization; Participation Cost Accruals

.34 An entity should amortize film costs and accrue (expense) participation costs using the individual-film-forecast-computation method, which amortizes or accrues (expenses) such costs in the same ratio that current period actual revenue (numerator) bears to estimated remaining unrecognized ultimate revenue as of the beginning of the current fiscal year (denominator). That is, (*a*) unamortized film costs as of the beginning of the current fiscal year are

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[2] In this context, *initial market* is the first market of exploitation in each territory, whether that market is a broadcast or cable television network, first-run syndication, or other. *Secondary markets* are any markets other than the initial market.

multiplied by the individual-film-forecast-computation method fraction and (*b*) unaccrued (that is, not yet expensed) ultimate participation costs at the beginning of the current fiscal year are multiplied by the individual-film-forecast-computation method fraction. In this way, in the absence of changes in estimates, film costs are amortized and participation costs are accrued (expensed) in a manner that yields a constant rate of profit over the ultimate period, as described in paragraph .39(*a*), for each film before exploitation costs, manufacturing costs, and other period expenses. An entity should accrue a liability for participation costs only if it is probable that there will be a sacrifice of assets to settle its obligation under the terms of the participation agreement. At each balance sheet date, accrued participation costs should not be less than the amounts that an entity is obligated to pay as of that date. An entity should begin amortization of capitalized film costs and accrual (expensing) of participation costs when a film is released and it begins to recognize revenue from that film.

.35 In the absence of revenue from third parties that is directly related to the exhibition or exploitation of a film, an entity should make a reasonably reliable estimate of the portion of unamortized film costs that is representative of the utilization of the film in that exhibition or exploitation. An entity should expense such amounts as it exhibits or exploits the film. (For example, a cable entity that does not accept advertising on its cable channel may produce a film and show it on that channel. In this example, the cable entity receives subscription fees from third parties that are not directly related to a particular film.) Consistent with the underlying premise of the individual film-forecast-computation method, all revenue should bear a representative amount of the amortization of film costs during the ultimates period.

.36 As a result of uncertainties in the estimating process, actual results may vary from estimates. An entity should review and revise estimates of ultimate revenue and participation costs as of each reporting date to reflect the most current available information. If estimates are revised, an entity should determine a new denominator that includes only the ultimate revenue from the beginning of the fiscal year of change (that is, ultimate revenue changes are treated prospectively as of the beginning of the fiscal year of change). The numerator (revenue for the current fiscal year) is unaffected by the change. An entity should apply the revised fraction to the net carrying amount of unamortized film costs and to the film's unaccrued (that is, not yet expensed) ultimate participation costs as of the beginning of the fiscal year, and the difference between expenses determined using the new estimates and any amounts previously expensed during that fiscal year should be charged or credited to the income statement in the period (for example, the quarter) during which the estimates are revised.

.37 Multiple seasons of an episodic television series that meets the conditions of paragraph .39(*b*) to include estimated secondary market revenue in ultimate revenue is considered to be a single product, with multiple seasons of the series combined for purposes of applying the individual film-forecast-computation method.

Ultimate Revenue

.38 Ultimate revenue to be included in the denominator of the individual-film-forecast-computation method fraction should include estimates of revenue that is expected to be recognized by an entity from the exploitation, exhibition, and sale of a film in all markets and territories, subject to the limitations set forth in paragraph .39.

.39 Ultimate revenue should be limited by the following.

a. For films other than episodic television series, ultimate revenue should include estimates over a period not to exceed ten years following the date of the film's initial release. For episodic television series, ultimate revenue should include estimates of revenue over a period not to exceed ten years from the date of delivery of the first episode or, if still in production, five years from the date of delivery of the most recent episode, if later. For previously released films acquired as part of a film library, ultimate revenue should include estimates over a period not to exceed twenty years from the date of acquisition. For purposes of this SOP, an entity should categorize as part of a film library only those individual films whose initial release dates were at least three years prior to the acquisition date.

b. For episodic television series, ultimate revenue should include estimates of secondary market revenue (that is, revenue from markets other than the initial market) for produced episodes only if an entity can demonstrate through its experience or industry norms that the number of episodes already produced, plus those for which a **firm commitment** exists and the entity expects to deliver, can be licensed successfully in the secondary market.

c. Ultimate revenue should include estimates of revenue from a market or territory only if persuasive evidence exists that such revenue will occur, or if an entity can demonstrate a history of earning such revenue in that market or territory. Ultimate revenue should include estimates of revenue from newly developing territories only if an existing arrangement provides persuasive evidence that an entity will realize such amounts.

d. Ultimate revenue should include estimates of revenue from licensing arrangements with third parties to market film-related products only if persuasive evidence exists that such revenue from that arrangement will occur for that particular film (such as a signed contract to receive a nonrefundable minimum guarantee or a nonrefundable advance) or if an entity can demonstrate a history of earning such revenue from that form of arrangement.

e. Ultimate revenue should include estimates of the portion of the wholesale or retail revenue from an entity's sale of peripheral items (such as toys and apparel) that is attributable to the exploitation of themes, characters, or other contents related to a particular film only if the entity can demonstrate a history of earning such revenue from that form of exploitation in similar kinds of films. For example, an entity may conclude that the portion of revenue from the sale of peripheral items that it should include in ultimate revenue is an estimate of what would be earned by the entity if rights for such form of exploitation had been granted under licensing arrangements with third parties. Ultimate revenue should not, however, include estimates of the entire amount of wholesale or retail revenue from an entity's sale of peripheral items.

f. Ultimate revenue should not include estimates of revenue from unproven or undeveloped technologies.

g. Ultimate revenue should not include estimates of wholesale promotion or advertising reimbursements to be received from third parties; an entity should offset such amounts against exploitation costs.

h. Ultimate revenue should not include estimates of amounts related to the sale of film rights for periods after those identified in paragraph .39(*a*).

.40 An entity should not discount ultimate revenue to its present value except as required by the provisions in paragraph .27. All foreign currency estimates of future revenues should be based on current spot rates. Ultimate revenue should not include amounts representing projections for future inflation.

Ultimate Participation Costs

.41 Estimates of unaccrued (that is, not yet expensed) ultimate participation costs are used in the individual-film-forecast-computation method to arrive at current period participation cost expense. Such costs should be determined using assumptions that are consistent with an entity's estimates of film costs, exploitation costs, and ultimate revenue, as limited by the provisions in paragraph .39. If, at any balance sheet date, the recognized participation costs liability exceeds the estimated unpaid ultimate participation costs for an individual film, the excess liability should be reduced with an offsetting credit to unamortized film costs. To the extent that an excess liability exceeds unamortized film costs for that film, it should be credited to income.

.42 A film may continue to generate revenue after its film costs are fully amortized. When revenue is recorded on fully amortized films, an entity should accrue associated participation costs as that revenue is recognized.

Film Costs Valuation

.43 The following are examples of events or changes in circumstances that indicate that an entity should assess whether the fair value of a film (whether completed or not) is less than its unamortized film costs.

a. An adverse change in the expected performance of a film prior to release

b. Actual costs substantially in excess of budgeted costs

c. Substantial delays in completion or release schedules

d. Changes in release plans, such as a reduction in the initial release pattern

e. Insufficient funding or resources to complete the film and to market it effectively

f. Actual performance subsequent to release fails to meet that which had been expected prior to release

.44 If an event or change in circumstance indicates that an entity should assess whether the fair value of a film is less than its unamortized film costs, the entity should determine the fair value of the film (the determination of which is affected by estimated future exploitation costs still to be incurred) and write off to the income statement the amount by which the unamortized capitalized costs exceeds the film's fair value. Exploitation costs incurred after such a write-off should be accounted for in accordance with the provisions of paragraph .49. An entity should treat the reduced amount of capitalized film costs that have been written down to fair value at the close of an annual fiscal period as the cost for subsequent accounting purposes, and an entity should not subsequently restore any amounts previously written off.

.45 As discussed in paragraph .17, a discounted cash flows model is often used to estimate fair value. If applicable, future cash flows based on the terms of any existing contractual arrangements, including cash flows over existing license periods without consideration of the limitations set forth in paragraph .39, should be included. An entity should consider the following factors, among others, in estimating future cash inflows for a film: (*a*) if previously released, the film's performance in prior markets, (*b*) the public's perception of the film's story, cast, director, or producer, (*c*) historical results of similar films, (*d*) historical results of the cast, director, or producer on prior films, and (*e*) running time of the film. In determining a film's fair value, it is also necessary to consider those cash outflows necessary to generate the film's cash inflows. Therefore, an entity should incorporate, if applicable, its estimates of future costs to complete a film, future exploitation and participation costs, or other necessary cash outflows in its determination of fair value when using a discounted cash flows model.

.46 When using the traditional discounted cash flow approach to estimate the fair value of a film, the relevant future cash inflows and outflows should represent the entity's estimate of the most likely cash flows. When determining the fair value of a film using the expected cash flows approach, all possible relevant future cash inflows and outflows should be probability weighted by period and the estimated mean or average by period should be used.

.47 When determining the fair value of a film using a traditional discounted cash flow approach, the discount rate(s) should not be an entity's incremental borrowing rate(s), liability settlement rate(s), or weighted average cost of capital as those rates typically do not reflect the risks associated with a particular film. The discount rate(s) should consider the time value of money and the expectations about possible variations in the amount or timing of the most likely cash flows and an element to reflect the price market participants would seek for bearing the uncertainty inherent in such an asset as well as other factors, sometimes unidentifiable, including illiquidity and market imperfections. When determining the fair value of a film using the expected cash flow approach, the discount rate(s) also would consider the time value of money. Because they are reflected in the expected cash flows, there would be no adjustment for possible variations in the amounts or timing of those cash flows. If not reflected in risk-adjusted expected cash flows, an additional element to reflect the price market participants would seek for bearing the uncertainty inherent in such an asset as well as other factors, sometimes unidentifiable, including illiquidity and market imperfections, should be added to the discount rate(s).

Subsequent Events

.48 For films released before or after the date of the balance sheet for which evidence of the possible need for a write-down of unamortized film costs occurs after the date of the balance sheet but before an entity issues its financial statements, a rebuttable presumption exists that the conditions leading to the write-off existed at the date of the balance sheet. In such situations, an entity should adjust its financial statements for the effect of any changes in estimates resulting from the use of the subsequent evidence. An entity can overcome the rebuttable presumption if it can demonstrate that the conditions leading to the write-down did not exist at the date of the balance sheet.

Exploitation Costs

.49 An entity should account for advertising costs in accordance with the provisions of SOP 93-7, *Reporting on Advertising Costs* [section 10,590]. All other exploitation costs, including marketing costs, should be expensed as incurred.

Manufacturing Costs

.50 An entity should charge manufacturing and/or duplication costs of products for sale, such as videocassettes and digital video discs, to expense on a unit-specific basis when the related product revenue is recognized. An entity should, at each balance sheet date, evaluate inventories of such products for net realizable value and obsolescence exposures, with appropriate adjustments recorded as necessary. An entity should charge the cost of theatrical **film prints** to expense over the period benefited.

Presentation and Disclosure

.51 If an entity presents a classified balance sheet, it should classify film costs as noncurrent on the face of the balance sheet. Regardless of whether an entity presents a classified or unclassified balance sheet, it should disclose in the notes to the financial statements the portion of the costs of its completed films that are expected to be amortized during the upcoming operating cycle, which is presumed to be twelve months. An entity should disclose its operating cycle if it is other than twelve months.

.52 An entity should disclose the components of film costs (including released, completed and not released, in production, or in development or preproduction) separately for theatrical films and direct-to-television product.

.53 An entity should disclose the percentage of unamortized film costs for released films, excluding acquired film libraries, that it expects to amortize within three years from the date of the balance sheet. If that percentage is less than 80 percent, an entity should provide additional information, including the period required to reach an amortization level of 80 percent. For acquired film libraries, an entity should disclose the amount of remaining unamortized costs, the method of amortization, and the remaining amortization period.

.54 An entity should disclose the amount of accrued participation liabilities that it expects to pay during the upcoming operating cycle.

.55 An entity should report cash outflows for film costs, participation costs, exploitation costs, and manufacturing costs as operating activities in the statement of cash flows, and it should include the amortization of film costs in the reconciliation of net income to net cash flows from operating activities.

.56 An entity should disclose its methods of accounting for revenue, film costs, participation costs, and exploitation costs.

.57 In accordance with paragraph 33 of APB Opinion 20, *Accounting Changes*, and paragraph 26 of APB Opinion 28, *Interim Financial Reporting*, an entity should disclose the effect on income before extraordinary items, net income, and related per share amounts of the current fiscal period for a change in estimate that affects several future periods.

.58 An entity should disclose events occurring subsequent to the date of the balance sheet that do not require an adjustment to the financial statements but that are of such a nature that disclosure of them is required to keep the financial statements from being misleading.

Amendment to Other Guidance

.59 This amends SOP 93-7 [section 10,590]. The following footnote is added to "FASB Statement No. 53" in the Appendix of SOP 93-7 [section 10,590.81].

In 2000, the FASB rescinded FASB Statement No. 53 and AcSEC issued SOP 00-2, Accounting by Producers or Distributors of Films. The provisions of SOP 93-7 apply to entities within the scope of SOP 00-2.

Effective Date and Transition

.60 This SOP is effective for financial statements for fiscal years beginning after December 15, 2000. Earlier application is encouraged. The cumulative effect of changes in accounting principles caused by adopting the provisions of this SOP should be included in the determination of net income in conformity with paragraph 20 of APB Opinion 20. Disclosure of pro forma effects of retroactive application (APB Opinion 20, paragraph 21) is not required. An entity should not restate previously issued annual financial statements.

The provisions of this Statement need not be applied to immaterial items.

Basis for Conclusions

Scope

.61 This SOP applies to all kinds of films, including an episodic television series. However, as a result of the unique nature of an episodic television series, AcSEC decided to provide additional guidance in this area. In response to some respondents to the exposure draft of the SOP, AcSEC reorganized the SOP to clearly distinguish between the accounting requirements for all kinds of films and the additional guidance for an episodic television series. The requirements of this SOP do not apply to transactions or activities within the scope of other authoritative literature listed in paragraph .05. The requirements of this SOP apply to films exploited by the entity directly, or licensed or sold to others. AcSEC observed that even though an entity may be considered to be primarily a film enterprise, it is still subject to generally accepted accounting principles (GAAP) besides those addressed in this SOP, for example, when involved with a transaction for the licensing of record masters, software development, and so forth.

Revenue Recognition

Basic Principles

.62 The basic standard for revenue recognition is set forth in paragraph 83 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, which provides that "[revenue] recognition involves consideration of two factors, (*a*) being realized or realizable and (*b*) being earned, with sometimes one and sometimes the other being the more important consideration."

.63 ***Exclusivity and Substantially All***. Paragraph 7 of the exposure draft proposed that, in addition to the conditions in paragraph 6 of that exposure draft, a licensing arrangement should transfer substantially all of the benefits and risks incident to ownership of a film on an exclusive basis for an individual market and territory in order for an entity to account for the transaction as a sale, and thus recognize revenue immediately. AcSEC based that concept on FASB Statement No. 13, *Accounting for Leases*, as it relates to the timing of revenue recognition when distinguishing between sales-type leases and operating leases. Therefore, under paragraph 7 of the exposure draft, an entity would have recognized revenue from a nonexclusive arrangement in a manner similar to an operating lease.

.64 Based on the arguments presented in the comment letters to the exposure draft, AcSEC decided that exclusivity should not be one of the conditions for revenue recognition in the film industry. AcSEC acknowledges that, under an exclusivity arrangement, the value of a film license to a customer has two major components: (*a*) the customer's right to use the film (in accordance with the license arrangement) and (*b*) the customer's right to use the film exclusively in a particular market and territory (which thereby restricts the entity's right to license the film to other customers). Therefore, for an exclusive license arrangement, AcSEC considered requiring bifurcation of the total license fee between the two major components. Under that scenario, an entity would recognize revenue from the fees allocated to the first component in accordance with the conditions of paragraph 6 of the exposure draft and it would recognize revenue on the fees allocated to the second component ratably over the license period.

.65 AcSEC rejected the bifurcation approach primarily because it believes that the approach is not operational. Also, AcSEC agrees with many of the respondents to the exposure draft who noted that the "substantially all" condition of paragraph 7 was subjective and, if kept as a revenue recognition condition, could lead to diversity in practice. AcSEC concluded that the approach proposed in the exposure draft was not operational.

.66 AcSEC also acknowledges the arguments made by some respondents to the exposure draft who noted that exclusivity, even though it may be part of licensing arrangements, is becoming less meaningful as entities are exploiting films concurrently in the same territories through various marketing approaches, such as pay-per-view and home video.

.67 A number of respondents to the exposure draft and AcSEC believe that if paragraph 7 of the exposure draft was maintained, AcSEC would need to more narrowly define *market* and *territory* to ensure comparability in financial reporting. Ultimately, AcSEC needed to choose between (*a*) attempting to provide restrictive definitions, which could lead to less desirable revenue recognition in certain circumstances, or (*b*) removing the requirements of paragraph 7 of the exposure draft, which would result in earlier but more consistent revenue recognition within and between entities. AcSEC believes that it cannot and should not define those terms narrowly. AcSEC believes that the definitions of market and territory should be sufficiently flexible to allow each entity to designate its markets and territories based on the way it conducts business. Accordingly, AcSEC decided not to include the provisions of paragraph 7 of the exposure draft in this SOP.

.68 ***Customer Acceptance***. Some respondents to the exposure draft believe that customer acceptance of a film should be an explicit condition of revenue recognition. Those respondents believe that this SOP should be consistent with paragraph 20 of SOP 97-2 [section 10,700.20]. AcSEC appreciates the arguments of those who desire complete consistency with the revenue recognition criteria of SOP 97-2 [section 10,700]. However, because of the rapid technological changes of software, and for other reasons, AcSEC believes that the differences between licensing arrangements of software and films may be significant and could result in different conclusions on revenue recognition. SOP 97-2 [section 10,700] addresses software arrangement under which customer acceptance is most often evidenced by physical delivery. In the film industry, physical delivery may often not occur until well after the point at which the customer's license period begins and the film is complete and available for immediate and unconditional delivery at the customer's request. Therefore, AcSEC concluded that the customer acceptance condition of this SOP should not be identical to that of SOP 97-2 [section 10,700]. AcSEC believes that the delivery conditions set out in paragraphs .11 through .14 of this SOP adequately address the issue of customer acceptance.

.69 ***Sales and Licensing***. Paragraph .07 of the SOP provides the revenue recognition conditions for a sale or licensing arrangement. Though most of the SOP provides guidance on what is commonly understood in the film industry as licensing arrangements, the conditions of paragraph .07 also apply to an entity's outright sale of its rights to a film. If the price from the sale of a film includes a variable element (as opposed to a fixed fee sale), AcSEC acknowledges that the application of the individual-film-forecast-computation method results in recognizing a gain/loss that is different than that calculated using a traditional sales model. However, AcSEC believes that by treating the accounting for an outright sale with a variable element similar to that of a license arrangement with a variable element, the SOP will help prevent diversity in practice because entities (*a*) will have no accounting reason to structure transactions as sales versus licenses and (*b*) will not have to determine which license arrangements are in-substance sales.

Persuasive Evidence of an Arrangement

.70 AcSEC understands that practice in the film industry varies regarding the use of contracts for the purpose of documenting license arrangements. Though licensing arrangements are normally documented by contracts, AcSEC understands that sales or exploitation arrangements in certain sectors of the industry are evidenced by documentation other than a contract. For example, customer orders in direct home video distribution are normally evidenced by written or on-line purchase orders. AcSEC believes that such documentation is sufficient to provide persuasive evidence of an arrangement. Accordingly, AcSEC concluded that documentation other than a contract can be sufficient evidence of an arrangement.

Delivery

.71 AcSEC believes that, for most product sales and licenses, an entity should not recognize revenue until it delivers the product to the customer. Recognition of revenue on delivery is consistent with paragraphs 83(b) and 84 of FASB Concepts Statement No. 5. Paragraph 83(b) provides the following guidance for recognition of revenue.

> Revenues are not recognized until earned. An entity's revenue-earning activities involve *delivering* or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. [Footnote omitted] [Emphasis added]

Paragraph 84 states that in recognizing revenues and gains:

> The two conditions [for revenue recognition] (being realized or realizable and being earned) are usually met by the time product or merchandise is delivered...to customers, and revenues...are commonly recognized at time of sale (usually meaning *delivery*). [Emphasis added]

.72 As discussed in paragraph .12 of this SOP, rather than requiring immediate or direct delivery of a film print to a customer, certain licensing arrangements in the film industry require only that an entity grant the customer immediate and unconditional access to the film. Once an entity provides access, the licensing arrangement obligates the customer to pay for the film regardless of whether the customer requests or receives the film. AcSEC believes that when an entity makes a completed film available to a customer, it "has substantially accomplished what it must do to be entitled to the benefits represented by the revenues" (as required by paragraph 83(b) of FASB Concepts Statement No. 5). In such arrangements, not physically delivering the film (often as a result of a customer not requesting the film even though the license period has begun) is not a factor sufficient to preclude revenue recognition. Therefore, AcSEC believes that an entity has complied with the delivery requirements of this SOP when the entity makes the film available to the customer and meets the other conditions of paragraph .07. Further, AcSEC believes that if the film is at a film laboratory, providing the customer with unconditional and immediate access to the film is a prerequisite for revenue recognition. If an arrangement is silent as to delivery, AcSEC concluded that physical delivery is an inherent requirement of revenue recognition.

.73 Many licensing arrangements require an entity to make changes to a film after it makes the film available to a customer. AcSEC considered the question of when changes that are required after a film's initial availability should preclude an entity from recognizing revenue on a film. AcSEC understands that an entity will make the changes often at a time requested by the customer, which may or may not be immediately after a film is initially available to the customer. The exposure draft stated, and AcSEC continues to believe, that an obligation to make significant changes to a film after its initial availability to a customer precludes the entity from recognizing revenue on the film until the entity completes those significant changes (and it meets the other conditions of paragraph .07).

.74 Based on comment letters received on the exposure draft, AcSEC clarified its definition of significant changes to a film after its initial availability to a customer. AcSEC believes that changes to a film are significant if they are additive; that is, they require the creation of additional content. Changes, such as dubbing and subtitling, are made to existing content and, therefore, they are not significant.

.75 AcSEC believes that an obligation to make insignificant changes to a film after its initial availability to a customer should not preclude revenue recognition if an entity meets all other conditions of paragraph .07 of this SOP. AcSEC believes that an obligation to make insignificant changes does not affect an entity's having substantially accomplished what it must do to earn revenue. AcSEC believes that SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* [section 10,330], supports AcSEC's position. Paragraph 30 of SOP 81-1 [section 10,330.30] states, "Under the completed-contract method, income is recognized only when a contract is completed or substantially completed." Paragraph 52 of SOP 81-1 [section 10,330.52] states, "As a general rule, a contract may be regarded as substantially completed if remaining costs and potential risks are insignificant in amount. The overriding objectives are to maintain consistency in determining when contracts are substantially completed and to avoid arbitrary acceleration or deferral of income."

Availability

.76 As discussed in paragraph .14, in certain situations, an entity may prohibit a customer from beginning its initial exploitation, exhibition, or sale of a film. One of the more common prohibitions is a "street date" restriction used in connection with the sales or rentals of videocassettes. This occurs when an entity ships videocassettes to a customer on a certain date, but restricts sales prior to the "street date." Because the customer does not have the ability to exploit, exhibit, or sell the film in such situations, the conditions of paragraph .07(*c*) are not met. Consequently, an entity should not recognize revenue until the restriction lapses. This initial-use prohibition does not apply to contractual restrictions after the period of exploitation, exhibition, or availability for sale of a film begins (for example, a licensing arrangement that allows a customer to air a film only once per year over the license period).

Fixed or Determinable Fee

.77 Paragraph 83 of FASB Concepts Statement No. 5 reads, in part, "Further guidance for recognition of revenues and gains is intended to provide an acceptable level of assurance of the existence and amounts of revenue and gains before they are recognized." AcSEC believes that "an acceptable level of assurance" of the amount is attained when the amount of the arrangement fee is fixed or determinable and the other conditions of paragraph .07 are met. If the arrangement fee is based on a percentage of a customer's revenue, the fee does not become fixed or determinable until the customer's revenue is earned. Because the customer's revenue is not earned until the exhibition or other exploitation of the film, AcSEC concluded that a fee that is based on a percentage of the customer's revenue from a film should not be recognized until the customer's exhibition or other exploitation of the film.

.78 ***Flat Fees***. In paragraph .16 of this SOP, AcSEC concluded that, if a licensing arrangement provides for a flat fee with respect to multiple films, markets, or territories, an entity should allocate the fee to the individual films based on the relative fair value(s) of the rights to exploit the film(s) in the respective markets and territories. AcSEC believes that basing the allocation on relative fair value is consistent with the accounting for multiple element transactions in other industries. For example, paragraph 12 of FASB Statement No. 45, *Accounting for Franchise Fee Revenue*, states the following.

> The franchise agreement ordinarily establishes a single initial franchise fee as consideration for the franchise rights and the initial services to be performed by the franchisor. Sometimes, however, the fee also may cover tangible property, such as signs, equipment, inventory, and land and building. In those circumstances, the portion of the fee applicable to the tangible assets shall be based on the fair value of the assets.

.79 The exposure draft stated that an entity should base the allocation on an *entity-specific* and *product-specific* estimate of relative fair values. AcSEC decided to drop that language because those terms do not provide substantive additional guidance on determining fair value. AcSEC believes that the requirement of allocations based on relative fair values is adequate.

.80 ***Variable Fees***. If a licensing arrangement bases an entity's arrangement fee on a percentage or share of a customer's revenue, the entity's fee does not become fixed or determinable until the customer exhibits or exploits the film. Because the customer's revenue is not earned until the exhibition or other exploitation of the film, AcSEC concluded an entity should not recognize revenue that is based on a percentage or share of the customer's revenue from a film until the customer's exhibition or other exploitation of the film (and the entity meets the other conditions of paragraph .07 of this SOP).

.81 ***Nonrefundable Minimum Guarantees (Not Cross-Collateralized)***. The exposure draft proposed that an entity should account for licensing arrangements with guaranteed nonrefundable minimum amounts payable against variable fees covering single films or covering multiple films in which the films are not cross-collateralized in a manner similar to how it should account for flat fees. Under that guidance, an entity would have recognized revenue when it met the conditions in both paragraphs 6 and 7 of the exposure draft. AcSEC was concerned about allowing an entity to recognize revenue immediately if, in fact, the entity may have been doing nothing more than financing against future revenue. However, the proposed requirements for revenue recognition in paragraph 7 of the exposure draft alleviated AcSEC's concern. Because AcSEC decided to delete paragraph 7 of the exposure draft in this final SOP, AcSEC believed that it was necessary to revisit the accounting for nonrefundable minimum guarantees.

.82 In its deliberations, AcSEC concluded that an entity should recognize a nonrefundable minimum guarantee fee against a variable fee covering a single film or covering multiple films that are not cross-collateralized as revenue immediately when the entity meets all of the conditions of paragraph .07. AcSEC believes that the conditions of paragraph .07 provide an appropriate model for determining whether an entity should recognize revenue for a nonrefundable minimum guarantee fee. AcSEC believes that such fees are similar to flat fees and flat fees with upside revenue potential, and that an entity should account for each kind of fixed fees similarly.

.83 In its deliberations, AcSEC was concerned about an entity recognizing revenue for a variable fee arrangement based on whether it could or could not secure a nonrefundable minimum guarantee fee. Consequently, AcSEC considered whether the SOP should require that an entity recognize all nonrefundable minimum guarantee fees as revenue ratably over the license period.

.84 If it had required ratable revenue recognition for nonrefundable minimum guarantee fees in arrangements that are not cross-collateralized, AcSEC believes that such a requirement would conflict with how AcSEC views flat fees because the economics of flat or fixed fees and nonrefundable minimum guarantee fees (on a film or films that are not cross-collateralized) are substantially similar. Therefore, AcSEC would have had to reconsider the accounting model for flat fees (and thus the revenue recognition conditions of paragraph .07). AcSEC believes that this reconsideration was not necessary.

.85 AcSEC understands that entities often cannot, in substance, determine the differences between a licensing arrangement with a flat fee plus a variable element (and thus the variable portion is an equity kicker) or a nonrefundable minimum guarantee fee against the variable fee. In fact, there is little, if any, economic difference in those two kinds of arrangements. If the SOP had required an entity to recognize all nonrefundable minimum guarantee fees ratably, AcSEC believes that entities could easily structure arrangements such that the nonvariable element would instead be a flat fee and recognize the flat fee as revenue immediately (if all of the other conditions of paragraph .07 were met).

.86 In reaching its conclusions on accounting for revenue related to fixed fees or nonrefundable minimum guarantees on a film or films that are not cross-collateralized, AcSEC considered various methods, including applying the guidance applicable to minimum guarantees in FASB Statement No. 50.

.87 In FASB Statement No. 50, a conclusion was reached that licensors should report minimum guarantees as liabilities and recognize revenue as the license fee is earned. AcSEC has been informed that there are differences between minimum guarantees in the film industry and minimum guarantees in the music industry. Minimum guarantees in the music industry generally relate to the rights to distribute the music product of an artist or artists for a specific period of time. Much of this product may not exist at the time the minimum guarantee arrangement is entered into. Minimum guarantees in the film industry may actually represent a sale of rights to exhibit a film in a particular market and territory during the film's useful life in that market and territory with a potential share in the results above some defined amount. These arrangements are used in connection with customers in lieu of actual results reported by the customer, which may be untimely, unreliable, or both. Because of the differences between the industries in the nature of the minimum guarantees and in the circumstances under which they are used, AcSEC concluded that the guidance in FASB Statement No. 50 should not be applied to minimum guarantees in the film industry.

.88 ***Nonrefundable Minimum Guarantees (Cross-Collateralized)***. AcSEC believes that the accounting for a nonrefundable minimum guarantee fee on a group of films that are cross-collateralized should be different than that for such a fee on a group of films that are not cross-collateralized. In a cross-collateralized arrangement, the fee paid by a customer is dependent on the performance of *all* of the films in the arrangement. Therefore, the fees are not fixed or determinable with respect to each film in the arrangement until the customer exhibits or exploits all of the films, and an entity should not immediately recognize the entire nonrefundable minimum guarantee fee as revenue because it cannot determine which film will earn revenue until exploitation occurs.

.89 AcSEC concluded that an excess of a nonrefundable minimum guarantee fee over the variable fee recognized in a cross-collateralized arrangement should be recognized as revenue at the end of the license period. AcSEC believes that such an excess is not earned until the period expires, and therefore, it should not be recognized as revenue until the arrangement period ends.

Collectibility

.90 AcSEC concluded that collectibility must be reasonably assured before an entity may recognize revenue. This conclusion is based on paragraph 1 of Chapter 1A of ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, which states the following.

> Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured.

Licensing of Film-Related Products

.91 AcSEC understands that in many arrangements, the release of a film is a requirement in order for the entity to be entitled to fees from its licensing of film-related products. Even if the release of a film is not a legal requirement in order for the entity to be entitled to such fees, AcSEC believes that, because of customer expectations, the entity has an implicit obligation to release the film in order to be entitled to the fees. Therefore, AcSEC concluded that an entity should not recognize revenue on such licensing arrangements until it releases the film. Because fees from licensing of film-related products usually varies directly with the success of a film, the film industry includes such fees in ultimate revenue.

Distribution Arrangements

.92 Some respondents to the exposure draft requested that the SOP address an entity's accounting for co-production and co-financing arrangements with other entities that are beyond "standard" distribution arrangements. Such arrangements are becoming prevalent in the film industry as entities look to share the risks (and thus the rewards) of producing and distributing films. AcSEC believes that such arrangements are not unique to the film industry (for example, real estate, construction, and pharmaceutical industries use co-production and co-financing arrangements), and, therefore, they are beyond the scope of this SOP. AcSEC also believes that the accounting for co-production and co-financing arrangements is based on facts, circumstances, and contractual agreements. For example, a shared arrangement could be any of the following:

a. A joint venture subject to joint venture accounting

b. An arrangement that requires one entity to consolidate another entity in its financial statements

c. A financing arrangement

d. An arrangement that is not a sale of a copyright but rather a sale of future revenue subject to the accounting requirements of EITF Issue No. 88-18, "Sale of Future Revenues"

This is not to say that an entity has a choice of these methods. The determination of the appropriate method is based on the specific facts and circumstances involved.

Costs and Expenses

Film Costs—Capitalization

.93 In paragraph .32 of this SOP, AcSEC concluded that, if a property under development has not been set for production within three years from the first capitalized transaction related to that property, it is presumed that the property will be disposed of. AcSEC acknowledges that (*a*) three years is arbitrary but decided to retain that aspect of current practice and (*b*) set for production is an intentionally chosen high hurdle to evidence use of a property. AcSEC also concluded that when an entity determines that such property will be disposed of at a loss, that loss should be recognized by a charge to the income statement. AcSEC considered retaining the provision of paragraph 17 of FASB Statement No. 53, wherein the cost of a property not used in production of a film, after being held for three years, be charged to production overhead. AcSEC concluded that this would result in amortizing overhead costs that were neither directly nor indirectly related to a film, and therefore, AcSEC rejected that approach. Additionally, AcSEC decided that in measuring impairment for capitalized costs of property not set for production within three years of the first capitalized transaction, the rebuttable presumption should be that the property will be disposed of by abandonment (not used) and as such has a fair value of zero. AcSEC concluded that an entity could overcome this presumption only if management, having the authority to approve the action, had committed to a plan to sell such property. AcSEC believes this provision will minimize the risk of reporting, for long periods, capitalized costs that do not have discernible future benefits and enhance comparability within the industry.

Film Costs—Capitalization (Episodic Television Series)

.94 AcSEC concluded that, for an episodic television series that has not yet met the conditions for including secondary market revenue in ultimate revenue, film costs for each episode in excess of contracted for revenue should be expensed immediately. AcSEC understands that entities produce a series knowing that the series will lose money in the early years. Although the success rate of producing a successful series is relatively low, entities are willing to incur such losses because some percentage of episodic television series will become successful and generate significant profits.

.95 What an entity is trying to develop is an episodic television series that will generate revenue from secondary markets. In order for it to become feasible to obtain secondary market revenue from a television series, an entity must produce a minimum number of episodes. Because many contracts between an entity and the initial exhibitor (for example, a network) result in the entity receiving less in fees than the costs necessary to develop the series, AcSEC views the arrangement as a partially funded research and development effort to "create" a series that will gain public acceptance.

.96 However, given the uncertainty of the potential for secondary markets in the early years of a series, AcSEC believes that it is inappropriate for an entity to report, as an asset, film costs for each episode in excess of revenue contracted for that episode. AcSEC believes that this uncertainty exists until an entity meets the conditions of paragraph .39(*b*).

.97 AcSEC considered and rejected requiring entities to recognize the total loss expected for the number of episodes that the entity expects to deliver under a contract. AcSEC considered paragraph 8 of FASB Statement No. 5, which requires accrual of a loss contingency if (*a*) information available prior to issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements, and (*b*) the amount of the loss can be reasonably estimated. AcSEC understands that, although the terms of contractual arrangements between a television network and an entity in the film industry for delivery of an episodic television series may be binding and noncancellable in form, in practice these contracts often are amended or canceled in the initial years of the series. If a series does not achieve ratings success quickly, the network may wish to cancel the series notwithstanding previously established contractual arrangements. Also, because producers normally incur losses while producing episodes in the early years, it is often in their best interests to cancel a series if secondary market exhibition or exploitation is unlikely. As a result of the discussion in this and preceding paragraphs, AcSEC believes that for a new series in development, notwithstanding a contract, the probability criterion of FASB Statement No. 5 has not been met. More important, given its views in paragraph 95 that the development of a series is akin to a partially funded research and development effort, AcSEC concluded that FASB Statement No. 5 accrual criteria and disclosures are not applicable.

.98 Once the criteria for considering secondary market revenue are met and the secondary market revenue is included in ultimate revenue, AcSEC believes that an entity should capitalize all film costs for an episodic product (without regard to initial market revenue limitations on each episode). AcSEC believes that when an entity is in this situation, the uncertainties surrounding whether a series will be successful are sufficiently minimized and, therefore, the probability of the recoverability of any additional film costs above contracted-for-revenue is high enough such that an entity should not immediately expense costs in excess of contracted-for-revenue.

Film Costs Amortization

.99 AcSEC continues to believe that the individual-film-forecast-computation method is the most appropriate method for expensing film costs in the film industry. AcSEC believes that this method best associates the costs of film production with the related revenue earned.

Participation Cost Accruals

.100 The accounting for participation and residual costs (referred to collectively as participation costs) was a complex issue for AcSEC. AcSEC considered various approaches to accounting for these costs.

.101 ***One event creates obligation***. The exposure draft proposed that an entity accrue total expected participation costs and report those amounts as film costs and related participation liabilities. That approach was based on AcSEC's belief that participation costs are a form of deferred compensation for individuals who provide services in the production of a film. Deferred compensation ordinarily is accrued in the periods when the recipients provide services. In this view, the generation of revenue is the confirming event that fixes the estimated amount payable, similar to a defined contribution plan that calls for contributions for periods after an individual retires or terminates. In addition, AcSEC concluded in the exposure draft that the proposed accounting for participation costs is consistent with FASB Statement No. 5, because the services provided by the participants under contract represent a past event that gives rise to a liability.

.102 ***Two events create obligation***. AcSEC also considered the views of those who believe that two events are needed to recognize a participation liability: (*a*) the participants' performance, and (*b*) the film earning the minimum cumulative revenue or profit required to trigger payments to participants. Proponents of this viewpoint believe that, even though the participants' performance has already occurred as the film was created, no participation liabilities will become due unless the film earns the minimum cumulative revenue or profit.

.103 ***Current practice***. Further, based on comments made by respondents to the exposure draft, AcSEC considered arguments suggesting that the SOP should maintain current practice, which is similar to how entities in other industries report royalty fees on licensed products. Those comment letters indicated that entities in other industries do not accrue liabilities for the total expected royalty fees they will pay on the products they license, even though they may have completed all of the manufacturing efforts and the total amount to be paid is reliably measurable. Rather, those entities record the royalty expense as a cost of the sale or license as they earn revenue on the products to which the royalties relate. This is a form of the two events liability recognition approach with the second event being earning the revenue from sales of products.

.104 AcSEC believes that the arguments supporting all three approaches have merit and can be supported by analogies to authoritative literature. Deciding the appropriateness of the one versus two event approaches would have had implications beyond the scope of this SOP and, therefore, AcSEC decided to maintain current practice in accounting for participation costs. Current practice requires that, during the ultimates period, an entity should accrue and expense participation costs in each reporting period by multiplying unaccrued (that is, not yet expensed) ultimate participation costs by the ratio of current period actual revenue to estimated remaining unrecognized ultimate revenue as of the beginning of the current fiscal year. The requirement to limit the period of ultimate participation costs to that for ultimate revenue maintains consistency within the SOP. Although the reported liability at any given time differs under the three approaches, AcSEC notes that the income statement results under current practice are not significantly different from the results under the approach proposed in the exposure draft.

.105 AcSEC was also informed that certain users of film entities' financial statements prefer the accrued participation liability under current practice compared to that under the approach prescribed by the exposure draft. Those users indicated that they would factor participation costs assets out of their analyses. AcSEC found this helpful in arriving at its conclusion, as discussed in the previous paragraph.

.106 AcSEC understands that a participation arrangement may require an actor to help promote the release of a film in a particular market or territory. AcSEC believes that such an activity and related costs relate to the exploitation of a film. AcSEC considered and rejected requiring an entity to identify and separate the portion of costs in a participation arrangement that relates to exploitation activities. AcSEC believes that such a requirement is not practicable because overall participation costs are typically not broken down by the specific efforts required of the actor in a participation arrangement. In addition, AcSEC believes that the benefits of separating the costs of the exploitation efforts are minimal.

Changes in Estimates

.107 The exposure draft proposed that an entity account for the effects of changes in estimates of revenue and costs prospectively, starting with the beginning of the period of change. FASB Statement No. 53 required that an entity account for the effects of changes in estimates prospectively, starting with the beginning of the fiscal year of change. Many respondents to the exposure draft favored the FASB Statement No. 53 approach for changes in estimates. They believe (and AcSEC concurs) that the exposure draft's approach would have encouraged entities to make aggressive estimates of ultimate revenue because revised estimates would be accounted for prospectively from the period of change.

.108 This SOP effectively maintains the approach required by FASB Statement No. 53. AcSEC believes that the film industry and users of financial statements find that this approach serves their needs, and AcSEC did not have a compelling reason to change current practice.

.109 AcSEC considered requiring a cumulative effect catch-up adjustment through the income statement, which would have required an entity to go back beyond the fiscal year of change. However, AcSEC rejected this approach primarily because of the expected difficulties of implementing this requirement, for example, the need to track impairment write-downs on a film-by-film basis and adjust previous estimates for those write-downs.

.110 The one exception to the changes in estimate guidance is when the recognized participation costs liability exceeds the estimated unpaid ultimate participation costs for an individual film. Because the individual-film-forecast-computation method does not provide a mechanism to reduce recognized liabilities in such situations, paragraph .41 requires a reduction in the reported participation liability and unamortized film costs under such circumstances. Because of the interaction of this calculation with the amortization of film costs calculation (which is based on estimates), AcSEC concluded that the offset to the reduction in the liability should be first used to reduce unamortized film costs before impacting an entity's income statement.

Ultimate Revenue

.111 In paragraphs .38 and .39 of this SOP, AcSEC reached conclusions that limit the amount of revenue that an entity should include in ultimate revenue. AcSEC concluded that estimated ultimate revenue should include only those revenues that are expected to be recognized within a limited period. In addition, AcSEC concluded that entities should not include certain forms of more speculative revenue in ultimate revenue. AcSEC believes that the guidance in this SOP will help promote comparability among entities within the industry.

.112 AcSEC acknowledges that the ten-year provision is arbitrary and that many films have lives that extend beyond ten years. AcSEC is concerned, however, about diversity that has arisen in the industry with respect to the estimation of ultimate revenue. AcSEC concluded that such a limitation is needed to provide greater comparability within the industry. AcSEC also notes that, in most instances, the significant majority of a film's revenue will have been earned within the ten-year period.

.113 One exception to the ten-year provision is for a successful episodic television series that has been in production for at least five years. In these instances, AcSEC decided that entities should include in ultimate revenue all revenue expected to be recognized through five years from the date of delivery of the most recent episode.

.114 Another exception to the ten-year provision is for acquisitions of previously released films as part of a film library. In many such acquisitions, the ultimate revenue used to assign acquisition cost or value to the films will be generated over periods exceeding ten years. AcSEC believes that in such situations, the same revenue used to value the acquired films should be used to apply the individual-film-forecast-computation method. However, to address concerns similar to those discussed in paragraph .112, AcSEC concluded that it should place a limitation on the revenue that an entity should include in the determination of ultimate revenue. AcSEC has been informed that in applying APB Opinion 16, *Business Combinations*, in the film industry, twenty years is the life most often assigned to a film library.

.115 AcSEC believes that an amortization period longer than ten years for films in a library is appropriate because of the differences between such films and new films exploited individually. In almost all cases, a new film that is exploited individually will earn the vast majority of its revenue within the first few years, followed by a relatively long stream of lower, more level revenue over the remainder of its life. However, a film that is included in a film library has experienced its initial cycle in all markets and, therefore, has entered into the period of more stable, lower level revenue. AcSEC's decision that a film must have had an initial release date at least three years prior to the acquisition date to be included in a film library is arbitrary, but AcSEC believes that its decision will help ensure comparability in practice.

.116 Paragraph 29(d) of the exposure draft proposed that ultimate revenue should exclude all revenue from the manufacture and sale of peripheral items. However, AcSEC decided that the limitations on ultimate revenue should be the same for both sales of peripheral items and licensing arrangements with third parties for peripheral items. Therefore, this SOP requires that an entity include in ultimate revenue the portion of the estimated revenue from the sale of peripheral items that is attributable to the exhibition or exploitation of a particular film.

Film Costs Valuation

.117 In the exposure draft and in this SOP, AcSEC concluded that, for impairment purposes, a long-lived asset model is more consistent with the manner in which an entity will exploit a film than is an inventory model. Revenue may be earned from a film over a long period. Additionally, a film is sold or licensed repeatedly by an entity in different markets and territories (unlike inventory, which is sold once). Therefore, AcSEC concluded that an entity should use the fair value of a film when measuring impairment.

.118 AcSEC decided that an entity's measurement of impairment of a particular film should be triggered by events or circumstances that indicate that the fair value of a film may be less than its carrying amount. AcSEC believes that an entity rarely would get to the step of measuring impairment of a film if the trigger (that is, recognition test) was a comparison of estimated future cash flows (undiscounted and without interest charges) to unamortized film costs. As a result, AcSEC concluded that the approach in this SOP is preferable.

.119 In determining the fair value of a film, AcSEC observed that the underlying premise of the individual-film-forecast-computation method is an entity's ability to reliably estimate future revenues. Therefore, AcSEC observed that the estimates of the most likely future cash inflows used in determining the fair value of a film would include those estimates used in the determination of a film's ultimate revenue in addition to other amounts, as discussed in paragraph .45.

.120 Many respondents to the exposure draft believe that films should not follow a long-lived asset model. They believe that the majority of film costs are amortized within the first few years of a film's life.

.121 Respondents favoring an alternative model believe that a film entity is in business to produce and license films, and that, films "are held for sale in the ordinary course of business," as discussed in paragraph 2 of chapter 4 of Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*.

.122 AcSEC believes that the arguments for both models have merit. AcSEC is less concerned with choosing an asset model for films than it is with ensuring that users of financial statements receive relevant information. AcSEC believes that users want and need film entities to report (*a*) the portion of film costs that will be amortized in the next operating cycle and (*b*) film costs, participation costs, exploitation costs, and manufacturing costs as cash flows from operating activities rather than from investing activities. Accordingly, this SOP requires entities to report the information that AcSEC believes users need. AcSEC also believes that the required treatment of cash flows is consistent with paragraphs 86 and 87 of FASB Statement No. 95, *Statement of Cash Flows*.

Exploitation Costs

.123 In the exposure draft, AcSEC noted that the film industry's pattern of incurring exploitation costs differs significantly from the pattern in other industries. A high proportion (perhaps as much as 80 percent) of the total lifetime exploitation costs incurred by an entity with respect to a film is incurred in connection with the release of a film into domestic and international theatrical markets. An entity will incur the most significant amount of expenditures on or before the first weekend to "open" the film domestically.

.124 The exposure draft discussed many different accounting alternatives for exploitation costs and presented AcSEC's original position on each alternative. Those arguments are not restated in this SOP; rather, this basis for conclusions addresses why AcSEC ultimately decided that an entity should account for exploitation costs in accordance with the provisions of SOP 93-7 [section 10,590] and why AcSEC changed its position from the exposure draft (which was that only initial theatrical exploitation costs would be capitalized and amortized over a period not to exceed three months; all other exploitation costs would be expensed as incurred).

.125 When SOP 93-7 [section 10,590] was issued, film entities were excluded from its scope because the SOP could not change the provisions in FASB Statement No. 53 (which falls into level a in the hierarchy of GAAP, as discussed in Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles). However, because the FASB will rescind FASB Statement No. 53 upon the effective date of this SOP, AcSEC was able to debate whether SOP 93-7 [section 10,590] should apply to films.

.126 The accounting for exploitation costs was a difficult issue for AcSEC. AcSEC believes that the accounting proposed in the exposure draft has merit. However, AcSEC's position in the exposure draft was a compromise between parties that preferred (a) capitalization and amortization of exploitation costs for all markets and territories, (b) amortization periods longer than three months, (c) capitalization and expensing at first showing of a film, or (d) inclusion of film entities in the scope of SOP 93-7 [section 10,590].

.127 Based on its review of the comment letters, AcSEC took a fresh look at its position in the exposure draft. Some respondents, including a number of producers of films, stated that the SOP should require that entities expense exploitation costs in accordance with SOP 93-7 [section 10,590]. Many supporters of the position in the exposure draft acknowledged that this solution is not well supported by existing authoritative accounting literature. AcSEC believes that SOP 93-7 [section 10,590] is the most definitive guidance for exploitation costs. AcSEC ultimately could not rationalize why an entity should account for such costs incurred in the film industry differently from how entities account for the same costs incurred in other industries. AcSEC concluded that the guidance in this SOP should be similar to how other industries account for similar costs. For a further discussion on the rationale for the accounting requirements in SOP 93-7 [section 10,590], entities may review the basis for conclusions in that SOP.

Presentation and Disclosure

.128 Paragraph .51 requires disclosure of the portion of the costs of completed films that are expected to be amortized during the upcoming operating cycle. This required disclosure responds to the needs of users of financial information.

.129 AcSEC believes that most entities will have an operating cycle of twelve months. However, AcSEC also believes that certain entities in the film industry may produce a small number of films and that the production period for those entities may exceed twelve months. Therefore, in accordance with paragraph 5 of Chapter 3A of ARB No. 43, AcSEC concluded that entities should be allowed to designate an operating cycle of greater than twelve months when facts and circumstances justify a longer period.

.130 Public companies are required to disclose in their annual filings with the U.S. Securities and Exchange Commission (SEC) the balances of unamortized capitalized film costs, excluding film libraries, whose amortization within three years of the reporting date would not consume 60 percent of the unamortized capitalized film costs and the estimated time period to achieve 60-percent accumulated amortization. Users of financial statements have indicated that this is useful information, but given changes in the film industry and the requirement to apply SOP 93-7 [section 10,590] to exploitation costs, an 80-percent threshold provides more relevant information. AcSEC agreed and decided to require this disclosure for all entities.

.131 AcSEC decided to require disclosures of methods of accounting to ensure that the SOP is consistent with paragraph 12(b) of APB Opinion 22, *Disclosure of Accounting Policies*, which requires disclosure of "Principles and methods peculiar to the industry in which the reporting entity operates, even if such principles and methods are predominately followed in that industry."

Effective Date and Transition

.132 AcSEC believes that the advantages of retroactive application in prior periods of the provisions of this SOP would not outweigh the disadvantages. Accordingly, AcSEC concluded that the cumulative effect of changes caused by adopting the provisions of this SOP should be included in the determination of net income. In addition, AcSEC extended the effective date of the SOP by one year from the date proposed in the exposure draft to give entities more time to comply with the provisions of the SOP.

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Appendix

Examples

Example 1

Revenue Recognition for a Fixed Fee, Single Film License Arrangement (In Accordance With Paragraphs .15 and .27)

A-1. An entity grants to a customer a license for cable television broadcast rights for a single film. Assumptions are the following:

a. End of entity's fiscal year is December 31.

b. Contract execution date is July 31, 2000.

c. License period is January 1, 2001 to December 31, 2003.

d. The entity has met all of the revenue recognition conditions of paragraph .07 at January 1, 2001.

e. License fee is $19,000.

f. Payment schedule is $1,000 at contract execution date, $6,000 on each of January 1, 2001, 2002, and 2003. Payments are non-interest bearing.

g. Appropriate interest rate for computation of interest is 12 percent per year.

A-2. Income recognition is computed as follows:

	Revenue	*Interest Income*
Year 2000	$ —	$ —
Year 2001	17,140[1]	1,217[2]
Year 2002	—	643[3]
Year 2003	—	—
	$17,140	$1,860

Example 2

Allocation of Revenue for a Fixed Fee, Multiple Film Arrangement (In Accordance With Paragraph .16)

A-3. Assumptions are the following:

a. An entity grants to a customer the cable television broadcast rights to three films under a single licensing arrangement in a particular market and territory. The arrangement calls for a fixed license fee of $30,000. The arrangement provides for a pro-rata reduction in the license fee if Film 3 is not completed and made available for delivery.

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[1] Sum of $1,000 paid on contract execution, $6,000 paid on January 1, 2001, plus the present value at 12 percent of the $6,000 payments due on January 1, 2002 and 2003.

[2] Interest at 12 percent for twelve months on a receivable (present valued) of $10,140.

[3] Interest at 12 percent for twelve months on a receivable (present valued) of $5,357.

b. At the date of the arrangement, Films 1 and 2 are complete; Film 3 is yet to be produced. An evaluation of the relative fair values of the licensed rights to Films 1 and 2 indicate that Film 1 should be assigned 55 percent of the fixed license fee and Film 2 should be assigned 45 percent of the fee. The amount potentially refundable if Film 3 is not completed and delivered is $10,000.

A-4. The entity should allocate the license fee as follows:

Film 1 = $11,000 ($30,000 license fee, less $10,000 potentially refundable for one incomplete film, multiplied by 55 percent)

Film 2 = $9,000 ($30,000 license fee, less $10,000 potentially refundable for one incomplete film, multiplied by 45 percent)

Film 3 = $10,000 (the refundable amount due if the film is not completed and made available for delivery)

A-5. The entity should recognize revenue on amounts allocated to each film in accordance with the provisions of this Statement of Position (SOP). If payments under such an arrangement are due in installments, applicable present value calculations should be performed, as illustrated in Example 1.

Example 3

Revenue Recognition for a Variable Fee, Single Film Arrangement With a Nonrefundable Minimum Guarantee (In Accordance With Paragraph .19)

A-6. Assumptions are the following:

a. An entity licenses to a customer the home video rights to one film for a period of two years. The licensing arrangement provides for a variable fee to the entity equal to 30 percent of the customer's gross receipts from the exploitation of this film during the license period. The licensing arrangement also requires the customer to pay the entity a $50,000 nonrefundable minimum guarantee against the variable fee.

b. For purposes of this example, assume that the customer generates gross receipts from the exploitation of the film equal to $100,000 in Year 1 and $80,000 in Year 2. Also, assume that the entity has met all other revenue recognition conditions of this SOP.

A-7. The entity should recognize revenue as follows:

	Nonrefundable Minimum Guarantee	*Variable License Fee*
Year 1	$50,000[4]	$ —[5]
Year 2	—	4,000[6]

[4] Amount is equal to the nonrefundable minimum guarantee.

[5] No variable fee is recognizable in Year 1, as the variable fee ($100,000 gross receipts * 30 percent = $30,000) is less than the nonrefundable minimum guarantee.

[6] The cumulative variable fee is $54,000 [($100,000+80,000) * 30 percent], which exceeds the previously recognized nonrefundable minimum guarantee by $4,000. Accordingly, revenue for Year 2 is $4,000.

Example 4

Revenue Recognition for a Variable Fee, Multiple Film Arrangement With a Nonrefundable Minimum Guarantee (In Accordance With Paragraph .20)

A-8. Assumptions are the following:

a. An entity licenses to a customer the home video rights to five films for a period of three years. The licensing arrangement provides for a variable fee to the entity equal to 30 percent of the customer's gross receipts from the exploitation of the films during the license period. The licensing arrangement also requires the customer to pay the entity a $50,000 nonrefundable minimum guarantee against the variable fees for the five films. The variable fees are cross-collateralized for purposes of determining any amounts due in excess of the $50,000 nonrefundable minimum guarantee.

b. For purposes of this example, assume the customer generates revenue as follows:

	Film 1	Film 2	Film 3	Film 4	Film 5
Year 1	$30,000	$20,000	$10,000	$ —	$ —
Year 2	10,000	10,000	5,000	10,000	5,000
Year 3	10,000	10,000	5,000	10,000	5,000
Total	$50,000	$40,000	$20,000	$20,000	$10,000

A-9. In this example, the entity cannot recognize the nonrefundable minimum guarantee as revenue upon the inception of the license period due to the cross-collateralization provisions of the arrangement. Instead, the entity should recognize revenue on a variable fee basis. The entity should recognize revenue as follows:

	Film 1	Film 2	Film 3	Film 4	Film 5	Total
Year 1(7)	$ 9,000	$ 6,000	$3,000	$ —	$ —	$18,000
Year 2(7)	3,000	3,000	1,500	3,000	1,500	12,000
Year 3(7)	3,000	3,000	1,500	3,000	1,500	12,000
Subtotal	$15,000	$12,000	$6,000	$6,000	$3,000	$42,000
Year 3, at end of license period(8)	2,857	2,286	1,143	1,143	571	8,000
Total	$17,857	$14,286	$7,143	$7,143	$3,571	$50,000

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[7] Amounts are computed using 30 percent of the customer's gross receipts for the applicable films and periods.

[8] The cumulative amount of the entity's variable fees earned is less than the nonrefundable minimum guarantee. The excess ($8,000) of the nonrefundable minimum guarantee over cumulative earned revenue is recognized at the end of the license period, and is allocated to the individual films based on their relative cumulative variable fees.

Example 5

Illustration of the Individual-Film-Forecast Method of Amortization, for a Film in Its Initial Year of Release (In Accordance With Paragraph .34)

A-10. Assumptions are the following:

a. Film cost—$50,000

b. Estimated ultimate revenue—$100,000

c. Actual revenue earned in Year 1—$60,000

d. Estimated ultimate participation costs—$10,000

A-11. Film Cost amortization in Year 1:

$$\frac{\text{\$60,000 earned revenue}}{\text{\$100,000 ultimate revenue}} * \text{\$50,000 film cost} = \underline{\underline{\text{\$30,000}}}$$

A-12. Participation costs accrued in Year 1:

$$\frac{\text{\$60,000 earned revenue}}{\text{\$100,000 ultimate revenue}} * \text{\$10,000 ultimate participation costs} = \underline{\underline{\text{\$6,000}}}$$

Example 6

Illustration of the Individual-Film-Forecast Method of Amortization, for a Film Where Estimates Are Revised Subsequent to the Initial Year of Release (In Accordance With Paragraph .36)

A-13. Assumptions are the following:

a. Film cost is $50,000

b. Estimated ultimate revenue:
- — Year 1—$100,000
- — Year 2—$90,000 (Note: not the remaining ultimate revenue starting from this year)

c. Actual revenue earned:
- — In Year 1—$60,000
- — In Year 2—$10,000

d. Estimated ultimate participation costs:
- — Year 1—$10,000
- — Year 2—$9,000 (Note: not the remaining ultimate participation costs starting from this year)

e. For Year 1, film cost amortization was $30,000 and participation costs accrued were $6,000.

A-14. Film Cost amortization in Year 2:

$$\frac{\$10{,}000 \text{ earned revenue}}{\$30{,}000 \text{ remaining ultimate revenue}^{(9)}} * \$20{,}000 \text{ unamortized film costs}^{(10)} = \underline{\underline{\$6{,}667}}$$

A-15. Participation costs accrued in Year 2:

$$\frac{\$10{,}000 \text{ earned revenue}}{\$30{,}000 \text{ remaining ultimate revenue}^{(9)}} * \$3{,}000 \text{ remaining ultimate participation costs}^{(11)} = \underline{\underline{\$1{,}000}}$$

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[9] Computed as follows: Year 2 revised ultimate revenue of $90,000 minus cumulative prior earned revenue of $60,000.

[10] Computed as follows: Film cost of $50,000 minus cumulative prior amortization of $30,000.

[11] Computed as follows: Year 2 revised ultimate participation expense of $9,000 minus cumulative prior accrual of $6,000.

Example 7

Adjustment of a Participation Liability That Is in Excess of a Revised Estimate of Amounts Ultimately Payable (In Accordance With Paragraph .41)

A-16. In accordance with paragraph .41 of this SOP, a participation liability that exceeds the unpaid amount expected to be ultimately payable should be offset against the remaining carrying value of the corresponding film. This scenario can result from changes in ultimate revenue and cost estimates that result in reduced expectations of ultimate participation costs.

A-17. Assumptions are the following:

a. Film cost—$50,000.

b. Estimated ultimate revenue:
- Year 1—$100,000
- Year 2—$80,000

c. Actual revenue earned:
- In Year 1—$60,000
- In Year 2—$10,000

d. Estimated ultimate participation costs:
- Year 1—$10,000
- Year 2—$0

e. For Year 1, film cost amortization was $30,000, and participation costs accrued were $6,000.

A-18. Adjustments of Participation Liability and Film Costs in Year 2:

	Unamortized Film Costs	*Participation Liability*
Balance at end of Year 1	$20,000	$6,000
Adjustment to eliminate excess liability	(6,000)	(6,000)
Adjusted balances	$14,000	$ —

A-19. Film Cost amortization in Year 2:

$$\frac{\$10{,}000 \text{ earned revenue}}{\$20{,}000 \text{ remaining ultimate revenue}^{(12)}} * \$14{,}000 \text{ unamortized film costs}^{(13)} = \underline{\underline{\$7{,}000}}$$

A-20. Participation costs accrued in Year 2:

$$\frac{\$10{,}000 \text{ earned revenue}}{\$20{,}000 \text{ remaining ultimate revenue}^{(12)}} * \$0 \text{ remaining ultimate participation costs}^{(14)} = \underline{\underline{\$0}}$$

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[12] Computed as follows: Year 2 revised ultimate revenue of $80,000 minus cumulative prior earned revenue of $60,000.

[13] Computed as follows: Film cost of $50,000 minus cumulative prior amortization of $30,000 and minus the excess participation liability adjustment of $6,000.

[14] Estimated ultimate participation costs were reduced to $0 in Year 2; accordingly, the excess liability was reversed and no further accruals are required.

Example 8

Accounting for Costs of Episodic Television Production Prior to the Establishment of Secondary Market Revenue Estimates (In Accordance With Paragraph .33)

A-21. Assumptions are the following:

a. An episodic television series is in its first year of production

b. Secondary market revenue estimable—none

c. Cost of production, per episode after the first episode—$700 (assume that most of the set costs were accounted for as part of the first episode, which is not illustrated in this example)

d. Exploitation costs, per episode—$5

e. Estimated ultimate revenue per episode:

Contracted	$400

A-22. Secondary market revenue is not estimable per the provisions of paragraph .39(*b*). Accordingly, capitalization of film costs is limited as follows:

	Per Episode
Revenue contracted	$400
Production costs to be capitalized	$400
Exploitation costs expensed	$ 5
Production costs to be charged directly to expense	$300[15]

[15] Computed as follows: Total cost of production of $700, less costs to be capitalized of $400.

Example 9

Illustration of the Individual-Film-Forecast Method of Amortization, for an Episodic Television Series (In Accordance With Paragraph .37)

A-23. Assumptions are the following:

a. An entity produces and distributes an episodic television series. Five seasons of the series are ultimately produced.

b. The entity's fiscal year end corresponds directly with the completion of each production season.

c. The beginning of Season 4 is when secondary market revenue estimates are initially established.

d. Costs of production are the following:

Seasons 1 to 3	$36,000 (fully expensed prior to Season 4)
Season 4	$16,000
Season 5	$18,000

e. Earned and remaining ultimate revenues are the following:

As of Season 4

Earned and reported in Season 4	$ 8,000
Earned and reported in Season 5	N/A
Remaining ultimate revenue, Seasons 1 to 4	$40,000
Remaining ultimate revenue, Season 5	N/A
	$48,000

As of Season 5

Earned and reported in Season 4	N/A
Earned and reported in Season 5	$11,000
Remaining ultimate revenue, Seasons 1 to 4	$40,000
Remaining ultimate revenue, Season 5	$10,000
	$61,000

f. Ultimate participation costs are as follows:

As of Seasons 1 to 3	$ 0
As of Season 4	$2,000
As of Season 5	$3,000

A-24. Amortization of film costs in accordance with paragraph .37 of this SOP is determined as follows for Seasons 4 and 5:

$$\text{Season 4} \quad \frac{\$8{,}000^{(16)}}{\$48{,}000^{(17)}} \times \$16{,}000^{(18)} = \$2{,}667$$

$$\text{Season 5} \quad \frac{\$11{,}000^{(16)}}{\$61{,}000^{(17)}} \times \$31{,}333^{(19)} = \$5{,}650$$

A-25. Accrual of participation costs is determined as follows:

$$\text{Season 4} \quad \frac{\$8{,}000^{(16)}}{\$48{,}000^{(17)}} \times \$2{,}000^{(20)} = \$333$$

$$\text{Season 5} \quad \frac{\$11{,}000^{(16)}}{\$61{,}000^{(17)}} \times \$2{,}667^{(21)} = \$481$$

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[16] Earned and reported revenue during the current season.

[17] Remaining ultimate revenue at the beginning of the current season.

[18] Remaining unamortized film costs at the beginning of Season 4 ($0 from Seasons 1 to 3, plus the cost of production of Season 4).

[19] Remaining unamortized film costs at the beginning of Season 5 ($13,333 unamortized as of the end of Season 4 plus the $18,000 cost of production of Season 5).

[20] Remaining unaccrued participation costs at the beginning of Season 4.

[21] Remaining unaccrued participation costs at the beginning of Season 5 (ultimate cost of $3,000, less prior cumulative accrual of $333).

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Glossary

Cross-collateralized. An arrangement that grants a licensee distribution rights to multiple films, territories and/or markets to a licensee, and the exploitation results for all applicable films, territories and/or markets are aggregated by this licensee for purposes of determining amounts payable to the licensor under the arrangement.

Distributor. An enterprise or individual that owns or holds the rights to distribute films. For purposes of this SOP, the definition of distributor of a film does not include, for example, those entities that function solely as broadcasters, retail outlets (such as video stores), or movie theaters.

Entity. Producer or distributor that owns or holds the rights to distribute or exploit films in one or more markets and territories.

Exploitation costs. All direct costs (including marketing, advertising, publicity, promotion, and other distribution expenses) incurred in connection with the distribution of a film.

Film costs. Film costs include all direct negative costs incurred in the physical production of a film, as well as allocations of production overhead and capitalized interest in accordance with FASB Statement No. 34. Examples of direct negative costs include costs of story and scenario; compensation of cast, directors, producers, extras, and miscellaneous staff; costs of set construction and operations, wardrobe, and accessories; costs of sound synchronization; rental facilities on location; and postproduction costs such as music, special effects, and editing.

Film prints. Those materials, produced on behalf of a film distributor for delivery to a theatre or other similar venue, that contain the completed audio and video elements of a film. Such materials are used by the theatre or other similar venue to exhibit the film to its customers.

Firm commitment. An agreement with a third party that is binding on both parties. The agreement specifies all significant terms, including items to be exchanged, consideration, and timing of the transaction. The agreement includes a disincentive for nonperformance that is sufficiently large to ensure the expected performance. In the context of episodic television series, a firm commitment for future production should include only episodes to be delivered within one year from the date of the estimate of ultimate revenue.

Market. A distribution channel within a certain territory. Examples of markets include theatrical exhibition, home video, pay television, free television, and the licensing of film-related products.

Nonrefundable minimum guarantee. Amount paid or payable by a customer in a variable fee arrangement that guarantees an entity a minimum fee on that arrangement. Such a guarantee applies to (*a*) an amount paid by a customer immediately and (*b*) an amount that the customer has a legally binding commitment to pay over a license period.

Participation costs. Parties involved in the production of a film may be compensated in part by contingent payments based on the financial results of a film pursuant to contractual formulas (participations) and by contingent amounts due under provisions of collective bargaining agreements (residuals). Such parties are collectively referred to as participants, and such costs are referred to collectively as *participation costs*. Participations may be given to creative talent, such as actors or writers, or to entities from whom distribution rights are licensed.

Producer. An individual or an entity that produces and has a financial interest in films for exhibition in movie theaters, on television, or elsewhere.

Revenue. Revenue earned by an entity from its direct distribution, exploitation, or licensing of a film, before deduction for any of the entity's direct costs of distribution. For markets and territories in which an entity's fully or jointly-owned films are distributed by third parties, revenue is the net amounts payable to the entity by third party distributors. Revenue is reduced by appropriate allowances, estimated returns, price concessions, or similar adjustments, as applicable.

Sale. The transfer of control of the master copy of a film and all the associated rights that go along with it (that is, an entity sells and gives up all rights to a film). An entity should determine a gain or loss on the sale of a film in accordance with the revenue recognition and cost amortization requirements of this SOP.

Set for production. As used in this SOP, this term means (*a*) management, with the relevant authority, implicitly or explicitly authorizes and commits to funding the production of a film; (*b*) active preproduction has begun; and (*c*) the start of principal photography is expected to begin within six months.

Territory. A geographic area in which a film is exploited. In most cases, a territory consists of a country. However, in certain instances, a territory may be defined as countries with a common language.

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The task force and staff gratefully acknowledge the contributions made to the development of this Statement of Position by John Giesecke, Peter C. Halt, and Francis E. Scheurell, Jr.

[The next page is 80,731.]

Section 10,810

Statement of Position 00-3 Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts

December 15, 2000

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) provides guidance on accounting by insurance enterprises for demutualizations and the formation of mutual insurance holding companies (MIHC). The SOP also applies to stock insurance enterprises that apply SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises* [section 10,650], to account for participating policies that meet the criteria of paragraph 5 of SOP 95-1 [section 10,650.05].

The SOP specifies the following:

- *Financial statement presentation of the closed block.* Closed block assets, liabilities, revenues, and expenses should be displayed together with all other assets, liabilities, revenues, and expenses of the insurance enterprise based on the nature of the particular item, with appropriate disclosures relating to the closed block.
- *Accounting for predemutualization participating contracts after the demutualization date or formation of an MIHC and for stock insurance enterprises that have adopted SOP 95-1* [section 10,650]. A demutualized insurance enterprise should continue to apply the guidance of SOP 95-1 [section 10,650.05] to its participating contracts issued before the date of demutualization or formation of the MIHC that are within the scope of SOP 95-1 [section 10,650.05]. However, the segregation of

undistributed accumulated earnings on participating contracts is meaningful in a stock life insurance company, because the objective of such presentation is to identify amounts that are not distributable to stockholders. Therefore, after the date of demutualization or formation of an MIHC, the provisions of paragraphs 41 and 42 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 60, *Accounting and Reporting by Insurance Enterprises*, relating to dividends on participating contracts should apply to such contracts sold before the date of demutualization or formation of the MIHC.

- *Emergence of earnings*. Cumulative actual closed block earnings in excess of the expected periodic amounts calculated at the date of demutualization or formation of an MIHC or, if not practicable for insurance enterprises that demutualized or formed an MIHC prior to January 1, 2001, as of the beginning of the year of adoption of this SOP, that will not inure to the stockholders should be recorded as an additional liability to closed block policyholders (referred to as a policyholder dividend obligation).

- *Accounting for participating policies sold outside the closed block after the date of demutualization or formation of an MIHC*. SOP 95-1 [section 10,650] should be applied to participating policies that meet its conditions and are sold outside the closed block after the date of demutualization or formation of the MIHC. However, provisions of paragraphs 41 and 42 of FASB Statement No. 60 relating to dividends on participating contracts should apply to such contracts sold after the date of demutualization or formation of an MIHC.

- *Accounting for expenses related to a demutualization and the formation of an MIHC*. Direct incremental costs related to a demutualization or formation of an MIHC should be classified as a single line item within income from continuing operations.

- *Accounting for retained earnings and other comprehensive income at the date of demutualization and formation of an MIHC*. An insurance enterprise that demutualizes in a distribution-form demutualization should reclassify all its retained earnings as of the demutualization date to capital stock and additional paid-in capital accounts (the capital accounts). A subscription-form demutualization does not by itself result in reclassification of retained earnings. The equity accounts of an MIHC at the date of formation should be determined using the principles for transactions of companies under common control, with the amount of retained earnings of the demutualized insurance enterprise, before reclassification to the capital accounts, being reported as retained earnings of the MIHC. Because the accounting bases and carrying amounts of assets and liabilities are not changed as a consequence of demutualization or formation of an MIHC, the amounts in accumulated other comprehensive income should also not be changed as a consequence of demutualization or formation of an MIHC.

- *Accounting for a distribution from an MIHC to its members*. Because the members of an MIHC are also policyholders of the stock insurance subsidiary, a distribution by an MIHC to its members should be accounted for according to the substance of the transaction. Unless there are substantive independent third-party stockholders, the distribution should be accounted for as a policyholder dividend.

This SOP applies to past and future demutualizations or formations of an MIHC. For those that occur after December 31, 2000, this SOP is effective on the date of the demutualization or formation of the MIHC. For a demutualization or formation of an MIHC that occurred on or before December 31, 2000, this SOP, with the exception of paragraph .18, should be applied retroactively through restatement or reclassification, as appropriate, of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. A stock insurance enterprise that has elected to adopt SOP 95-1 [section 10,650] and that did not convert from a mutual life insurance enterprise should apply the provisions of paragraph .17 of this SOP retroactively through restatement of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. Paragraph .18 of this SOP is effective upon issuance with restatement required for those expenses presented in financial statements for any period presented for comparative purposes. Early adoption of this SOP is encouraged.

The beginning balance of retained earnings and, if necessary, any other components of stockholders' equity, for the earliest year presented should be adjusted for the effect of restatement or reclassification as of the earliest year restated. In the year this SOP is first applied, the financial statements should disclose the effect on income before extraordinary items, net income, and related per share amounts for each year restated or reclassifed. If the actuarial calculation is prepared as of the beginning of the year of adoption of this SOP, its implementation will not result in restatement to recognize a policyholder dividend obligation. Pro forma information for years prior to a demutualization or formation of an MIHC is not required.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing a final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.

2. The proposal will result in an improvement in practice.

3. The AICPA demonstrates the need for the proposal.

4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Introduction and Background

.01 Mutual insurance enterprises differ from stock insurance enterprises in that they do not have stockholders. The enterprise is considered to be owned by policyholders whose insurance contracts embody their rights as insureds and as members of the mutual insurance enterprise. Many mutual insurance enterprises are seeking enhanced financial flexibility and better access to capital markets to support long-term growth and to accomplish strategic initiatives. In light of those economic factors as well as increased competition and regulatory considerations, there has been a recent trend for certain mutual insurance companies to demutualize or to form mutual insurance holding companies (MIHC). The process of **demutualization**[1] or formation of an MIHC is subject to scrutiny and approval by state insurance regulatory authorities. Most states have some form of demutualization statute. A range of demutualization statutes and regulations exist for insurance enterprises. Typically, those laws contemplate a direct and full reorganization of the mutual insurer to a stock form. In accordance with some demutualization statutes, eligible policyholders receive stock, **policy credits**, policyholder benefits, cash, or subscription rights as consideration for their membership interest. This Statement of Position (SOP) uses the term *distribution-form demutualization* to refer to situations in which eligible policyholders receive stock, policy credits, additional policyholder benefits, cash or rights to purchase stock at favorable terms. This SOP uses the term *subscription-form demutualization* to refer to situations in which eligible policyholders receive only the right to purchase stock in the insurance enterprise or its parent at terms essentially equivalent to the terms offered to independent third parties.

.02 The process for allocating the aggregate consideration among eligible policyholders varies based on individual company circumstances and applicable regulatory statutes. The allocation process generally consists of a fixed and a variable component. The fixed component represents consideration for eligible policyholders' membership interest in the mutual insurer and consists of a given number of shares per policyholder (or sometimes, per policy). The variable component represents consideration for eligible policyholders' contribution to the value of the insurer. The variable component of the aggregate compensation is allocated to policyholders in proportion to the actuarial contributions of their eligible policies, if positive. A policy's actuarial contribution consists of its historical equity share (the policy's past contribution to company equity) and, in most cases, the prospective equity share (the present value of the policy's expected future contributions to company equity).

.03 An alternative to demutualization, in the jurisdictions where it is permitted, is for a mutual insurance enterprise to form an MIHC. The mutual insurer is converted to a stock insurance enterprise and becomes a stockholder-owned entity that operates as a subsidiary of the newly formed MIHC. All the initial stock of the reorganized enterprise is issued to the MIHC; MIHC governance is established by the former mutual insurance enterprise's board of directors. The converted stock insurer may generate additional capital through an initial or subsequent public offering; however, most statutes specify

[1] Terms defined in the glossary [paragraph .80] are in boldface type the first time they appear in this Statement of Position.

that the MIHC must own greater than 50 percent of the voting rights of the converted insurer to ensure that the MIHC maintains effective control. The policyholders of the converted insurer become members of the MIHC through the transfer of their mutual membership interests to the MIHC, retaining the same voting rights they had previously. Policyholders with **participating insurance contracts** retain their participating contract in the converted stock insurer, but unlike in a demutualization, there is no distribution of equity or subscription rights to policyholders. A number of states have enacted or are currently contemplating enactment of MIHC statutes.

.04 A demutualization or formation of an MIHC in and of itself does not constitute a change in ownership that requires a change in the historical accounting bases or **carrying amounts** of assets and liabilities. Paragraph 24 of Financial Accounting Standard Board (FASB) Technical Bulletin (TB) 85-5, *Issues Relating to Accounting for Business Combinations*, states in part, "In the special case of a mutual or cooperative enterprise that converts to stock ownership for purposes of effecting a business combination, the conversion is not a shift of equity ownership from one group of equity owners to another. It is a shift from a form of organization that has no substantive equity ownership to one that has." This SOP does not address what constitutes a change in ownership or reporting entity that would require a change in basis for the reported assets and liabilities.

.05 Most of the past demutualizations and at least one of the past MIHC conversions have been accompanied or followed by an initial public offering of the stock of a demutualized insurance enterprise or an intermediate holding company of the MIHC. In connection with a demutualization or the formation of an MIHC, some state insurance departments require that a **closed block** or alternative mechanism be established for certain participating insurance policies to protect the adjustable policy features and dividend expectations of participating life insurance policyholders from the competing interests of stockholders. Typically, the **plan of demutualization** describes how the closed block will operate. The closed block assets and cash flows provided by those assets (see paragraph .08 of this SOP) will not inure to the stockholders of the demutualized company; instead, all cash flows from those assets will be used to benefit the closed block policyholders (absent regulatory approval to the contrary or insolvency of the insurer). Because the insurance enterprise remains obligated to provide for minimum guarantees under the participating policy, it is consequently possible under certain circumstances that funds from outside the closed block will have to be used to meet the contractual benefits of the closed block policyholders. The assets designated to the closed block are subject to the same liabilities, with the same priority in the case of insolvency or in liquidation, as assets outside the closed block. In many situations, commissions and other expenses (including management expenses) of operating and administering the closed block will not be charged to the closed block. Unless the state insurance department consents to an earlier termination, the closed block will continue in effect until the date on which none of the policies in the closed block remains in force.

.06 Alternatives to the closed block have arisen in practice encompassing, for a number of types of contracts, various mechanisms believed by the insurance enterprise and state insurance regulators to be appropriate in the specific circumstances. Closed block alternative mechanisms have been used in lieu of closed blocks for certain participating life contracts to commit to the insurance regulator that the insurance company will continue to follow its established dividend practices. Closed block alternative mechanisms also have been used to protect nonguaranteed elements of participating and **nonparticipating insurance contracts** such as interest credits on deferred annuities and adjustable premiums on adjustable premium term business. In some instances, the methodology and limitations defined in the agreements with the state insurance regulators have considered only specific profit components, such as **mortality** experience on a block of term insurance or investment spreads on a block of annuities, and in other instances have considered virtually all components of product profitability. If there is a limitation on the profits that may inure to the stockholders, there is an agreement between the insurance company and the insurance regulators that defines (*a*) the contracts covered by the limitation, (*b*) the profit limitation calculation, and (*c*) the timing and manner (for example, as policy dividends, reduced premiums, or additional benefits) in which amounts that may not be distributed to stockholders are to be distributed to policyholders. The conclusions reached in this SOP apply to all formal closed blocks and to closed block alternative mechanisms to the extent the concepts are applicable to them, and are referred to as *closed block* in this SOP.

Operation of the Closed Block

.07 The process of formation of the closed block is negotiated between the insurance company and the applicable state insurance regulators. Estimated future cash flows are considered in determining the nature and amount of assets designated to the closed block. The assets that are designated to the closed block are expected to produce cash flows sufficient to satisfy the obligations of the closed block, as well as the continuation of policyholder **dividend scales** and policy credits before the demutualization, if the underlying experience continues. Actual policy dividends paid may be increased or decreased based on the effect of future events, such as investment experience, mortality gains or losses, and **persistency** of the closed block policies. The assets designated to the closed block continue to be accounted for as they were before the date of demutualization.

.08 The specific policyholder contracts designated for inclusion in the closed block are part of the negotiation process with the insurance regulators. The policyholder liabilities for those closed block participating policies continue to be calculated under the provisions of SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises* [section 10,650], and FASB Statement of Financial Accounting Standards Nos. 60, *Accounting and Reporting by Insurance Enterprises*, and 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, as well as this SOP.

.09 If cash flows from the closed block assets and experience of the closed block are, in the aggregate, more or less favorable than assumed in the funding of the closed block, total dividends paid to closed block policyholders could differ from the original dividend assumptions. Net favorable deviations in closed block performance, unless reversed by subsequent unfavorable experience, will be available for distribution over time only to closed block policyholders and will not be available to the insurance enterprise or its stockholders. Net unfavorable deviations could result in reduced dividends to closed block policyholders, unless reversed by future favorable experience or ultimately funded from assets outside of the closed block.

.10 Regardless of the closed block's performance, the insurance enterprise is obligated to pay guaranteed benefits under the policies in accordance with their terms. If the cash flows from the assets allocated to the closed block and the policies included in the closed block prove to be insufficient to pay the benefits guaranteed under the policies included in the closed block, the insurance enterprise will be required to make those payments from assets outside of the closed block.

Applicability and Scope

.11 This SOP is applicable to all insurance enterprises subject to FASB Statement No. 60 that demutualize or form an MIHC or have done so before the effective date of this SOP. However, if an insurance enterprise demutualized before the effective date of FASB Statement No. 120, *Accounting and Reporting by Mutual Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, this SOP does not require the insurance enterprise to apply SOP 95-1 [section 10,650] unless it had previously elected to do so. For those stock insurance enterprises that apply the provisions of SOP 95-1 [section 10,650], the provisions of paragraph .17 of this SOP apply.

Conclusions

Financial Statement Presentation of the Closed Block

.12 Closed block assets, liabilities, revenues, and expenses should be displayed together with all other assets, liabilities, revenues, and expenses of the insurance enterprise based on the nature of the particular item, with appropriate disclosures relating to the closed block. (See paragraphs .24 and .25 of this SOP.)

Accounting for Predemutualization Participating Contracts After the Demutualization Date or Formation of an MIHC

.13 The accounting guidance in SOP 95-1 [section 10,650] is the appropriate accounting method for participating policies that meet the conditions of paragraph 5 of SOP 95-1 [section 10,650.05] and, therefore, an insurance enterprise should continue to apply that guidance to demutualized insurance enterprises' participating contracts issued before the date of demutualization or formation of an MIHC. However, the segregation of undistributed accumulated earnings on participating contracts is meaningful in a stock life insurance company, because the objective of such presentation is to identify amounts that are not distributable to stockholders. Therefore, after the **date of demutualization** or formation of an MIHC, the provisions of paragraphs 41 and 42 of FASB Statement No. 60 relating to dividends on participating contracts should apply to those contracts sold before the date of demutualization or formation of an MIHC.

Emergence of Earnings

.14 The amounts to be included in net income relative to assets and liabilities included in the closed block are limited, based on a calculation prepared as of the date of demutualization or formation of an MIHC or, if not practicable for insurance enterprises that demutualized or formed an MIHC prior to January 1, 2001, as of the beginning of the year of adoption of this SOP

(actuarial calculation date). As of the actuarial calculation date, the generally accepted accounting principles (GAAP) carrying amount of closed block liabilities will typically exceed the GAAP carrying amount of closed block assets. Certain of those assets, such as debt securities classified as available-for-sale under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, will be carried at fair value with unrealized holding gains and losses included in other comprehensive income until realized. A demutualization or formation of an MIHC does not, in and of itself, constitute a change in ownership that results in the realization of those unrealized gains and losses. Instead, those unrealized gains and losses will be realized over the period the closed block policies remain in force, as are all other transactions relating to the closed block assets and liabilities. As a result, the GAAP carrying amounts of the closed block assets must be adjusted to remove those unrealized amounts to determine the maximum future earnings (before items that may not have been considered in the funding of the closed block, such as commissions and maintenance expenses; see paragraph .06 of this SOP) that would be recognized in income over the period the policies in the closed block remain in force. For example, as part of the negotiations surrounding the closed block and demutualization process, the insurance enterprise may agree with the insurance regulator to designate participating policies with a GAAP carrying amount (liability) of $2,500,000,000 for the closed block. Fixed maturity available-for-sale investments with a carrying value and fair value of $2,300,000,000 and an amortized cost of $2,240,000,000 are designated as the closed block assets. If there are no other assets or liabilities included in the closed block, the maximum future earnings from the closed block that would be recognized in income over the period in which the closed block remains in force is $260,000,000.

.15 The changes in the **net closed block liability** over time represents the expected closed block GAAP contribution to the earnings of the insurer that inure to the benefit of the stockholders. As of the actuarial calculation date, a calculation is developed that represents the cash flows expected to be generated from the assets and liabilities included in the closed block. Based on that calculation (the **actuarial calculation)**, the periodic expected changes in the net closed block liability (on a GAAP basis), which is after the elimination of the effect of the applicable items of other comprehensive income should be derived. The actuarial calculation should be based on a best estimate (with no provision for adverse deviation) of the future performance of the closed block assets and liabilities as of the actuarial calculation date. Cumulative actual closed block earnings in excess of the cumulative expected periodic amounts reflected in the actuarial calculation do not inure to the stockholders and should be recorded as an additional liability to closed block policyholders (referred to as a policyholder dividend obligation). Those amounts will result in additional future dividends to closed block policyholders unless otherwise offset by less-favorable-than-expected future performance of the closed block.

Determination of the Policyholder Dividend Obligation

.16 The actuarial calculation described above should continue to be used in subsequent accounting periods to determine the change in the policyholder dividend obligation. The actuarial calculation should not be revised in future accounting periods. The amount of the policyholder dividend obligation should be determined by comparing cumulative actual earnings of the closed block from the actuarial calculation date to the date of measurement with the amount of cumulative expected earnings based on the actuarial calculation for the same period. Cumulative actual earnings in excess of cumulative expected earnings based on the actuarial calculation should be recorded as a policyholder dividend obligation. Unrealized investment gains and losses and other amounts related to the closed block normally reported in accumulated other comprehensive income that have arisen after the actuarial calculation date should be included in the determination of the amount of the policyholder dividend obligation limited, in the case of losses, to the extent that the policyholder dividend obligation is otherwise positive. Unrealized investment gains and losses and other items related to the closed block normally reported in accumulated other comprehensive income that have arisen at or after the actuarial calculation date should continue to be reported in accumulated other comprehensive income. Amounts related to the closed block that have arisen after the actuarial calculation date should enter into the determination of the policyholder dividend obligation with an offsetting amount reported in accumulated other comprehensive income. The amount charged to policyholder dividend obligation for losses should be limited to the extent that the policyholder dividend obligation is otherwise positive. Unrealized investment gains and losses, other items of accumulated other comprehensive income, and the amount of offsetting policyholder dividend obligation should not be netted in the presentation of other comprehensive income. Those amounts should be reported in the income statement and the amounts previously reported in other comprehensive income should be reversed when investment gains and losses and other items of other comprehensive income are realized. Unrealized investment losses and other loss items related to the closed block that would result in a negative policyholder dividend obligation should be recognized in other comprehensive income applicable to stockholders—the policyholder dividend obligation account may not have a negative balance. The policyholder dividend obligation will decrease if experience is less favorable than expected and the dividend scale is not commensurately reduced. If dividends paid are higher than originally expected in the dividend scale, the policyholder dividend obligation will decrease.

Accounting for Participating Policies Sold After the Date of Demutualization or Formation of an MIHC and for Stock Insurance Enterprises That Adopted SOP 95-1 [section 10,650]

.17 The accounting guidance in SOP 95-1 [section 10,650] should be applied to demutualized insurance enterprise participating contracts meeting the SOP's criteria issued after the date of demutualization or formation of an MIHC. The segregation of undistributed accumulated earnings on participating contracts in excess of amounts that inure to stockholders is meaningful in a stock life insurance company because the objective of such presentation is to identify amounts that are not distributable to stockholders. Therefore, the provisions of paragraphs 41 and 42 of FASB Statement No. 60 relating to dividends on participating contracts should apply to contracts that are sold after the date of demutualization or formation of an MIHC and meet the requirements of SOP 95-1 [section 10,650]. Those provisions should also be applied by stock insurance enterprises that adopted SOP 95-1 [section 10,650] with respect to participating contracts for which limitations exist on the amount of net income that may be distributed to stockholders. If there is a limitation on the amount of income from participating contracts issued after the date of demutualization or formation of an MIHC that may be distributed to stockholders, the policyholders' share of income on those contracts that may not be distributed to stockholders should be charged to operations with a corresponding credit to a liability. Dividends paid to participating policyholders reduce that liability.

Accounting for Demutualization and MIHC Expenses

.18 In connection with a demutualization or formation of an MIHC, an insurance enterprise will incur expenses, including those for legal services, actuarial services, printing, and postage. Direct and incremental costs related to a demutualization or formation of an MIHC should be classified as a single line item within income from continuing operations and should not be classified as an extraordinary item.

Accounting for Retained Earnings and Accumulated Other Comprehensive Income at the Date of Demutualization or Formation of an MIHC

.19 Depending on the form of demutualization, a reclassification of retained earnings at the date of demutualization may be appropriate. An insurance enterprise that demutualizes in a distribution-form demutualization should reclassify all its retained earnings as of the date of demutualization to capital stock and additional paid-in capital accounts (the capital accounts). If the enterprise distributes cash or policy credits to policyholders in lieu of capital stock, as part of the demutualization, the distribution should be recorded as a direct reduction to the appropriate capital accounts. A subscription-form demutualization does not, by itself, result in reclassification of retained earnings.

.20 The equity accounts of an MIHC at the formation date should be determined using the principles for transactions of companies under common control, with the amount of retained earnings of the demutualized insurance enterprise, before reclassification to the capital accounts, being reported as retained earnings of the MIHC. Because the accounting bases and carrying amounts of assets and liabilities are not changed as a consequence of demutualization or formation of an MIHC, the amounts in accumulated other comprehensive income also should not be changed as a consequence of demutualization or formation of an MIHC.

Accounting for the Dividends From a Stock Insurance Subsidiary to an MIHC

.21 A dividend payable to stockholders, whether declared by a stock insurer or its holding company, is a common corporate capital transaction. Cash dividends should be recorded on the books of the corporation as a liability on the declaration date. A stock dividend declared by the stock insurer should be accounted for in accordance with Accounting Research Bulletin (ARB) 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 7, "Capital Accounts," section B, Stock Dividends and Stock Split-ups. Under existing laws or regulations, an MIHC is required to own a controlling voting interest in the stock insurance subsidiary and, therefore, should reflect the stock insurer or intermediate holding company on a consolidated basis. As a result, intercompany dividends should be eliminated in the consolidated accounts of the MIHC.

Accounting for a Distribution From an MIHC to Its Members

.22 Because the members of an MIHC are also policyholders of the stock insurance subsidiary, a distribution by an MIHC to its members should be accounted for according to the substance of the transaction. Unless there are substantive independent third-party stockholders of the demutualized insurance enterprise or intermediate holding company of the MIHC, the distribution should be accounted for as a policyholder dividend. If there are substantive independent third-party stockholders and the following conditions also are satisfied, the distribution is presumed to be appropriately accounted for as an equity dividend.

a. There is a mechanism to ensure that policyholder dividends are not a component of the MIHC distribution.

b. All MIHC members are eligible to receive the MIHC distribution and the allocation of MIHC distribution is consistent with the concept of MIHC membership (depending on the jurisdiction, it may be based on equity share or equally distributed to each MIHC member).

c. The distribution is legally characterized as a membership distribution rather than a policyholder distribution.

.23 If a distribution by the MIHC is determined to be a policyholder dividend expense, the insurance subsidiary should reflect the policyholder dividend in its separate financial statements as an expense with recognition of a corresponding capital contribution from the MIHC. The MIHC should reflect the amount of the distribution as a capital contribution to the insurance subsidiary in its separate financial statements. In consolidated financial statements, the expense would be reported and the capital contribution would be eliminated.

Disclosures

.24 An insurance enterprise should disclose the nature and terms of a demutualization or formation of an MIHC and the basis of presentation and terms of operation of the closed block. In addition, the insurance enterprise should provide a general description of the method of emergence of earnings from the closed block, presentation of assets and liabilities of the closed block, and the policyholder dividend obligation.

.25 An insurance enterprise that has formed a closed block should disclose the following (refer to appendix A, "Illustrative Guidance—Footnote Disclosure for the Closed Block" [paragraph .78], for an illustrative example):

a. A general description of the closed block, including the purpose of the closed block, the types of insurance policies included, and the nature of the cash flows that increase and decrease the amount of closed block assets and liabilities. The description should indicate the continuing responsibility of the insurance enterprise to support the payment of contractual benefits and the nature of expenses charged to the closed block operations.

b. Summarized financial data of the closed block as of, or for periods ending on the date of, the financial statements presented, which should include, at a minimum, the carrying amounts for the major types of invested assets of the closed block, future policy benefits and policyholders' account balances, policyholder dividend obligation, premiums, net investment income, realized investment gains and losses, policyholder benefits, policyholder dividends, and the amount of maximum future earnings remaining to inure to the benefit of stockholders from the assets and liabilities of the closed block as well as an analysis of the changes in the policyholder dividend obligation.

c. GAAP disclosures that typically would be required for the various specific elements included in the closed block need not be made separately for the closed block if the nature of the information for the closed block would not differ significantly from that already included for the reporting entity as a whole. For example, it is not necessary to show a separate schedule of contractual maturities of closed block fixed maturity securities if the relative composition of contractual maturities is similar to those of the reporting entity taken as a whole. However, if the relative maturities of the closed block fixed maturities securities differ from those of the reporting entity taken as a whole, separate disclosures should be made.

Effective Date and Transition

.26 This SOP applies to past or future demutualizations or formations of an MIHC. For those that occur after December 31, 2000, this SOP is effective on the date of the demutualization or formation of the MIHC. For a demutualization or formation of an MIHC that occurred on or before December 31, 2000, this SOP, with the exception of paragraph .18, should be applied retroactively through restatement or reclassification, as appropriate, of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. A stock insurance enterprise that has elected to adopt SOP 95-1 [section 10,650] and did not convert from a mutual life insurance enterprise should apply the provisions of paragraph .17 of this SOP retroactively through restatement of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. Paragraph .18 of this SOP is effective upon issuance with restatement required for those expenses presented in financial statements for any period presented for comparative purposes. Early adoption of this SOP is encouraged.

.27 The beginning balance of retained earnings and, if necessary, any other components of stockholders' equity for the earliest year presented, should be adjusted for the effect of restatement or reclassification as of the earliest year restated or reclassified. In the year this SOP is first applied, the financial statements should disclose the effect on income before extraordinary items, net income, and related per share amounts for each year restated. If the actuarial calculation is prepared as of the beginning of the year of adoption of this SOP, its implementation will not result in restatement to recognize a policyholder dividend obligation. Pro forma information for years prior to a demutualization or formation of an MIHC is not required.

The provisions of this Statement need not be applied to immaterial items.

Basis for Conclusions

.28 This section discusses considerations that were deemed significant by AcSEC members in reaching the conclusions in this SOP. In April 2000, AcSEC issued for public comment an exposure draft of a proposed SOP, *Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts*. During the sixty-day comment period, twelve comment letters were received by AcSEC.

Financial Statement Presentation of the Closed Block

.29 In demutualizations to date, practice has been to aggregate closed block assets and liabilities into two single-line captions (one for assets and one for liabilities), which is similar to the presentation of separate account (as defined in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*) assets and liabilities. In addition, practice has been to present the closed block pretax results of operations on one line in the statement of operations as "contribution from the closed block." AcSEC concluded that that presentation was not the most meaningful for obtaining an understanding of the overall operations of an insurance enterprise.

.30 The only products of an insurance enterprise that are displayed on a single-line segregated basis on the balance sheet are those included in separate accounts. AcSEC believes that the closed block is not analogous to pure-pass-through separate account arrangements that are displayed on a single-line basis. One significant difference between a closed block and a separate account is that separate account arrangements transfer substantially all investment risk to the policyholder, whereas closed block policies usually provide minimum guaranteed returns in accordance with contractual provisions that are not altered by establishment of the dividend protection mechanism. Another significant difference is that the insurance enterprise directs investment options for policies in the closed block, whereas the policyholder, not the insurance company (sponsor), of the pure-pass-through separate account directs the allocation of the assets among various investment options. In addition, the rights of a separate account contractholder and a closed block policyholder differ as to their priority interest in the dedicated assets in the event of insolvency. Whereas separate account assets are often isolated from the general claims of creditors of the insurance enterprise, including other nonseparate account policyholders, closed block assets are not isolated in the event of insolvency.

.31 AcSEC believes that management's funding strategy may influence the level of perceived profitability of the closed block if a segregated presentation is used. That may occur because the insurance enterprise selects assets used in funding the closed block, and selection of the assets in part determines the level and timing of earnings that will emerge with respect to the closed block. Therefore, a single-line presentation is less meaningful and may be misinterpreted.

.32 AcSEC also believes an integrated presentation of the closed block is consistent with the presentation of other contractual arrangements involving dedicated assets. AcSEC believes that a closed block may be analogous in some respects to certain participating group pension contracts that provide for assets that specifically support obligations to the pension contractholders, as well as payment of policyholder dividends. It is accepted practice to classify assets, liabilities, revenues, and expenses for those contracts among the various financial statement accounts.

.33 AcSEC believes there is no substantial economic difference between dividend protection mechanisms that operate through formal identification of assets for inclusion in a closed block and those that do not provide for the formal designation. In either case, the dividend protection mechanism may be most similar to arrangements in which the income that may inure to stockholders of the stock insurance enterprise is limited as described in FASB Statement No. 60, paragraph 42. Policy liabilities for contracts under those arrangements, the assets that support them, and the policyholders' share of the results of operations are commingled among the appropriate accounts of the enterprise, with profits that do not inure to the benefit of stockholders recognized as a liability.

.34 Because cash flows of assets of the insurance enterprise other than those of the closed block may be used to support the operation of the closed block, AcSEC believes that a single line presentation of only those assets actually designated to the closed block may be misinterpreted. AcSEC further believes that the benefits of integrated financial statement presentation outweigh the benefit of isolating assets whose cash flows cannot, by contract or regulation, inure to the benefit of stockholders, a restriction that can be readily disclosed in a note similar to the disclosure of other restricted assets.

Accounting for Predemutualization Participating Contracts After the Demutualization Date or Formation of an MIHC and for Stock Insurance Enterprises That Have Adopted SOP 95-1 [section 10,650]

.35 Currently the following three situations exist for demutualized insurance enterprises:

a. Former mutual life insurance enterprises that converted before the effective date of FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, and, as stock insurance companies at the effective date of that Statement, could elect to apply the provisions of SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises* [section 10,650], to participating policies that meet SOP 95-1 [section 10,650]'s requirements but did not do so

b. Mutual or stock life insurance enterprises that have published GAAP financial statements and have applied SOP 95-1 [section 10,650] to those participating contracts that meet SOP 95-1 [section 10,650]'s conditions

c. Mutual life insurance enterprises that have not published GAAP financial statements and, therefore, have not yet applied SOP 95-1 [section 10,650]

.36 AcSEC concluded that insurance enterprises described in the first situation outlined in paragraph .35 of this SOP that have not elected to adopt SOP 95-1 [section 10,650] should remain grandfathered because of the provisions of FASB Statement No. 120. For insurance enterprises that fall into the second and third situations in paragraph .35 of this SOP, SOP 95-1 [section 10,650] should be used for the qualifying participating policies both before and after demutualization or formation of an MIHC. AcSEC believes that SOP 95-1 [section 10,650] is the appropriate accounting guidance for participating policies that meet its requirements and, accordingly, that the insurance enterprises in the second and third situations should apply, or continue to apply, the provisions of SOP 95-1 [section 10,650] after the effective date of demutualization or formation of an MIHC.

.37 Paragraph 32 of FASB Statement No. 120 states that "the Board believes, however, that there are likely to be only a limited number of stock life insurance enterprises with material amounts of those [participating life insurance] contracts and decided not to require those enterprises to comply with the SOP [for those participating life insurance contracts]." Therefore, it was not the FASB's intention to have life insurance companies with significant amounts of participating contracts that meet the conditions of SOP 95-1 [section 10,650] apply FASB Statement No. 60 in its entirety to those contracts.

.38 Paragraphs 32 and 34 of FASB Statement No. 120 discuss the FASB's decision to permit rather than require stock life insurance enterprises to apply SOP 95-1 [section 10,650] to certain participating contracts as follows:

> 32. The Board recognizes that the information provided to users about the insurance and reinsurance activities of life insurance enterprises could be improved by limiting the diversity among insurance enterprises in accounting and reporting for those activities. The Board acknowledges that permitting stock life insurance enterprises with participating life insurance contracts that meet the conditions in paragraph 5 of this Statement to apply the accounting in the SOP to those contracts may cause inconsistencies between insurance enterprises in their accounting for those contracts. The Board believes, however, that there are likely to be only a limited number of stock life insurance enterprises with material amounts of those contracts and decided not to require those enterprises to comply with the SOP. . . .
>
> 34. . . . The Board also believes that a decision to require stock life insurance enterprises to apply the SOP's accounting to those contracts would necessitate adding the accounting conclusions in the SOP to this Statement thereby requiring time-consuming deliberations. The Board decided not to require stock life insurance enterprises to apply the provisions of the SOP because the overall benefits of providing timely guidance on the accounting and reporting of insurance activities by mutual life insurance enterprises outweigh the incremental improvement in the consistency and comparability of financial reporting among insurance enterprises that would result from requiring stock life insurance enterprises to apply the SOP's accounting. . . .

.39 AcSEC concluded that the most appropriate accounting for policies of a demutualized insurance enterprise that meet SOP 95-1 [section 10,650]'s scope requirements would be continued application of SOP 95-1 [section 10,650]'s provisions, except that the insurance enterprise should recognize an obligation for future policyholder dividends based on accumulated undistributed earnings in a manner that is consistent with paragraphs 41 and 42 of FASB Statement No. 60. AcSEC believes that the provisions of FASB Statement No. 120 and SOP 95-1 [section 10,650] that do not appear to support recognition of such an obligation were intended for mutual life insurance enterprises. Upon conversion to a stock life insurance enterprise, the provisions of paragraphs 41 and 42 of FASB Statement No. 60 are more appropriate to the new stock organization and should be applied to all participating contracts. In paragraph 42 of SOP 95-1 [section 10,650.42], AcSEC acknowledged that segregating undistributed accumulated earnings on participating contracts in a manner similar to minority interest may be meaningful in a stock life company because the objective of that presentation is to identify amounts that are not distributable to stockholders. AcSEC concluded that it would be appropriate to follow accounting guidance based on the nature of the contract, and whether the insurance company is a mutual or stock company is significant to the relevance of segregating undistributed accumulated earnings on participating policies. AcSEC believes, however, that the restriction on the stock insurance enterprise's ability to pay certain amounts of undistributed accumulated earnings to the stockholders should be shown as a liability to the policyholders, as discussed below.

Conflict in the Literature on Accounting for Dividends of Participating Contracts

.40 Existing GAAP literature distinguishes whether an obligation for future dividends based on accumulated earnings should be recorded for participating policies primarily based on the form of the issuing insurance enterprise, and there is conflicting guidance for insurance enterprises that convert from mutual to stock form. FASB Statement No. 60 requires an insurance enterprise to recognize a liability for future dividends of earnings attributable to a participating contract that cannot be distributed to stockholders; however, SOP 95-1, paragraph 42 [section 10,650.42], does not appear to support the recognition of a liability. Thus, AcSEC had to determine the circumstances in which recognition of a liability is appropriate in accounting for the participating policies that have been and will continue to be accounted for under SOP 95-1 [section 10,650] after designation into a closed block.

.41 FASB Statement No. 120 states that participating contracts of mutual life insurance enterprises should be accounted for in accordance with FASB Statement Nos. 60 and 97, as appropriate, unless those contracts meet the conditions in paragraph 5 of FASB Statement No. 120. The conditions in that paragraph are the same as the conditions for a participating contract to be within the scope of SOP 95-1 [section 10,650].

.42 SOP 95-1, paragraph 10 [section 10,650.10], states in part that "FASB Statement No. 60 addresses accounting for traditional forms of participating contracts issued, but does not address the participating contracts issued by mutual life insurance enterprises. . . ." SOP 95-1 [section 10,650] also discusses the differences between the participating contracts considered within FASB Statement No. 60 and those considered in SOP 95-1 [section 10,650] as follows:

> 30. AcSEC concluded that separate consideration of the participating life insurance contracts covered by [SOP 95-1] is justified by the differences between those contracts and both traditional nonparticipating life insurance contracts, covered by FASB Statement No. 60, and universal life-type contracts, covered by FASB Statement No. 97. Participating life insurance contracts covered under [SOP 95-1] have attributes of the contracts covered by FASB Statement Nos. 60 and 97. AcSEC concluded, therefore, that contracts covered by [SOP 95-1] were not sufficiently similar to those covered by either FASB Statement to warrant applying either of them in its entirety.

.43 Paragraph 32 of SOP 95-1 [section 10,650.32] states the following:

> Despite those similarities in form to FASB Statement No. 60 contracts, the dividend feature introduces a variable that affects the substance of the earnings flow to the company. The dividend feature causes the contracts covered by [SOP 95-1] to more closely resemble contracts in which the earnings emerge in relation to margins rather than contracts in which earnings emerge proportional to the level of premiums received in that year. Participating policies covered by [SOP 95-1] share in the results of investment activity, mortality experience, and contract administration costs through dividends, which are not fixed or guaranteed by contract terms. As a result, earnings on those products, after annual policyholder dividends, tend to emerge as the margin recognized on investments, mortality, and expenses.

.44 FASB Statement No. 60 states the following in discussing the accounting for policyholder dividends:

> 41. Policyholder dividends shall be accrued using an estimate of the amount to be paid.

> 42. If limitations exist on the amount of net income from participating insurance contracts of life insurance enterprises that may be distributed to stockholders, the policyholders' share of net income on those contracts that cannot be distributed to stockholders shall be excluded from stockholders' equity by a charge to operations and a credit to a liability relating to participating policy holders' funds in a manner similar to the accounting for net income applicable to minority interests. Dividends declared or paid to participating policyholders

shall reduce that liability; dividends declared or paid in excess of the liability shall be charged to operations. Income-based dividend provisions shall be based on net income that includes adjustments between general-purpose and **statutory** financial statements that will reverse and enter into future calculations of the dividend provision.

43. For life insurance enterprises for which there are no net income restrictions and that use life insurance dividend scales unrelated to actual net income, policyholder dividends (based on dividends anticipated or intended in determining gross premiums or as shown in published dividend illustrations at the date insurance contracts are made) shall be accrued over the premium-paying periods of the contracts.

.45 AcSEC believes that SOP 95-1 [section 10,650] is the more appropriate guidance in accounting for participating policies whose provisions meet the criteria of that SOP, whether those policies are issued by a mutual insurance enterprise or were issued by a mutual that converts to a stock insurance company. However, AcSEC believes that the demutualization process changes the nature of the relationship between the enterprise and its policyholders. Therefore, continued application of paragraph 42 of SOP 95-1 [section 10,650.42] in its entirety is not warranted. AcSEC views the new relationship of the closed block policyholders and the insurance enterprise's stockholders as more similar to the relationship that would exist in the situation described in paragraphs 41 and 42 of FASB Statement No. 60 rather than to the relationship that would exist in the situation contemplated in paragraphs 41 and 42 of SOP 95-1 [section 10,650.41 and .42]. Accordingly, AcSEC believes that the application of the dividend concepts described in paragraph 42 of FASB Statement No. 60 is more appropriate for the participating policies of a demutualized insurance enterprise, whether those policies are issued before or after demutualization.

Emergence of Earnings

.46 The process of demutualization or formation of an MIHC does not, in and of itself, change the basis of accounting, other than recognition of a policyholder dividend obligation as discussed in paragraphs .15 and .16 of this SOP; the accounting methods used to measure assets, liabilities, revenues, and expenses remain unchanged. Amortization of **deferred acquisition costs** (DAC) will continue to consider all components of estimated gross margins attributable to the policies, whether the components reside inside or outside the closed block.

.47 At the actuarial calculation date, a calculation is developed based on the cash flows expected to be generated from the assets and policy contracts included in the closed block. Based on that calculation, the expected periodic changes in the net closed block liability should be derived (the actuarial calculation). As actual experience emerges, that experience is likely to differ from that expected in the actuarial calculation. Because all the cash flows of the closed block assets and policy contracts will inure to the closed block policyholders pursuant to the plan of demutualization, AcSEC believes that cumulative net favorable experience compared to that contemplated at the actuarial calculation date represents an obligation to closed block policyholders. Such favorable experience will ultimately be paid to closed block policyholders in the form of dividends, unless otherwise offset by future performance of the closed block that is less favorable than originally expected.

.48 The concept of establishing a liability for participating insurance contracts where profit limitations exist, and of recording a liability for policyholder dividends on those policies using an estimate of the amount to be paid, is contemplated by paragraphs 41 and 42 of FASB Statement No. 60 and paragraph 77 of FASB Statement No. 97. Paragraph 77 of FASB Statement No. 97 states the following, in part:

> The Board acknowledges that some contracts with policyholders may entitle policyholders to an amount equal to a portion of specific investment performance. The recording of liabilities to reflect amounts to which those policyholders are entitled is appropriate, but the deferral of realized gains and losses is not justified.

.49 In paragraph 42 of SOP 95-1 [section 10,650.42], AcSEC stated that it is not appropriate or meaningful to segregate undistributed accumulated earnings on participating contracts in the context of a mutual insurance enterprise. However, AcSEC acknowledged in that same paragraph the relevance of such accounting treatment for a stock life insurance company, as follows:

> Annual policyholder dividends of participating contracts covered by this SOP are based on actual company performance. Accordingly, AcSEC believes dividends on participating contracts covered by this SOP are not similar to either of the types of dividends discussed in FASB Statement No. 60. While AcSEC acknowledges that segregating undistributed accumulated earnings on participating contracts in a manner similar to minority interests may be meaningful in a stock life insurance company, it is not meaningful for a mutual life insurance enterprise, because the objective of such presentation is to identify amounts that are not distributable to stockholders.

.50 Based on the above guidance, AcSEC believes that the provisions of FASB Statement No. 120 and SOP 95-1 [section 10,650] do not recognize the segregation of accumulated earnings on participating contracts for mutual life insurance companies. However, AcSEC believes a mutual life insurance enterprise, upon conversion to a stock life insurance company, should continue to apply SOP 95-1 [section 10,650] modified by the provisions of paragraphs 41 and 42 of FASB Statement No. 60 in accounting for SOP 95-1 [section 10,650] contracts. In essence, the conversion from a mutual life insurance enterprise to a stock life insurance enterprise creates an additional measurement requirement for accumulated undistributed earnings because of the newly established stockholder constituency. The establishment of a policyholder dividend obligation recognizes that a portion of earnings in certain cases will not inure to the stockholders of the insurance company.

.51 Several respondents to the exposure draft of the SOP expressed a view that realization of cumulative closed block earnings in excess of the amount indicated by the actuarial calculation, in and of itself, is insufficient to require recognition of a policyholder dividend obligation and believed that the continued application of SOP 95-1 [section 10,650], without modification, was sufficient to measure the emergence of earnings of the closed block. Those respondents acknowledge that earnings in excess of the amount indicated by the actuarial calculation would be reasonably expected to be returned to policyholders through adjustment of dividend scales, but believe that the obligating event required for accounting recognition takes place upon the actual adjustment of the dividend scales rather than at the earlier date at which the earnings are measured. Those respondents believe that the regulatory supervision of the activity of the closed block results in timely adjustments of the dividend scales, and the recordkeeping requirements necessary for the establishment of a policyholder dividend obligation do not meet a cost/benefit test. Although the actual adjustment of the dividend scales is a necessary condition for identification of the recipients of the amounts to be distributed, AcSEC does not believe that such identification is a necessary prerequisite for accounting recognition under the guidance of FASB Statement of Accounting Concepts No. 6, *Elements of Financial Statements*. Paragraph 36 of FASB Concepts Statement No. 6 states the following, in part:

> Liabilities commonly have other features that help identify them—for example, most liabilities require the obligated entity to pay cash to one or more identified other entities and are legally enforceable. However, those features are not essential characteristics of liabilities. . . . That is, liabilities may not require an entity to pay cash but to convey other assets, to provide or stand ready to provide services, or to use assets. And the identity of the recipient need not be known to the obligated entity before the time of settlement.

.52 AcSEC believes that given the regulatory supervision of operations of a closed block, the insurance enterprise has only limited discretion as to the timing of its adjustment of dividend scales under the circumstances where this SOP requires recognition of a policyholder dividend obligation but cannot adjust those dividend scales contemporaneously. AcSEC also believes that, at a given point, assets in excess of the amounts contemplated at the actuarial calculation date represent undistributed accumulated earnings that ultimately will be distributed to policyholders under the terms of the closed block agreements unless offset by future experience less favorable than that indicated by the actuarial calculation. Those incremental assets, therefore, will not become available for distribution to stockholders. Accordingly, AcSEC believes that the usefulness of financial statements may be compromised if the obligation is not recognized until the actual adjustment of dividend scales takes place.

.53 Several respondents to the exposure draft of the SOP expressed a belief that recognition of a policyholder dividend obligation under the circumstances when it would be required under the guidance herein would result in a pattern of income recognition based on a predetermined actuarial calculation and therefore would not be appropriately responsive to changes in experience of the closed block. However, AcSEC believes that in the absence of a policyholder dividend obligation for participating policies in the closed block if there are closed block cumulative earnings in excess of the amount indicated by the actuarial calculation, earnings and net assets reported to stockholders will fail to recognize the obligation of the insurance company to distribute excess returns from the designated assets to the closed block policyholders in future periods. The recognition of favorable experience deviations that will not inure to stockholders as earnings would result in reduced earnings when the results of that experience are ultimately distributed by means of increased dividends to closed block policyholders. As a consequence, the integrity and usefulness of financial statements during periods if there are cumulative earnings in excess of the amount indicated by the actuarial calculation may be compromised by reporting amounts as earnings of stockholders that those stockholders cannot ultimately realize.

.54 AcSEC also considered whether it would be appropriate to recognize a negative balance in the policyholder obligation account in the event of the following:

a. There is cumulative experience of the closed block less favorable than anticipated in the actuarial calculation.

b. The insurance company expects to reduce future dividends or anticipates future favorable performance of the closed block.

Net unfavorable deviations may result in reduced dividends to closed block policyholders, unless offset by future favorable experience of the closed block or subsidized by the insurance company using assets outside of the closed block. Although some, including several respondents to the exposure draft of the proposed SOP, believe that a policyholder dividend receivable is a consistent extension of the policyholder dividend obligation concept and it could be potentially recoverable based on future dividend adjustments, AcSEC believes that recognition of a negative balance as an asset is not supported by paragraph 42 of FASB Statement No. 60. Due to competitive pressures and other considerations, the board of directors of an insurance enterprise may choose not to reduce dividends to closed block policyholders. If an insurance enterprise has favorable experience it is compelled to pass it along to the closed block policyholders. If the insurance enterprise has unfavorable experience, the insurance enterprise has the ability to pass it on but may be constrained by the marketplace in its ability to do so.

Determination of the Policyholder Dividend Obligation

.55 AcSEC determined that cumulative net favorable experience of the closed block in relation to expectations indicated by the actuarial calculation that will be paid to policyholders, unless otherwise offset by future performance of the closed block that is less favorable than expected in the actuarial calculation, should not be reflected in earnings of stockholders for the reasons previously discussed in the "Emergence of Earnings" section.

.56 Therefore, in the absence of unusual circumstances, the maximum earnings from closed block assets and liabilities that will inure to stockholders is the amount of closed block liabilities in excess of the closed block assets, adjusted for the related items in accumulated other comprehensive income at the actuarial calculation date. Further, AcSEC believes that experience gains and losses of the closed block ultimately may result in an adjustment of dividends or other variable policy benefits paid to policyholders. Therefore, the actuarial calculation provides the expected earnings to be used by the insurance enterprise to measure net positive experience that should not be reflected in the earnings of stockholders.

.57 This SOP requires the portion of the unrealized investment gains and losses that have arisen after the actuarial calculation date to be included in the determination of the amount of the policyholder dividend obligation. AcSEC determined that it was necessary to separate the portion of unrealized investment gains and losses that are attributable to the policyholders and not the stockholders; such amounts should be displayed fully and not netted in the presentation of other comprehensive income, as appropriate. In reaching that conclusion, AcSEC considered the guidance in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, to determine the treatment of unrealized and realized gains and losses of closed block assets. Under FASB Statement No. 115, assets classified as available-for-sale are reported at fair value with unrealized gains and losses excluded from earnings and reported in other comprehensive income. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 130.]

.58 AcSEC considered whether the actuarial calculation should be revised after the actuarial calculation date for purposes of revising the measurement described above. One alternative considered was to revise the actuarial calculation at each financial reporting date. Under that approach, the measurement of excess experience gains would be based on the current estimate (giving effect to past events and current expectations for future events) of the timing of maximum closed block earnings inuring to stockholders. AcSEC believes that the principal assumptions other than investment performance affecting the timing of stockholder earnings from the closed block over the long-term would be persistency and mortality. Persistency and mortality affect the assumed amount of life insurance **in force** and the life of the block of business, which are key factors in the recognition of stockholder earnings. Cash flow effects of differences between assumptions and actual should result in revised dividends or policy benefits to policyholders. AcSEC rejected frequent revisions of the actuarial calculation because short-term movements in persistency and mortality for a block of business with a life of up to 100 years should not have a significant effect on the timing of recognizing earnings that will ultimately be realized by stockholders. AcSEC believes that the "lock in" alternative is most appropriate because the actuarial calculation is developed solely to measure the performance of the closed block in relation to a maximum amount of earnings that will inure to stockholders. Negative performance in relation to the actuarial calculation is recognized currently, and positive performance is recognized as a policyholder dividend obligation. AcSEC also believes periodic loss-recognition tests would identify situations in which significant negative experience should result in the recognition of additional losses to stockholders. Further, AcSEC believes the purpose of the actuarial calculation is to serve as an approach to measure aggregate favorable experience that will not inure to stockholders and may not achieve the intended objective if the actuarial calculation is revised.

.59 AcSEC also considered whether the actuarial calculation should be revised upon (*a*) the occurrence of a significant unanticipated event, (*b*) the determination that there has been a significant change in the assumptions for persistency or mortality, or (*c*) the designation of significant additional assets for the closed block that would not revert to the stockholders. AcSEC rejected that approach because the actuarial calculation is a measure of the maximum amount of earnings that would be recognized over the life of the block of business. Actual results of the closed block will flow into stockholder income unless cumulative earnings to date are in excess of the maximum that can be recognized based on the actuarial calculation. Therefore, positive performance of the closed block in relation to the actuarial calculation results in a policyholder dividend obligation, and negative performance results in either reduced dividends to closed block participating policyholders or lower earnings than anticipated at the actuarial calculation date. Cumulative negative performance of the closed block represents an amount included in the excess of closed block liabilities over closed block assets that may have to be funded with assets outside the closed block unless offset by future positive performance of the closed block or reduced policyholder dividends. It is believed that a designation of additional assets for the closed block business would result from historical negative performance of the closed block. This negative performance would have been recognized in income as it occurred because negative performance in relation to the actuarial calculation does not result in recognition of an asset.

Accounting for Participating Policies Sold After the Date of Demutualization or the Formation of an MIHC

.60 AcSEC considered whether a demutualized insurance enterprise should apply FASB Statement No. 60 or SOP 95-1 [section 10,650] to participating policies sold after the date of demutualization or the formation of an MIHC. AcSEC concluded that a demutualized insurance enterprise should continue to apply SOP 95-1 [section 10,650] to participating policies that meet the scope requirements of SOP 95-1 [section 10,650]. If the scope requirements of SOP 95-1 [section 10,650] are not met, FASB Statement Nos. 60 or 97 should be applied. In the application of SOP 95-1 [section 10,650], the stock insurance enterprise should recognize an obligation for future policyholder dividends based on accumulated undistributed earnings in a manner that is consistent with paragraphs 41 and 42 of FASB Statement No. 60. (See paragraph .39 of this SOP for the basis for establishing an obligation for future policyholder dividends for SOP 95-1 [section 10,650] policies.)

Accounting for Demutualization and MIHC Expenses

.61 Paragraph 20 of Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, provides the two criteria that must be met for an event or transaction to be classified as an extraordinary item as stated in part below:

> Extraordinary items are events and transactions that are distinguished by their unusual nature and by the infrequency of their occurrence. Thus, both of the following criteria should be met to classify an event or transaction as an extraordinary item:
>
> *a.* Unusual nature—The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.
>
> *b.* Infrequency of occurrence—The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

.62 Demutualizations and formations of MIHCs are changes in legal forms of organizations. Several respondents to the exposure draft of the proposed SOP said that demutualizations and formations of MIHCs satisfy the above criteria and that the associated costs should therefore be classified as an extraordinary item. However, AcSEC believes that the events represent consequences of customary and continuing activities in efforts to remain competitive in the financial services industry. AcSEC believes that such events do not possess a sufficient degree of abnormality required by paragraph 20(a) of APB Opinion 30. AcSEC recognizes that the prior practice in demutualizations to date has been to classify such costs as extraordinary. However, AcSEC considered the environment in which the insurance industry operates and the nature of the activities of the individual mutual insurance enterprises which have continued to evolve in recent years. AcSEC believes a demutualization has characteristics similar to other forms of corporate reorganizations and restructurings in which costs do not meet the criteria for extraordinary treatment. Because one of the criteria of paragraph 20 of APB Opinion 30 is met, the direct incremental costs associated with a demutualization or formation of an MIHC should be reported as a separate component of income from continuing operations. Further, AcSEC believes that such classification of expenses should be limited to costs that are direct and incremental to the transaction and should not include allocations of general and administrative-type costs.

Accounting for Retained Earnings and Other Comprehensive Income at the Date of Demutualization or Formation of an MIHC

.63 Stockholders' equity usually is displayed in two broad categories: contributed or paid-in capital and retained earnings. Contributed or paid-in capital represents the amount provided by stockholders or resulting from subsequent transactions with stockholders. Retained earnings represents the amount of the enterprise's previous income that has not been distributed to owners as dividends or transferred to contributed or paid-in capital.

.64 A demutualization is a change in legal form of organization "from a form of organization that has no substantive equity ownership to one that has" (FASB Technical Bulletin 85-5, *Issues Relating to Accounting for Business Combinations*, paragraph 24); thus, the distribution of shares of stock represents the distribution of the then-existing equity to the owners of the mutual insurer's equity. Several respondents to the exposure draft of the proposed SOP said that because a demutualization does not, in and of itself, result in a change of the historical carrying values of the assets and liabilities of the resulting stock insurance enterprise, the transaction also should not result in the reclassification of accumulated retained earnings as of the demutualization date. AcSEC believes, however, that it is appropriate to reflect the substance of this transaction by reclassifying accumulated retained earnings as of the demutualization date to the capital stock and additional paid-in capital accounts. Therefore, AcSEC concluded that all retained earnings after capital transactions resulting from the demutualization should be reclassified, as of the demutualization date, to capital stock and paid-in capital accounts for a distribution-form demutualization.

.65 This SOP uses the term *subscription-form demutualization* to refer to situations in which eligible policyholders receive only the right to purchase stock in the insurance enterprise or its parent at terms essentially equivalent to the terms offered to independent third parties. AcSEC believes that a subscription-form demutualization is very similar to the kinds of demutualizations that have taken place in the savings and loan industry. Consistent with practice for those kinds of transactions that has not resulted in a reclassification of retained earnings, AcSEC concluded that a subscription-form demutualization does not, by itself, result in reclassification of retained earnings because retained earnings are not being distributed.

.66 The process of demutualization or formation of an MIHC does not, by itself, change the basis of accounting, and therefore there is no change in other comprehensive income. As of the actuarial calculation date, the existing accumulated other comprehensive income may relate to items included in the closed block. At the actuarial calculation date, existing accumulated other comprehensive income items related to the closed block should be identified and segregated in the financial records of the insurance enterprise. For example, unrealized investment gains and losses reflect the present value of the difference between market interest rates and the stated interest rates of the closed block fixed income securities or unrealized appreciation or depreciation of closed block equity securities at the actuarial calculation date. As with all such assets, the future contribution to earnings that will be recognized in the financial statements associated with those assets will be based on their cost or amortized cost. Therefore, existing unrealized investment gains and losses will be part of net investment income or realized investment gains when realized. Accordingly, the actuarial calculation of the earnings of the closed block should be determined on the basis of cost or amortized cost of the invested assets at the actuarial calculation date.

Accounting for the Dividends From a Stock Insurance Subsidiary to an MIHC

.67 Subsequent to the formation of an MIHC and conversion of the mutual insurer to a stock insurance company, the stock insurer's board of directors would be expected to declare and pay cash dividends to its stockholders as deemed appropriate in view of the insurer's operating results and capital needs. The National Association of Insurance Commissioners' whitepaper titled *Mutual Insurance Holding Company Reorganizations* indicates that states should "prohibit the MIHC from waiving dividends payable by its stock subsidiaries to ensure that dividend earnings are received by the MIHC and are therefore available to benefit its members." For example, Iowa law protects member interests in earnings distributions by assuring that the class of stock held by the MIHC has dividend and other rights no less favorable than any other class of stock. A dividend declared by a stock insurer (or its holding company, or both) payable to its stockholders is a standard corporate capital transaction and should be accounted for accordingly.

Accounting for a Distribution From an MIHC to Its Members

.68 Dividends or other distributions may be made to the MIHC by the insurer or intermediate holding company. At some point, it is possible the MIHC board of directors, with the concurrence of the insurance regulator, may conclude that it is appropriate to distribute some portion of the MIHC's accumulated funds to or on behalf of the members. The form of this distribution could be cash directly to the members or it could be in the form of policy credits, additional policy benefits, or both, purchased by the MIHC from the subsidiary insurance company.

.69 Membership interests are not securities under the federal securities laws; the Uniform Commercial Code defines a security as an "obligation of an issuer or a share, participation or other interest in an issuer or in property or an enterprise of an issuer . . . and which by its terms is divisible into a class or series of shares, participations, interests or obligations. . . ." There is an argument that because membership interests are not securities and have not been unitized, members do not have "equity" interests. It is conceptually difficult to argue that a distribution is a capital transaction when the recipient does not have an equity interest. One might compare a member distribution with a patronage refund made by a cooperative, which is a distribution of allocated member-sourced earnings to members and is recorded as a capital transaction. However, the same analogy could be made for policyholder dividends, which are accounted for as expenses.

.70 Some respondents to the exposure draft of the proposed SOP requested that AcSEC not provide guidance on MIHC distributions until the related legal and tax issues have been more thoroughly examined. However, AcSEC believes it is appropriate to provide conceptual guidance related to MIHC distributions, which it believes should be applied to those transactions so that they will be accounted for in accordance with their economic substance. Because of the ongoing dual relationship of MIHC members as policyholders of the insurance subsidiary, the distributions from the MIHC to its members, whether made directly or through the purchase of contract benefits from its insurance subsidiary, should be accounted for at fair value based on an evaluation of the specific facts and circumstances. AcSEC believes that the threshold criteria that need to be present to constitute a capital transaction are the following:

a. The existence of substantive independent third-party stockholders in the stock life insurance subsidiary or intermediate holding company

b. An equivalence in the dividend from the MIHC to its members relative to the dividends from the stock life subsidiary or intermediate holding company

Until there are substantive independent third-party stockholders, a distribution should not be accounted for as a capital transaction.

.71 MIHC distributions accounted for as dividends would have no impact on the insurance company's or intermediate holding company's net income, except to the extent the MIHC purchased policy credits and benefits from the insurance company. If the purchase of policy credits and benefits were on the same terms as available to third parties (considering the impact of lower or nonexistent acquisition costs), the insurance company would account for the policy credits and benefits in the same manner as for third-party transactions.

.72 MIHC distributions accounted for as policyholder dividends would result in the insurance company reflecting a policyholder benefit expense for the amount of the dividend distribution and a capital contribution from the MIHC in an equal amount. The MIHC would reflect the amount of the distribution as a capital contribution to the insurance subsidiary.

Disclosures

.73 If the financial statements of the reporting entity include disclosures for assets, liabilities, revenues, and expenses that are attributed to the closed block in whole or in part, a determination shall be made about whether disclosures of similar data for the closed block elements alone would be similar, in all material respects, to that related to the financial statements of the reporting entity. For example, depending on the debt securities included in the closed block, the contractual maturity information disclosed as of the date of the most recent statement of financial position presented as required by FASB Statement No. 115, paragraph 20, may be materially consistent for closed block assets to that presented for the reporting entity. For any such items where disclosure related to the closed block item would not be consistent, in all material respects, to that presented for the reporting entity, disclosure for the particular closed block items should be presented separately.

.74 Several respondents to the exposure draft of the proposed SOP suggested that the disclosures, as illustrated in appendix A [paragraph .78], are more extensive than necessary. AcSEC's intention was to provide an illustrative reference for auditors and preparers of financial statements to become familiar with the mechanics of the numbers involved in typical disclosures. The level of detail in appendix A [paragraph .78] is not required but is intended to be illustrative.

Effective Date and Transition

.75 AcSEC acknowledged the practical concerns, identified by a number of respondents to the exposure draft of the proposed SOP, associated with implementation of the transition provisions proposed in the exposure draft that would have required restatement of all earlier financial statements presented by insurance enterprises that had demutualized or formed an MIHC prior to the issuance of this SOP. AcSEC believes that companies should prepare the actuarial calculation as of the date of demutualization or formation of an MIHC. In rare circumstances, it may not be practicable to prepare the actuarial calculation as of such date because an enterprise demutualized many years prior to January 1, 2001, and the information needed to prepare the calculation as of such date is not available or to do so would be a time-consuming and expensive process; under those circumstances the calculation may be prepared as of the beginning of the year of adoption of this SOP.

.76 In those rare circumstances when it is not practicable, for insurance enterprises that demutualized or formed an MIHC prior to January 1, 2001, to prepare the actuarial calculation as of the date of demutualization or formation of an MIHC as described above, the actuarial calculation described in paragraph .16 is prepared as of the beginning of the year of adoption of this SOP. In those circumstances, the SOP's implementation will not result in restatement to recognize a policyholder dividend obligation and there will not be a cumulative effect resulting from the implementation of this SOP.

.77 AcSEC concluded that for a demutualization or formation of an MIHC that occurs after December 31, 2000, this SOP should be effective on the date of the demutualization or formation of the MIHC. AcSEC also considered the financial reporting for demutualizations or formations of an MIHC that occurred on or before December 31, 2000. For those transactions, AcSEC believes that improved reporting is needed as soon as practicable, and that the benefits of comparability outweigh the costs and efforts of restatement of earlier periods presented. Accordingly, AcSEC concluded that financial statements of earlier periods presented should be restated to conform to the SOP's provisions. However, AcSEC notes that certain entities may not have readily available information to comply with the provisions of paragraphs .16 and .17 of this SOP for prior periods, and that entities that are engaged in the transactions covered by this SOP may require modifications to their systems and procedures to conform with the provisions of this SOP. To allow adequate time for implementation, an entity that demutualized or formed an MIHC on or before December 31, 2000, should apply this SOP, with the exception of paragraph .18, retroactively through restatement or reclassification, as appropriate, of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. AcSEC also concluded that a stock insurance enterprise that has elected to adopt SOP 95-1 [section 10,650] and did not convert from a mutual life insurance enterprise should apply the provisions of paragraphs 41 and 42 of FASB Statement No. 60 retroactively through restatement of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. However, the provision of paragraph .18 of this SOP, to report expenses associated with a demutualization or formation of an MIHC as a single line item within income from continuing operations is effective upon issuance of this SOP. Accordingly, presentation of those expenses presented in financial statements for any period presented for comparative purposes should be restated, if necessary.

.78

Appendix A

Illustrative Guidance—Footnote Disclosure for the Closed Block

A.1. This Appendix provides specific examples that illustrate the disclosures that this Statement of Position (SOP) requires and depicts the application of certain principles of this SOP. The formats and level of detail, including the shaded areas, in the illustrations are not requirements. The Accounting Standards Executive Committee (AcSEC) encourages a format that provides the information in the most understandable manner in the specific circumstances. Entities are not required to display the disclosure information contained herein in the specific manner illustrated. Alternative ways of disclosing the information are permissible as long as the disclosure requirements of this SOP, as described in paragraphs .24 and .25, are met. The following illustrations are for a single hypothetical insurance enterprise, referred to as ABC Life Insurance Company.

Example Footnote Disclosures for the Closed Block

X. Policy Footnote (in Part) Related to the Demutualization

At the effective date (January XX, 20X1) of the Plan of Demutualization, eligible policyholders received, in the aggregate, approximately $XX million of cash, $XX million of policy credits, and XX million shares of common stock of ABC Holding Company in exchange for their membership interests in ABC Life Insurance Company. The demutualization was accounted for as a reorganization. Accordingly, ABC Life Insurance Company's retained earnings at the Plan Effective Date (net of the aforementioned cash payments and policy credits, which were charged directly to retained earnings) were reclassified to common stock and capital in excess of par.

Z. Closed Block

As of January XX, 20X1, ABC Life Insurance Company established a closed block for the benefit of certain classes of individual participating policies for which ABC Life Insurance Company had a dividend scale payable in 20X0 and that were in force on January XX, 20X1. Assets were allocated to the closed block in an amount that, together with anticipated revenues from policies included in the closed block, was reasonably expected to be sufficient to support such business, including provision for payment of benefits, certain expenses, and taxes, and for continuation of dividend scales payable in 20X0, assuming experience underlying such scales continues. Assets allocated to the closed block inure solely to the benefit of the holders of the policies included in the closed block and will not revert to the benefit of stockholders of ABC Life Insurance Company. No reallocation, transfer, borrowing, or lending of assets can be made between the closed block and other portions of ABC Life Insurance Company's general account, any of its separate accounts, or any affiliate of ABC Life Insurance Company without the approval of the Z State Insurance Department.

If, over time, the aggregate performance of the closed block assets and policies is better than was assumed in funding the closed block, dividends to policyholders will be increased. If, over time, the aggregate performance of the closed block assets and policies is less favorable than was assumed in the funding, dividends to policyholders could be reduced.

The assets and liabilities allocated to the closed block are recorded in ABC Life Insurance Company's financial statements on the same basis as other similar assets and liabilities. The carrying amount of closed block liabilities in excess of the carrying amount of closed block assets at the date of demutualization (adjusted to eliminate the impact of related amounts in accumulated other comprehensive income) represents the maximum future earnings from the assets and liabilities designated to the closed block that can be recognized in income over the period the policies in the closed block remain in force. ABC Life Insurance Company has developed an actuarial calculation of the timing of such maximum future stockholder earnings, and this is the basis of the policyholder dividend obligation.

If actual cumulative earnings are greater than expected cumulative earnings, only expected earnings will be recognized in income. Actual cumulative earnings in excess of expected cumulative earnings represents undistributed accumulated earnings attributable to policyholders, which are recorded as a policyholder dividend obligation because the excess will be paid to closed block policyholders as an additional policyholder dividend unless otherwise offset by future performance of the closed block that is less favorable than originally expected. If actual cumulative performance is less favorable than expected, only actual earnings will be recognized in income.

The principal cash flow items that affect the amount of closed block assets and liabilities are premiums, net investment income, purchases and sales of investments, policyholders' benefits, policyholder dividends, premium taxes, and income taxes. The principal income and expense items excluded from the closed block are management and maintenance expenses, commissions and net investment income, and realized investment gains and losses of investment assets outside the closed block that support the closed block business, all of which enter into the determination of total gross margins of closed block polices for the purpose of the amortization of deferred acquisition costs. The amounts shown in the following tables for assets, liabilities, revenues, and expenses of the closed block are those that enter into the determination of amounts that are to be paid to policyholders.

Summarized financial information for the closed block follows (in millions):

The shaded information is intended to depict the application of the principles of this SOP, and does not represent required disclosure.

[*Table follows*.]

	December 31, 20X2	20X2 Activity*	December 31, 20X1
Closed block liabilities:			
Future policy benefits and policyholder account balances	$8903	$ (8) B	$8911
Policyholder dividends payable	88		88
Policyholder dividend obligation	163	93 E (10)C	80
Other closed block liabilities	12		12
Total closed block liabilities	9166	75	9091
Assets designated to the closed block:			
Fixed maturities:			
Held to maturity, at amortized cost (estimated fair value, 20X2, $275; 20X1, $319)	289		289
Available for sale, at estimated fair value (amortized cost, 20X2, $3,809; 20X1, $3,502)	4001	307 D 93 E	3601
Equity securities, at estimated fair value	202		202
Mortgage loans on real estate	1273	(307)D	1580
Policy loans	1766		1766
Real estate	105		105
Short-term investments	62		62
Cash and cash equivalents	119	82 A	37
Other closed block assets	76		76
Total closed block assets	7893	175	7718
Excess of reported closed block liabilities over assets designated to the closed block	1273	(100)	1373
Portion of above representing other comprehensive income			
— increase in unrealized appreciation	192	93	99
— increase in policyholder dividend obligation	(93)	(93)	
Total	99	0	99
Maximum future earnings to be recognized from closed block assets and liabilities	$1372	$(100)	$1472

* Assumed 20X2 activity for assets and liabilities (similarly identified in statement of operations as applicable):

A items are assumed settled in cash, with net impact reflected in "Cash and cash equivalents."

B and C are given effect in their respective balance sheet accounts.

D represents the assumed sale of mortgage loans at book value and reinvestment of the proceeds in available-for-sale fixed maturities.

E represents the increase in unrealized appreciation on available-for-sale securities held at both December 31, 20X1 and December 31, 20X2. It is assumed that there are no related taxes and that the available-for-sale fixed maturities sold (see above) had fair value equal to book value both at December 31, 20X1, and when sold.

It is further assumed that the unrealized appreciation at December 31, 20X1, is equal to that at the date of demutualization. Unrealized appreciation that arises since the date of demutualization is to be included in the determination of the policyholder dividend obligation.

Change in Policyholder Dividend Obligation:

	December 31, 20X2	*December 31, 20X1*
Balance at beginning of year	$ 80	$ 0
Impact on net income before income taxes	(10)	5
Unrealized investment gains (losses)	93	75
Balance at end of year	$163	$80

Change in Other Comprehensive Income:

	December 31, 20X2	*Change for 20X2*	*December 31, 20X1*
Fixed maturities available for sale:			
Fair value	$4001	$400	$3601
Amortized cost	3809	307 D	3502
Unrealized appreciation	$ 192	$ 93 E	$ 99

	20X2		*20X1*
Closed Block Operations:			
Closed block revenues:			
Premiums	$ 303	A	$ 318
Net investment income	205	A	215
Realized investment gains (losses)	(2)	A	10
Other closed block revenues	5	A	5
Total closed block revenues	511		548
Closed block benefits and expenses:			
Policyholder benefits	402	A	376
Change in policyholder benefits and interest credited to policyholder account balances	(8)	B	17
Dividends to policyholders	8	A	8
Change in policyholder dividend obligation	(10)	C	5
Other closed block expenses	10	A	10
Total closed block benefits and expenses	402		416
Closed block revenues, net of closed block benefits and expenses, before income taxes	109		132
Income taxes	9	A	10
Closed block revenues, net of closed block benefits and expenses and income taxes	$ 100		$ 122
Maximum future earnings from closed block assets and liabilities:			
Beginning of year	$1,472		$1,594
End of year	1,372		1,472
Change during the year	$ (100)		$ (122)

.79

Appendix B

Illustrations for Accounting for Closed Block Business

B.1. The accompanying schedules illustrate the accounting for closed block business (meaning those assets and liabilities both inside and outside of the closed block that relate to or support the closed block policies) after the demutualization date. The illustrations display the computations involved in (*a*) determining the amount of the policyholder dividend obligation (PDO) (*b*) deriving estimated gross margins (EGM) for purposes of amortizing deferred acquisition costs (DAC) and (*c*) revising EGM as actual experience emerges.

B.2. To simplify the example, the illustrations assume the closed block has not been funded for income taxes. In practice, the closed block may or may not be funded for income taxes. If the closed block is funded for income taxes, the actuarial calculation would be constructed on a post-tax basis. However, for the purpose of determining PDO and EGM, pretax amounts should be used. Generally, this would be accomplished by converting post-tax actuarial calculation values to corresponding pretax values for purposes of determining EGM and PDO amounts. If the closed block is funded for income taxes, a change in income tax rates would result in an experience gain or loss that would affect closed block cash flows and, therefore, estimated gross margins and amortization of deferred acquisition costs.

B.3. Schedule 1 is the illustration of the computation of estimated gross margins that appears in schedule 1 of appendix A, "Illustration of Computation of Gross Margins," of Statement of Position 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises* [section 10,650.63]. This schedule illustrates the projection of the estimated gross margins of the closed block business. The closed block business is assumed to be written in year 1, with demutualization occurring at the end of year 5.

B.4. Schedule 2 illustrates the contribution to the EGM in Schedule 1 from the closed block (meaning, those assets and liabilities actually included in the closed block). As discussed more fully in paragraph .15 of this Statement of Position, this schedule is based on the actuarial calculation for the closed block developed at the demutualization date and represents the expected changes in the net closed block liability (closed block deficit) over the life of the closed block. The data in this schedule will be compared to actual results throughout the life of the closed block to determine the need for a PDO (as illustrated in footnote X). Schedule 2 depicts an increase in interest rates in year 6 from 8.5 percent to 9.5 percent, which results in the board of directors increasing dividends in years 7 through 10. All other assumptions are held constant.

B.5. Schedule 3 illustrates the closed block business EGM contribution associated with the assets and liabilities outside of the closed block. Schedule 3 also shows the total EGM's used to amortize DAC for the closed block business. Those EGMs differ from those shown in schedule 1 based on the emergence of actual experience in year 6 and the creation of the PDO.

Schedule 1—Computation of Estimated Gross Margins*

Year	Premium	Interest on NLPR	Interest on Current Activity	Death Benefits Incurred	Surrender Benefits Incurred	Recurring Expenses Incurred	(Increase) Decrease in NLPR	Dividends Incurred	Post-dividend Gross Margins	Revised Gross Profit at Year 2
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	
1	$ 210,000	$ 0	$ 16,244	$ (9,000)	$ 0	$ (18,900)	$(126,103)	$ (18,857)	$ 53,384	$ 53,384
2	184,611	10,719	14,280	(10,549)	0	(16,615)	(109,116)	(21,399)	51,931	50,546
3	169,621	19,994	13,120	(13,731)	(7,148)	(15,266)	(93,669)	(24,230)	48,691	47,419
4	155,763	27,955	12,048	(14,835)	(14,984)	(14,019)	(79,754)	(26,574)	45,600	44,432
5	142,990	34,735	11,060	(15,661)	(21,760)	(12,869)	(67,117)	(28,509)	42,869	41,797
6	131,222	40,440	10,150	(15,622)	(17,237)	(11,810)	(73,236)	(30,043)	33,864	32,880
7	124,333	46,665	9,617	(16,578)	(20,989)	(11,190)	(66,499)	(32,301)	33,058	32,126
8	117,768	52,317	9,109	(16,824)	(24,427)	(10,599)	(60,005)	(34,367)	32,972	32,089
9	111,526	57,417	8,627	(17,526)	(27,566)	(10,037)	(53,706)	(36,230)	32,505	31,669
10	105,582	61,982	8,167	(18,603)	(30,406)	(9,502)	(47,485)	(37,915)	31,820	31,028
11–20	779,517	760,283	60,296	(311,112)	(398,831)	(70,157)	(162,077)	(424,092)	233,827	227,980
21–55	589,392	1,222,685	45,589	(1,187,632)	(686,079)	(53,041)	938,767	(669,668)	200,013	195,591
Total	$2,822,325	$2,335,192	$218,307	$(1,647,673)	$(1,249,427)	$(254,005)	$ (0)	$(1,384,185)	$840,534	$820,941
Present values at an earned rate of 8.5 percent:									$371,261	$362,945

Explanation of columns:

(*a*) Gross premiums.

(*b*) Interest, at 8.5 percent earned rate, on net level premium reserve (NLPR) at the end of the previous year. The NLPR is based on guaranteed mortality and the dividend fund interest rate.

(*c*) Interest, at the 8.5 percent earned rate, on current-year cash flow. This illustration assumes premiums are received, and all expenses incurred, at the start of the year. This illustration assumes death benefits, surrender benefits, and dividends are all at the end of the year.

(*d*) Death benefits, not reduced by related NLPR.

(*e*) Surrender benefits, not reduced by related NLPR.

(*f*) Recurring expenses not included in capitalized acquisition costs.

(*g*) Net decrease (increase) in aggregate NLPR in the year.

(*h*) Policyholder dividends for the year.

(*i*) Sum of (*a*) through (*h*) inclusive.

* This schedule is taken from *SOP 95-1, appendix A, "Illustration of Computation of Gross Margins"* [section 10,650.63].

Schedule 2—Closed Block Components

Year	Premium	Interest on Closed Block Assets	Interest on Current Activity	Death Benefits Incurred	Surrender Benefits Incurred	(Increase) Decrease in NLPR	Dividends Incurred	Estimated Gross Margin	(Increase)/ Decrease in Policyholder Dividend Obligation	Closed Block Initial Estimated Gross Margin
	(a)	*(b)*	*(c)*	*(d)*	*(e)*	*(g)*	*(h)*	*(i)*	*(j)*	*(k)*
1–5	n/a	n/a	n/a	n/a	n/a	(475,759)	n/a	n/a	n/a	n/a
6	$ 131,222	$ 11,200	$ 12,466	$ (15,622)	$ (17,237)	$ (73,236)	$ (30,043)	$ 18,750	$(2,491)	$ 16,259
7	124,333	17,839	10,568	(16,578)	(20,989)	(66,499)	(33,061)	15,613	549	16,162
8	117,768	24,819	10,010	(16,824)	(24,427)	(60,005)	(35,127)	16,214	595	16,809
9	111,526	31,298	9,480	(17,526)	(27,566)	(53,706)	(36,990)	16,515	646	17,161
10	105,582	37,266	8,974	(18,603)	(30,406)	(47,485)	(38,675)	16,653	701	17,354
11–20	779,517	585,648	66,259	(311,112)	(398,831)	(162,077)	(424,092)	135,312	0	135,312
21–55	589,392	1,103,633	50,099	(1,187,632)	(686,079)	(938,767)	(669,668)	138,512	0	138,512
Total	$1,959,340	$1,811,703	$167,856	$(1,583,897)	$(1,205,535)	$ 0	$(1,267,656)	$357,569	$ (0)	$357,569

Remarks:

1) Example assumes demutualization begins in year six.
2) Expenses assumed to be excluded from the closed block.
3) Closed Block policyholder dividend obligation (PDO) Calculation * Cumulative Closed Block EGM:

Actual as of Measurement Date	$18,750
- Initial Actuarial Calculation	$16,259
= PDO at Measurement Date	$ 2,491

4) Shaded figures indicate differences from the example shown in Schedule 1.

Notes:

(g.) (475,759) represents the cumulative (increase) decrease in net level premium reserve (NLPR) reported in Schedule 1, column (g) for years one to five
(j.) PDO as of end of last year minus PDO as of end of current year.
(k.) (i) + (j)

Schedule 3—Open Block Components

Year	Interest on Open Block Assets	Interest on Current Activity	Recurring Expenses Incurred	Open Block EGM	Closed Block EGM	Total EGM	DAC Amortization
	(b)	*(c)*	*(f)*	*(i)*	*(k)*	*(l)*	*(m)*
1–5	n/a	n/a	n/a	n/a	n/a	$242,474	$ 63,336
6	$ 33,998	$ (1,122)	$ (11,810)	$ 21,066	$ 16,259	$ 37,324	$ 9,409
7	29,037	(951)	(11,190)	16,896	16,162	33,058	7,263
8	27,663	(901)	(10,599)	16,163	16,809	32,972	7,854
9	26,234	(853)	(10,037)	15,344	17,161	32,505	8,248
10	24,776	(807)	(9,502)	14,467	17,354	31,821	8,535
11–20	174,635	(5,963)	(70,157)	98,515	135,312	233,827	66,591
21–55	119,052	(4,510)	(53,041)	61,501	138,512	200,013	70,265
Total Year 6–55	$435,395	$(15,107)	$(176,336)	$243,957	$357,569	$601,520	$178,164
Grand Total						$843,994	$241,500

Notes:

(l.) (i) + (k)

(m.) Deferred acquisition costs (DAC) balance as of end of prior year minus DAC balance as of end of current year.

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Glossary

Actuarial Calculation. The periodic expected changes in the net closed block liability (on a generally accepted accounting principles basis), which is after the elimination of the effect of applicable items of other comprehensive income. The amortization of deferred acquisition costs is not a component of the actuarial calculation because deferred acquisition costs are not a closed block asset.

Actuarial Calculation Date. The date as of which the actuarial calculation is performed, which is as of the date of demutualization or formation of a mutual insurance holding company (MIHC) or, if not practicable for insurance enterprises that demutualized or formed an MIHC prior to January 1, 2001, as of the beginning of the year of adoption of this Statement of Position.

Carrying Amount. The amount of an item as displayed in the financial statements.

Closed Block. A mechanism to preserve (over time) the reasonable dividend expectations of individual policyholders with individual life, health, or annuity policies for which dividends are currently being paid or are expected to be paid under the current dividend scale. A closed block comprises a defined, limited group of policies and a defined set of assets, and is governed by a set of operating rules.

Date of Demutualization. The date the plan of reorganization becomes effective.

Deferred Acquisition Costs (DAC). Costs incurred in the acquisition of new and renewal insurance contracts. Acquisition costs include those costs that vary with and are primarily related to the acquisition of insurance contracts (for example, agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees).

Demutualization. The conversion of a mutual insurance enterprise to a stock insurance enterprise.

Dividend Scales. The actuarial formulas used by life insurance companies to determine amounts payable as dividends on participating policies based on experience factors relating, among other things, to investment results, mortality, **lapse rates**, expenses, premium taxes and policy loan interest.

Fair and Equitable. The term *fair and equitable* is generally the terminology used in the demutualization or mutual insurance holding company state regulation to describe how the allocation of consideration to eligible policyholders should be determined.

In Force. Generally, policies and contracts written and recorded on the books of an insurance carrier that are unexpired as of a given date.

Lapse Rate. The rate at which insurance contracts terminate through failure of the insureds to continue required premium payments. The lapse rate may also be considered a rate of *non-persistence.* It is usually expressed as a ratio of the number of contracts that terminated by reason of failure of insureds to make premium payments during a given period, to the total number of contracts at the beginning of the period from which those lapses occurred.

Mortality. The relative incidence of death in a given time or place.

Net Closed Block Liability. The carrying amount of closed block liabilities in excess of the carrying amount of closed block assets each adjusted to eliminate the impact of related amounts in accumulated other comprehensive income at the actuarial calculation date. Deferred acquisition costs are not assets of the closed block.

Nonparticipating Insurance Contracts. Insurance contracts that are not entitled to dividends. Usually issued by a stock life insurance entity at premium rates that are usually lower than those charged where dividends are payable. Mutual entities may issue nonparticipating contracts.

Participating Insurance Contracts. Insurance in which the contractholder is entitled to share in the entity's earnings through dividends that reflect the difference between premium charged and the actual experience.

Persistency. Percentage of life insurance policies or annuity contracts remaining in force between measurement dates.

Plan of Demutualization. The plan of reorganization (including all exhibits and schedules thereto), as it may be amended from time to time, which is adopted by the board of directors of the demutualizing company, pursuant to which the company demutualizes.

Policy Credits. Additional values applied to a policy through dividends, increases in fund values, accumulation values or accumulation account values or extensions of coverages.

Statutory. An other comprehensive basis of accounting principles required by statute, regulation, or rule, or permitted by specific approval, that an insurance enterprise is required to follow when submitting its financial statements to state insurance departments.

Accounting Standards Executive Committee (1999-2000)

Demutualization Task Force

AICPA Staff

AcSEC would like to gratefully acknowledge the contributions of J. Peter Duran, Carl H. Harris, Brad Irick, Elaine M. Lehnert, Steven H. Mahan, Albert J. Reznicek, Mary K. Riley, Darryl G. Wagner, Deborah H. Whitmore, and the members of the former AICPA Insurance Companies Committee.

[The next page is 80,781.]

Section 10,820

Statement of Position 01-1 Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools*

March 27, 2001

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) amends SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships* [section 10,660], to include within the scope of SOP 95-2 [section 10,660] investment partnerships that are commodity pools subject to regulation under the Commodity Exchange Act of 1974.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.

2. The proposal will result in an improvement in practice.

3. The AICPA demonstrates the need for the proposal.

4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, a number of which are included in the documents.

Introduction and Background

.01 Statement of Position (SOP) 95-2, *Financial Reporting by Nonpublic Investment Partnerships* [section 10,660], requires that nonpublic investment partnerships present the following:

a. A condensed schedule of investments

b. A statement of operations in accordance with the provisions of the Audit and Accounting Guide *Audits of Investment Companies* (Investment Companies Guide)

c. Management fees and disclosure of the calculation of management fees

Nevertheless, paragraph 5(*b*) of SOP 95-2 excludes from its scope "investment partnerships that are commodity pools subject to regulation under the Commodity Exchange Act of 1974."

.02 Paragraph 5 of SOP 95-2 says that investment partnerships excluded from the scope of SOP 95-2 [section 10,660] should comply with the financial reporting requirements of the AICPA *Audit and Accounting Guides* applicable to those entities. Footnote 1 of SOP 95-2 says that the then-current Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* (the Broker-Dealer Guide) specified requirements for commodity pools[1] but adds that the Broker-Dealer Guide was being revised and that a forthcoming Guide that would apply to commodity pools was being prepared for comment.

.03 The revised Broker-Dealer Guide does not provide financial reporting requirements for commodity pools because the Accounting Standards Executive Committee (AcSEC) expected at the time the Broker-Dealer Guide was being prepared that it would issue a separate Guide for commodity pools.

.04 AcSEC did not issue a separate Guide for commodity pools. Instead, the AICPA issued a nonauthoritative Practice Aid entitled *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools*. Therefore, AcSEC decided to develop an authoritative standard to address whether SOP 95-2 [section 10,660] should apply to investment partnerships that are commodity pools subject to regulation under the Commodity Exchange Act of 1974.

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[1] Part 4 of the Commodity Futures Trading Commission Regulations defines pool as any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading commodity interests.

.05 AcSEC issued an exposure draft of a proposed SOP, *Amendment to Scope of Statement of Position 95-2*, Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools*, on August 15, 2000. AcSEC received four comment letters in response to the exposure draft. See the section entitled "Basis for Conclusions" for a discussion of AcSEC's response to the comment letters received.

Scope

.06 This SOP applies to investment partnerships that are commodity pools subject to regulation under the Commodity Exchange Act of 1974.

Conclusions

.07 Paragraph 5(*b*) of SOP 95-2 is deleted. Therefore, SOP 95-2 [section 10,660] applies to investment partnerships that are commodity pools subject to regulation under the Commodity Exchange Act of 1974.

.08 Paragraph 5 of SOP 95-2 is replaced in its entirety with the following.

> This SOP applies to investment partnerships that are exempt from SEC registration under the Investment Company Act of 1940 and defined as investment companies in the Guide, with one exception.[1] This SOP does not apply to investment partnerships that are brokers and dealers in securities subject to regulation under the Securities Exchange Act of 1934 (registered broker-dealers) and that manage funds only for those who are officers, directors, or employees of the general partner. Investment partnerships identified in the previous sentence as being exempt from the scope of this SOP should comply with the financial reporting requirements in the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*.
>
> Investment partnerships that are SEC registrants must comply with the financial statement reporting requirements as set forth in the Guide and as required by Articles 6 and 12 of the SEC's Regulation S-X.

[1] Investment partnerships that are commodity pools subject to regulation by the Commodity Futures Trading Commission (CFTC) should also comply with the financial statement reporting requirements of Part 4 of the CFTC Regulations.

Effective Date

.09 This SOP is effective for financial statements issued for periods ending after December 15, 2001. Earlier application is encouraged.

The provisions of this Statement need not be applied to immaterial items.

Basis for Conclusions

.10 Prior to this SOP, existing authoritative literature did not require certain commodity pools to make disclosures that some, including AcSEC, believe are important and useful. As noted in a comment letter from the Commodity Futures Trading Commission (CFTC) on the September 1998 exposure draft of the Investment Companies Guide, the annual reports of many commodity pools do not contain condensed schedules of investments. A commodity pool operator could elect to become subject to the Commodity Exchange Act of 1974 without having to trade commodities, and thus was able to exclude itself from the scope of SOP 95-2 [section 10,660]. Therefore, two pools with similar operations and investment portfolios could have had different disclosures in the financial statements if one was subject to CFTC regulation and the other was not.

.11 The exclusion of certain commodity pools from the scope of SOP 95-2 [section 10,660] is a consequence of AcSEC's original intent to issue a separate Audit and Accounting Guide for those entities. AcSEC believes that SOP 95-2 [section 10,660] requires the disclosure of important and useful information and that commodity pools subject to regulation under the Commodity Exchange Act of 1974 should disclose that information. AcSEC determined that there was no compelling reason to continue to exempt those entities from the scope of SOP 95-2 [section 10,660]. Further, AcSEC believes that this SOP should help improve the transparency and comparability of financial statement disclosures made by commodity pools, hedge funds, and other kinds of funds.

.12 AcSEC considered the views of commentators on the September 1993 exposure draft of the proposed SOP, *Financial Reporting for Investment Partnerships* (which resulted in the issuance of SOP 95-2 [section 10,660]), and the August 15, 2000, exposure draft of this SOP. Certain commentators recommended that investment partnerships registered with the CFTC as commodity pool operators be exempt from the scope of SOP 95-2 [section 10,660]. A number of those views are summarized and discussed in appendix B of SOP 95-2 [section 10,660.24], which describes comments received on the exposure draft of that SOP.

.13 Among the views expressed by commentators on the September 1993 exposure draft was that a condensed schedule of investments (as required by paragraph 10 of SOP 95-2 [section 10,660.11]) may not be meaningful and may even be misleading because of the frequent turnover of most commodity portfolios. That is, investments held at the date of the balance sheet may not represent trading strategies used during the past year or that will be used in the coming year.

.14 In addition, some believe that a condensed schedule of investments, which may include investments in derivative instruments, may not convey the risks associated with derivative investments.

.15 While concluding to no longer exempt commodity pools subject to regulation under Commodity Exchange Act of 1974 from the scope of SOP 95-2 [section 10,660], AcSEC agrees that many commodity portfolios turn over frequently. However, AcSEC believes that a schedule of investments is nonetheless useful. For example, AcSEC understands that hedge funds held large derivative positions via over-the-counter trades in the summer and fall of 1998 and that some time elapsed before the funds could unwind those positions during the Asian liquidity crisis in 1998. AcSEC believes that presentations of condensed schedules of investments by hedge funds would have helped users to better assess their investments in such funds.

.16 An attempt to improve disclosures of derivative investments to better convey the risks associated with those investments is beyond the scope of this SOP. In addition, commodity pools are subject to the provisions of chapter 7 of the Investment Companies Guide, which provides guidance on the disclosure of futures and forwards investments, and Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

.17 Some believe that disclosure of a condensed schedule of investments could result in competitive harm because that information is proprietary and akin to trade secrets in other industries. They believe that competitors could mimic a partnership's trading strategies or devise strategies to profit at the expense of the partnership, such as in a short squeeze. Although AcSEC recognizes the need to balance a fair presentation with protection of proprietary information, complete confidentiality of investments is not a compelling reason for excluding information on material items from financial statements. AcSEC acknowledges that disclosure can produce certain detriments, but AcSEC believes that the need for adequate disclosure outweighs the possibility of negative results. Furthermore, as noted by several respondents to the exposure draft of SOP 95-2 [section 10,660], although the disclosure of investment positions may be detrimental to a number of funds that have material short positions outstanding at a reporting date, many such positions will have expired or will have been covered before the availability of the financial statements.

.18 AcSEC believes that reporting basic information about investments is vital for a fair presentation of commodity pools' financial statements. AcSEC notes that paragraph 10(*b*) of SOP 95-2 [section 10,660.11*b*] requires identification of only those individual investments constituting more than 5 percent of net assets; all other investments are categorized in accordance with paragraph 10(*a*) of SOP 95-2 [section 10,660.11*a*]. In addition, AcSEC notes that funds outside the scope of SOP 95-2 [section 10,660] are required to disclose individual investments that constitute more than 1 percent of net assets.

.19 Two respondents to the August 15, 2000, exposure draft propose that in lieu of identifying a fund-of-funds' individual investments (in other funds) constituting more than 5 percent of net assets, a pool should disclose other information, such as the size of each investment, the gross fees paid, net profit or loss, a description of the trading strategy, and terms of liquidity. The respondents note that, under their proposed approach, a pool would not be required to disclose the names of funds for which it has a greater than 5 percent investment. The respondents believe that disclosing the name of a pool's investee funds could harm the pool as potential investors might invest directly with the pool's investee funds instead of with the pool.

.20 AcSEC believes that a fund-of-funds should disclose the name of investee funds that constitute more than 5 percent of the net assets of the fund-of-funds because a fund name allows an investor to access information about the fund, such as its trading strategy. In addition, AcSEC notes that fund-of-funds not subject to SOP 95-2 [section 10,660], as amended, are required by the Investment Companies Guide to disclose the name of the investee funds that meet the criteria of that Guide. This SOP does not require disclosure to any greater extent than what other investment partnerships are required to disclose.

.21 One respondent to the August 15, 2000, exposure draft believes that this SOP will result in increased diversity in financial reporting because managers of commodity pools may (*a*) move their businesses outside the United States to avoid reporting under generally accepted accounting principles (U.S. GAAP) or (*b*) accept qualified opinions from the pools' auditors for not complying with the provisions of this SOP.

.22 AcSEC notes that two main considerations in the development of financial reporting standards by U.S. standard setters are the usefulness of financial statements to owners and other general purpose users, and the comparability of financial information reported by those entities that comply with U.S. GAAP. As noted above, AcSEC believes that the disclosures required by this SOP are useful to investors and others. AcSEC could find no compelling reason for commodity pools subject to regulation under the Commodity Exchange Act of 1974 to present different information than other nonpublic investment partnerships.

.23 Two respondents to the August 15, 2000, exposure draft believe that the final SOP should increase the percentage threshold of disclosing a fund-of-funds' investment in investee funds from greater than 5 percent of net assets to 10 percent of net assets. The respondents cite a January 19, 2000, letter from the CFTC to commodity pool operators, which requests that a fund-of-funds disclose investments in investee funds that are greater than or equal to 10 percent of the pool's net assets.

.24 AcSEC understands that the CFTC based its disclosure requirement on an existing rule that defines "material investee pool." AcSEC also understands that the CFTC rule related to material investee pools is broader than CFTC disclosure requirements for annual reports. Further, AcSEC understands that the January 19, 2000, letter from the CFTC does not attempt to portray concentrations of investments, which is the intent of paragraph 10 of SOP 95-2 [section 10,660.11]. AcSEC continues to believe that the greater than 5-percent threshold in SOP 95-2 [section 10,660] is a useful disclosure.

Accounting Standards Executive Committee (2000-2001)

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Section 10,830

Statement of Position 01-2 Accounting and Reporting by Health and Welfare Benefit Plans

April 20, 2001

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) amends chapter 4 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide), and SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans* [section 10,530].

This SOP—

1. Specifies the presentation requirements for benefit obligations information.
2. Requires disclosure of information about retirees' relative share of the plan's estimated cost of providing postretirement benefits.
3. Clarifies the measurement date for benefit obligations.
4. Establishes standards of financial accounting and reporting for postemployment benefits provided by health and welfare benefit plans.
5. Requires disclosure of the discount rate used for measuring the plan's obligation for postemployment benefits.
6. Requires the identification of investments representing 5 percent or more of the net assets available for benefits.

This SOP is effective for financial statements for plan years beginning after December 15, 2000, with earlier application encouraged. Financial statements presented for prior plan years are required to be restated to comply with the provisions of this SOP.

Foreword

The Financial Accounting Standards Board (FASB) has cleared the accounting guidance contained in this document. The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing the following in public board meetings:

- A prospectus for a project to develop a document
- A proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members
- A proposed final document that has been approved by at least ten of AcSEC's fifteen members

The document is cleared if five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In a number of situations, before clearance, the FASB will propose suggestions, many of which are included in the documents.

Introduction

.01 The AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide) provides guidance to preparers and auditors of financial statements of employee benefit plans, including defined benefit pension plans, defined contribution pension plans, and both defined benefit and defined contribution health and welfare benefit plans.

.02 In August 1992, the AICPA issued Statement of Position (SOP) No. 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans* [section 10,530], primarily to update the Guide to apply certain concepts of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, to health and welfare benefit plans. SOP 92-6 [section 10,530] has been incorporated into the Guide as chapter 4.

.03 Many employers have continued to amend their postretirement health and welfare benefit plans to reduce benefits provided, to introduce or increase cost-sharing arrangements, or both, creating the need for more relevant information about how the plan's costs are shared. Also, since SOP 92-6 [section 10,530] was issued there has been diversity in practice in implementing a number of its requirements, including the measurement date for benefit obligations. In addition, preparers and others have questioned the restrictive nature of some of the presentation requirements of SOP 92-6 [section 10,530] and the adequacy of certain disclosure requirements.

.04 In November 1992, FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*, was issued, establishing standards of financial accounting and reporting by employers for certain postemployment benefits provided to former or inactive employees after employment but before retirement. Benefits provided may include salary continuation, supplemental unemployment benefits, severance, disability-related job training and counseling, and continuation of health care and life insurance. SOP 92-6 [section 10,530] contains only limited accounting and reporting guidance related to postemployment benefits provided by health and welfare benefit plans (principally only accumulated eligibility credits).

.05 This SOP amends the Guide and SOP 92-6 [section 10,530] to provide accounting and reporting guidance for health and welfare benefit plans in the following areas:

a. Presentation of benefit obligations information

b. Accounting for and reporting of postemployment benefit obligations

c. Measurement date for benefit obligations

d. Disclosure of information about retirees' relative share of the plan's estimated cost of providing postretirement benefits

e. Disclosure of discount rate used for measuring the plan's obligation for postemployment benefits

f. Disclosure of investments representing 5 percent or more of the net assets available for benefits.

.06 SOP 92-6 [section 10,530] currently provides guidance in a number of those areas. However, certain aspects of that guidance require clarification. This SOP, which provides additional guidance on accounting and reporting by health and welfare benefit plans, adopts certain measurement concepts of FASB Statement No. 112, which applies to employer accounting for postemployment benefits. Terminology used in discussing postemployment benefits in this SOP is intended to follow that in FASB Statement No. 112.

Scope

.07 This SOP applies to all health and welfare benefit plans, including single-employer, multiple-employer, and multiemployer sponsored plans, as described in paragraphs 1 through 4 of SOP 92-6 [section 10,530.01–.04] (as amended[1]) and paragraphs 4.01 through 4.04 of the Guide.

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[1] The original paragraphs of Statement of Position (SOP) 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans* [section 10,530], were renumbered by the issuance of SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans* [section 10,620]. Subsequent references in this SOP to SOP 92-6 [section 10,530] (as amended) refer to SOP 92-6 [section 10,530] as amended by SOP 94-4 [section 10,620]. The amended SOP can be found in section 10,530.

Conclusions

Reporting and Disclosures

Presentation of Benefit Obligations Information

.08 Paragraph 41 of SOP 92-6 [section 10,530.41] (as amended) and paragraph 4.40 of the Guide identify the following kinds of benefit obligations:

a. Claims payable and currently due for active and retired participants

b. Premiums due under insurance arrangements

c. Claims incurred but not reported (IBNR) to the plan for active participants

d. Accumulated eligibility credits for active participants

e. Postretirement benefits for the following:

(1) Retired participants, including their beneficiaries and covered dependents

(2) Active or terminated participants who are fully eligible to receive benefits

(3) Active participants not yet fully eligible to receive benefits.

.09 Information about the benefit obligations should be presented in a separate statement, combined with other information on another financial statement, or presented in the notes to financial statements. Regardless of the format selected, the plan financial statements should present the benefit obligations information in its entirety in the same location. In addition, the minimum disclosure requirements for benefit obligations are the actuarial present value, as applicable, of the following:

a. Claims payable, claims IBNR,[2] and premiums due to insurance companies

b. Accumulated eligibility credits and postemployment benefits, net of amounts currently payable

c. Postretirement benefits for the following groups of participants:

(1) Retired plan participants, including their beneficiaries and covered dependents, net of amounts currently payable and claims IBNR[3]

(2) Other plan participants fully eligible for benefits

(3) Plan participants not yet fully eligible for benefits.

Aggregating claims payable and claims IBNR is often appropriate if adequate time has passed to provide sufficient data on costs incurred and the actuarially determined expected cost of long-term medical claims is insignificant. Benefits expected to be earned for future service by active participants (for example, vacation benefits) during the term of their employment should not be included.

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[2] Claims incurred but not reported (IBNR) may be computed in the aggregate for active participants and retirees. Alternatively, if claims IBNR are not calculated in the aggregate for active participants and retirees, the claims IBNR for retirees are included in the postretirement benefit obligation.

[3] See footnote 2.

Benefit obligations should be reported as of the end of the plan year. The effect of plan amendments should be included in the computation of the expected and accumulated postretirement benefit obligations once they have been contractually agreed to, even if some provisions take effect only in future periods. For example, if a plan amendment grants a different benefit level for employees retiring after a future date, that increased or reduced benefit level should be included in current-period measurements for employees expected to retire after that date. To the extent they exist, the amounts of benefit obligations in each of the three major classifications identified above, should be shown as separate line items in the financial statements or notes to financial statements. For negotiated plans, the disclosure of benefit obligations due during a plan's contract period may, but need not, be disclosed.

.10 This SOP amends paragraph 55 of SOP 92-6 [section 10,530.55] (as amended) and paragraph 4.56 of the Guide to require that changes in each of the three major classifications of benefit obligations be presented in the body of the financial statements or in the notes to financial statements; the information may be presented in either a reconciliation or a narrative format.

Accounting for and Reporting of Postemployment Benefit Obligations

.11 The accounting and reporting for postemployment benefit obligations depend on the nature of the benefit promise. For plans that meet the conditions specified in paragraph .12, the benefit obligation is considered earned over the employee's service period as described in that paragraph. Otherwise, the benefit obligation is accounted for and reported as described in paragraph .13. In some cases, a plan participant's receipt of postemployment benefits is conditioned on the participant sharing in the plan's benefit cost by making contributions to the plan. However, unlike contributory postretirement benefit plans, in which participants usually are required to contribute to the plan during their retirement period (that is, after their service to the employer has ended), contributory postemployment benefit plans generally require contributions only during the participants' active service periods (for example, before the event triggering postemployment benefits occurs).

.12 Plans that provide postemployment benefits should recognize a benefit obligation for current participants, based on amounts expected to be paid in subsequent years, if all of the following conditions are met:

a. The participants' rights to receive benefits are attributable to services already rendered.

b. The participants' benefits vest or accumulate.[4]

c. Payment of benefits is probable.

d. The amount can be reasonably estimated.

The postemployment benefit obligation should be measured as the actuarial present value of the future benefits attributed to plan participants' services rendered to the measurement date, reduced by the actuarial present value of future contributions expected to be received from the current plan participants. That amount represents the benefit obligation that is to be funded by contributions from the plan's participating employer(s) and from existing plan assets.

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[4] For example, the supplemental unemployment benefit is fifty-two weeks' pay if a participant worked three years, seventy-eight weeks' pay if a participant worked five years, and 104 weeks' pay if a participant worked seven years. In this situation, the benefits would be considered accumulating. Benefits that increase solely as a function of wage or salary increases are not considered accumulating.

The obligation is to be measured assuming the plan continues in effect and all assumptions about future events are met. Any anticipated forfeitures or integration with other related programs (for example, state unemployment benefits) should be considered. The benefit obligation should be discounted using rates of return on high-quality fixed-income investments currently available with cash flows that match the timing and amount of expected benefit payments and expected participant contributions.

.13 For postemployment benefits that do not meet conditions (*a*) and (*b*) of paragraph .12 of this SOP, the plan should recognize a benefit obligation if the event that gives rise to a liability has occurred and the amount can be reasonably estimated. For example, if all participants receive the same medical coverage upon disability regardless of length of service (the benefits do not accumulate), and the benefits do not vest, medical benefits for disabled participants should be accrued at the date of disability and not over the participants' working lives. When participant contributions are required after the event triggering postemployment benefits occurs, the postemployment benefit obligation should be measured in a manner consistent with paragraph .12. As a result, in those situations the benefit obligation should represent the amount that is to be funded by contributions from the participating employer(s) and from existing plan assets.

.14 If an obligation for postemployment benefits is not recognized in accordance with paragraphs .12 or .13 only because the amount cannot be reasonably estimated, the financial statements should disclose that fact.

Measurement Date for Benefit Obligations

.15 The financial status of the plan considers assets and obligations as of the same date. Because plan assets are required to be presented as of the plan's year end, the benefit obligations also should be measured and presented as of the plan's year end. That requirement does not, however, preclude the plan from using the most recent benefit obligations valuation rolled forward to the plan's year end to account for subsequent events (such as employee service and benefit payments), provided that it is reasonable to expect that the results will not be materially different from the results of an actuarial valuation as of the plan's year end. In rolling forward the benefit obligations to the plan's measurement date, the discount rates should be adjusted as appropriate to reflect current rates of return on high-quality fixed-income investments. For example, if a valuation was performed at September 30 and the plan has a calendar year end, the benefit obligations as of September 30 should be rolled forward to December 31 by making appropriate adjustments, such as for additional employee service; the time value of money; benefits paid; and changes in the number of participants, actuarial assumptions, discount rates, per capita claims costs, and plan terms.

Disclosures

Postretirement Benefit Obligations

.16 A plan's obligation for postretirement benefits represents the actuarial present value of all future health and welfare benefits expected to be paid to or for (*a*) currently retired or terminated employees and their beneficiaries and dependents and (*b*) active employees and their beneficiaries and dependents after retirement from service with the participating employer or a group of employers based on the terms of the plan and the portion of the expected postretirement benefit obligation attributed to the employees' service rendered to date,[5] reduced by the actuarial present value of contributions expected to be received from the current plan participants during their remaining active service and postretirement periods. That amount represents the benefit obligation that is to be funded by contributions from the plan's participating employer(s) and from existing plan assets. In many cases, a plan participant's receipt of benefits under the plan is conditioned on the participant sharing in the benefit cost of the plan by making contributions to the plan, during either active service or retirement. Consequently, information about the extent of participant contributions provides important and useful information about how the cost of the plan is shared by the plan's participating employer(s) and the participants.

.17 This SOP amends paragraph 58 of SOP 92-6 [section 10,530.58] to require health and welfare plans to disclose in the notes to the financial statements for each year for which a year-end statement of net assets available for benefits is presented, the portion of the plan's estimated cost[6] of providing postretirement benefits funded by retiree contributions. The information about retiree contributions should be provided for each significant group of retired participants to the extent their contributions differ. If the plan terms provide that a shortfall in attaining the intended cost sharing in the prior year(s) is to be recovered by increasing the retiree contribution in the current year, that incremental contribution should be separately disclosed. Similarly, if the plan terms provide that participant contributions in the current year are to be reduced by the amount by which participant contributions in prior years exceeded the amount needed to attain the desired cost sharing, the resulting reduction in the current year contribution should be separately disclosed.

Postemployment Benefits

.18 A health and welfare benefit plan should disclose, in the notes to financial statements, the weighted-average assumed discount rate used to measure the plan's obligation for postemployment benefits.

Investment Transactions

.19 A health and welfare benefit plan should disclose, in the notes to financial statements, investments representing 5 percent or more of the net assets available for benefits as of the end of the year.

Amendments to the Guide and SOP 92-6

Presentation of Benefit Obligations Information

.20 The second sentences of paragraph 4.18 of the Guide and paragraph 20 of SOP 92-6 [section 10,530.20] (as amended) are replaced with the following:

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[5] The guidance in paragraphs 43 and 44 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, should be followed in attributing the expected postretirement benefit obligation to participants' service with the employer(s).

[6] The plan's estimated cost of postretirement benefits is the plan's expected claims cost for the year. It excludes benefit costs paid by Medicare and costs, such as deductibles and copayments, paid directly to the medical provider by participants. The portion of the plan's estimated cost that is funded by retiree contributions is determined at the beginning of the year based on the plan sponsor's cost-sharing policy. In determining that amount, the retirees' required contribution for the year should be reduced by any amounts intended to recover a shortfall (or increased by amounts intended to compensate for an overcharge) in attaining the desired cost-sharing in the prior year(s).

Information about the benefit obligations should be presented in a separate statement, combined with other information on another financial statement, or presented in the notes to financial statements. Regardless of the format selected, the plan financial statements should present the benefit obligations information in its entirety in the same location.

.21 Paragraphs 4.40 and 4.41 of the Guide and paragraphs 41 and 42 of SOP 92-6 [section 10,530.41 and .42] (as amended) are replaced with the following:

Benefit obligations* for single-employer, multiple-employer, and multiemployer defined-benefit health and welfare benefit plans should include the actuarial present value, as applicable, of the following:

a. Claims payable, claims IBNR,† and premiums due to insurance companies

b. Accumulated eligibility credits and postemployment benefits, net of amounts currently payable

c. Postretirement benefits for the following groups of participants:†

(1) Retired plan participants, including their beneficiaries and covered dependents, net of amounts currently payable and claims IBNR†

(2) Other plan participants fully eligible for benefits

(3) Plan participants not yet fully eligible for benefits.

Aggregating claims payable and claims IBNR is often appropriate if adequate time has passed to provide sufficient data on costs incurred and the actuarially determined expected cost of long-term medical claims is insignificant. Benefits expected to be earned for future service by active participants (for example, vacation benefits) during the term of their employment should not be included. Benefit obligations should be reported as of the end of the plan year. The effect of plan amendments should be included in the computation of the expected and accumulated postretirement benefit obligations once they have been contractually agreed to, even if some provisions take effect only in future periods. For example, if a plan amendment grants a different benefit level for employees retiring after a future date, that increased or reduced benefit level should be included in current-period measurements for employees expected to retire after that date.

To the extent they exist, the amounts of benefit obligations in each of the three major classifications identified above should be shown as separate line items in the financial statements or notes to financial statements. Regardless of the format selected, the plan financial statements should present the benefit obligations information in its entirety in the same location. For negotiated plans, benefit obligations due during a plan's contract period may, but need not, be disclosed.

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* Administrative expenses expected to be paid by the plan (but not those paid directly by the plan's participating employer(s)) that are associated with providing the plan's benefits should be reflected either by including the estimated costs in the benefits expected to be paid by the plan or by reducing the discount rate(s) used in measuring the benefit obligation. If the latter method is used, the resulting reduction in the discount rate(s) should be disclosed.

† Claims IBNR may be computed in the aggregate for active participants and retirees. Alternatively, if claims IBNR are not calculated in the aggregate for active participants and retirees, the claims IBNR for retirees are included in the postretirement benefit obligation.

Subsequent footnotes in the Guide and in SOP 92-6 [section 10,530] will be renumbered accordingly.

.22 The second sentence in paragraph 4.56 (paragraph 4.60 as amended by this SOP) of the Guide and in paragraph 55 of SOP 92-6 (paragraph 59 [section 10,530.59] as amended by this SOP) are replaced with the following:

> Changes in each of the three major classifications of benefit obligations should be presented in the body of the financial statements or in the notes to the financial statements; the information may be presented in either a reconciliation or narrative format.

Accounting for and Reporting of Postemployment Benefits

.23 The following section addressing postemployment benefits is added following paragraph 4.55 of the Guide and paragraph 54 of SOP 92-6 [section 10,530.54] (as amended):

> **Postemployment Benefits**
>
> Plans that provide postemployment benefits should recognize a benefit obligation for current participants, based on amounts expected to be paid in subsequent years, if all the following conditions are met:
>
> *a.* The participants' rights to receive benefits are attributable to services already rendered.
>
> *b.* The participants' benefits vest or accumulate.[‡]
>
> *c.* Payment of benefits is probable.
>
> *d.* The amount can be reasonably estimated.
>
> The postemployment benefit obligation should be measured as the actuarial present value of the future benefits attributed to plan participants' services rendered to the measurement date, reduced by the actuarial present value of future contributions expected to be received from the current plan participants. That amount represents the benefit obligation that is to be funded by contributions from the plan's participating employer(s) and from existing plan assets. The obligation is to be measured assuming the plan continues in effect and all assumptions about future events are met. Any anticipated forfeitures or integration with other related programs (for example, state unemployment benefits) should be considered. The benefit obligation should be discounted using rates of return on high-quality fixed-income investments currently available with cash flows that match the timing and amount of expected benefit payments and expected participant contributions.
>
> For postemployment benefits that do not meet conditions (*a*) and (*b*) of the preceding paragraph, the plan should recognize a benefit obligation if the event that gives rise to a liability has occurred and the amount can be reasonably estimated. For example, if all participants receive the same medical coverage upon disability regardless of length of service (the benefits do not accumulate) and the benefits do not vest, medical benefits for disabled participants should be accrued at the date of disability and not over the participants' working lives. When participant contributions are required after the event triggering postemployment benefits occurs, the postemployment benefit obligation should be measured in a manner consistent with the preceding paragraph. As a result, in those situations the benefit obligation should represent the amount that is to be funded by contributions from the participating employer(s) and from existing plan assets.

If an obligation for postemployment benefits is not recognized in accordance with the two preceding paragraphs only because the amount cannot be reasonably estimated, the financial statements should disclose that fact.

‡ For example, the supplemental unemployment benefit is fifty-two weeks' pay if a participant worked three years, seventy-eight weeks' pay if a participant worked five years, and 104 weeks' pay if a participant worked seven years. In this situation, the benefits would be considered accumulating. Benefits that increase solely as a function of wage or salary increases are not considered accumulating.

The remaining paragraphs will be renumbered beginning with paragraph 4.59 of the Guide and beginning with paragraph 58 of SOP 92-6 [section 10,530.58] (as amended) as a result of those amendments.

Measurement Date for Benefit Obligations

.24 Footnote 17 of SOP 92-6 [section 10,530.41] (as amended) and footnote 28 of chapter 4 of the Guide are replaced by the following:

> The financial status of the plan considers assets and obligations as of the same date. Because plan assets are required to be presented as of the plan's year end, the benefit obligations also should be measured and presented as of the plan's year end. That requirement does not, however, preclude the plan from using the most recent benefit obligations valuation rolled forward to the plan's year end to account for subsequent events (such as employee service and benefit payments), provided that it is reasonable to expect that the results will not be materially different from the results of an actuarial valuation as of the plan's year end. In rolling forward the benefit obligations to the plan's measurement date, the discount rates should be adjusted as appropriate to reflect current rates of return on high-quality fixed-income investments. For example, if a valuation was performed at September 30 and the plan has a calendar year end, the benefit obligations as of September 30 should be rolled forward to December 31, by making appropriate adjustments, such as for additional employee service; the time value of money; benefits paid; and changes in the number of participants, actuarial assumptions, discount rates, per capita claims costs, and plan terms.

Disclosures

Postretirement Benefit Obligations

.25 The following is added at the end of the third bullet of paragraph 4.59 of the Guide (paragraph 4.63 as amended by this SOP) and paragraph 58 of SOP 92-6 (paragraph 62 [section 10,530.62] as amended by this SOP):

> For each year for which a year-end statement of net assets available for benefits is presented, the plan should disclose a description of the portion of the plan's estimated cost[||] of providing postretirement benefits funded by retiree contributions. If the plan terms provide that a shortfall in attaining the intended cost sharing in the prior year(s) is to be recovered by increasing the retiree contribution in the current year, that incremental contribution should be separately disclosed. Similarly, if the plan terms provide that participant contributions in the current year are to be reduced by the amount by which participant contributions in prior year exceeded the amount needed to attain the desired cost-sharing, the resulting reduction in the current year contribution should be

separately disclosed. The information about retiree contributions should be provided for each significant group of retired participants to the extent their contributions differ.

|| The plan's estimated cost of postretirement benefits is the plan's expected claims cost for the year. It excludes benefit costs paid by Medicare and costs, such as deductibles and copayments, paid directly to the medical provider by participants. The portion of the plan's estimated cost that is funded by retiree contributions is determined at the beginning of the year based on the plan sponsor's cost-sharing policy. In determining that amount, the retirees' required contribution for the year should be reduced by any amounts intended to recover a shortfall (or increased by amounts intended to compensate for an overcharge) in attaining the desired cost-sharing in prior year(s).

.26 The following modifications to appendix F of the Guide and paragraph 67, exhibit A, of SOP 92-6 [section 10,530.67] are made to provide an example of the financial reporting for a defined benefit health and welfare plan under which retirees contribute a portion of the cost for their medical coverage. The illustration being modified is the first example, Allied Industries Benefit Plan. The revised Statements of Plan's Benefit Obligations follow:

EXHIBIT F-3

Allied Industries Health Care Benefit Plan
Statements of Plan's Benefit Obligations
December 31, 20X1 and 20X0

	20X1	*20X0*
Amounts currently payable		
Claims payable, claims incurred but not reported, and premiums due to insurers	$ 1,200,000	$ 1,050,000
Postemployment benefit obligations, net of amounts currently payable		
Death and disability benefits for inactive participants	1,350,000	1,000,000
Postretirement benefit obligations, net of amounts currently payable		
Retired participants	2,000,000	1,900,000
Other participants fully eligible for benefits	4,000,000	3,600,000
Participants not yet fully eligible for benefits	5,000,000	4,165,000
	11,000,000	9,665,000
PLAN'S TOTAL BENEFIT OBLIGATIONS	$13,550,000	$11,715,000

The accompanying notes are an integral part of the financial statements.

.27 The Statement of Changes in Plan's Benefit Obligations also is revised, as follows:

EXHIBIT F-4

Allied Industries Health Care Benefit Plan
Statement of Changes in Plan's Benefit Obligations
Year Ended December 31, 20X1

	20X1
Amounts currently payable	
Balance at beginning of year	$ 1,050,000
Claims reported and approved for payment, including benefits reclassified from benefit obligations	16,920,000
Claims paid	(16,770,000)
Balance at end of year	1,200,000
Postemployment benefit obligations, net of amounts currently payable	
Balance at beginning of year	1,000,000
Increase (decrease) in postemployment benefits attributable to:	
Benefits earned	600,000
Benefits reclassified to amounts currently payable	(450,000)
Interest	90,000
Changes in actuarial assumptions and other actuarial gains and losses	110,000
Balance at end of year	1,350,000
Postretirement benefit obligations, net of amounts currently payable	
Balance at beginning of year	9,665,000
Increase (decrease) in postretirement benefits attributable to:	
Benefits earned	1,150,000
Benefits reclassified to amounts currently payable	(650,000)
Interest	750,000
Plan amendment	(175,000)
Changes in actuarial assumptions and other actuarial gains and losses	260,000
Balance at end of year	11,000,000
PLAN'S TOTAL BENEFIT OBLIGATIONS AT END OF YEAR	$13,550,000

The accompanying notes are an integral part of the financial statements.

.28 The notes to financial statements in exhibit A of SOP 92-6 [section 10,530.67] and exhibit F-5 of the Guide are modified as follows:

a. In Note 1, "Description of Plan," the second sentence in the paragraph *Contributions* is replaced with the following:

> Employees may contribute specified amounts, determined periodically by the Plan's actuary, to extend coverage to eligible dependents. The costs of the postretirement benefit plan are shared by the Plan's participating employers and retirees. In addition to deductibles and copayments, participant contributions in the current (and prior, if applicable) year were as follows:

Participants Retiring	***20X1 Retiree Contribution***	***20X0 Retiree Contribution***
(1) Pre-1990	(1) None	(1) None
(2) 1990–1994	(2) Retirees contribute 20% of estimated cost of providing their postretirement benefits#	(2) Retirees contribute 20% of estimated cost of providing their postretirement benefits
(3) 1995–1999	(3) Retirees pay the cost of providing their postretirement benefits in excess of $200 per month "cap" (approximately 60% of the estimated cost)	(3) Retirees pay the cost of providing their postretirement benefits in excess of $200 per month "cap" (approximately 50% of the estimated cost)
(4) 2000 and after	(4) Retirees pay 100% of estimated cost of providing their postretirement benefits	(4) Retirees pay 100% of estimated cost of providing their postretirement benefits

Excluding $15 per month per capita increase in 20X1 due to adverse claims experience in 20X0.

b. In Note 2, "Summary of Significant Accounting Policies," the following paragraph replaces the first two sentences of the first paragraph of section C, "Postretirement Benefits":

> The amount reported as the postretirement benefit obligation represents the actuarial present value of those estimated future benefits that are attributed by the terms of the plan to employees' service rendered to the date of the financial statements, reduced by the actuarial present value of contributions expected to be received in the future from current plan participants. Postretirement benefits include future benefits expected to be paid to or for (1) currently retired or terminated employees and their beneficiaries and dependents and (2) active employees and their beneficiaries and dependents after retirement from service with participating employers. The postretirement benefit obligation represents the amount that is to be funded by contributions from the plan's participating employers and from existing plan assets.

Postemployment Benefits

.29 The following is added at the end of the bullets in paragraph 4.59 (paragraph 4.62 as amended by this SOP) of the Guide and at the end of the bullets in paragraph 58 of SOP 92-6 (paragraph 61 [section 10,530.61] as amended by this SOP):

- The weighted-average assumed discount rate used to measure the plan's obligation for postemployment benefits.

.30 The illustrative financial statement examples of an employee benefit plan that provides postemployment benefits in appendix B [paragraph .34] of this SOP are added to the Guide as exhibits F-14 through F-16 and to SOP 92-6 [section 10,530.70] as exhibit C.

Investment Transactions

.31 The first sentence of the seventh bullet (including the addition of paragraph .25 of this SOP) of Guide paragraph 4.59 (paragraph 4.62 as amended by this SOP), and the first sentence of the seventh bullet (including the addition of paragraph .25 of this SOP) of paragraph 58 (paragraph 61 [section 10,530.61] as amended by this SOP) of SOP 92-6, are replaced with the following:

> Identification of investments that represent 5 percent or more of the net assets available for benefits as of the end of the year.

Effective Date and Transaction

.32 This SOP is effective for financial statements for plan years beginning after December 15, 2000. Earlier application is encouraged. Financial statements presented for prior plan years are required to be restated to comply with the provisions of this SOP. The effect of restating the beginning balance of benefit obligations for the earliest year presented should be disclosed.

The provisions of this Statement need not be applied to immaterial items.

.33

Appendix A

Background Information and Basis for Conclusions

Measurement and Reporting of Postretirement Benefit Obligations

A.01 The primary objective of the financial statements of a health and welfare plan is to provide financial information that is useful in assessing the plan's current and future ability to pay its benefit obligations when due. To accomplish that objective, a plan's financial statements should provide information about the following:

a. Plan resources and the manner in which the stewardship responsibility for those resources has been discharged

b. Benefit obligations

c. Results of transactions and events that affect the information about those resources and obligations

d. Other information necessary for users to understand the information.

A.02 The plan document states the nature and extent of benefits the plan will provide to its participants. The plan is dependent on the participating employer(s), plan participants, or both, to provide funding for those benefits. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, requires employers to quantify the promises they make to current and former employees to provide them with postretirement benefits other than pensions.

A.03 When SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans* [section 10,530], originally was developed, the intent was that the plan would report the postretirement benefit obligation (measured in accordance with FASB Statement No. 106) to minimize actuarial and audit costs to health and welfare benefit plans. Under FASB Statement No. 106, the postretirement benefit obligation recognized by the employer (the plan sponsor for a single-employer plan) is the amount expected to be funded by contributions from the employer; it does not include amounts expected to be funded by participants' future contributions. In addition, since SOP 92-6 [section 10,530] was issued, many employers have continued to amend their plans to reduce benefits provided, to introduce or increase cost-sharing arrangements, or both. Also, there has been diversity in practice in implementing a number of its requirements, including the measurement date for benefit obligations.

A.04 Employees may contribute specified amounts, determined periodically by the plan's actuary, to extend coverage to eligible dependents. The costs of the postretirement benefit plan are shared by the plan's participating employer(s) and participants (for example, retirees). Many health and welfare plans integrate benefits with Medicare. That integration normally is described in detail in the plan document. Benefits to be provided by Medicare are neither benefits provided by the plan nor obligations of the plan. Deductible amounts and copayments, which are described in the plan document, also are neither part of the benefits provided nor part of the plan's obligations. The plan's postretirement benefit obligation does not include the cost of benefits to be provided by Medicare or deductible amounts and copayments that are to be paid directly by the plan participants.

A.05 On March 22, 2000, an exposure draft of this SOP, *Accounting for and Reporting of Certain Health and Welfare Benefit Plan Transactions*, was issued. That exposure draft proposed the presentation of a combination of two alternative measures of the plan's obligations on the statement of benefit obligations. It proposed the presentation of the "gross" measure of the obligation—the postretirement benefits expected to be paid by the plan—and reconciliation (by deducting the amount of the postretirement benefit obligations expected to be paid by contributions from plan participants) of that amount to the net postretirement benefit obligation, which represents the obligation to be paid by the plan's participating employer(s) and from existing plan assets. The Accounting Standards Executive Committee (AcSEC) believed that presentation would provide more useful information about the plan's expected benefit payments and sources of funding than the presentation under SOP 92-6 [section 10,530].

A.06 AcSEC considered the cost of measuring the plan's total benefit obligations attributed to participant service rendered to the measurement date (that is, the gross measure of postretirement benefits expected to be paid by the plan). It was believed that in most cases, the plan's total benefit obligations for a single-employer plan would be readily available if the sponsoring employer measures its postretirement benefit obligation in accordance with FASB Statement No. 106. Paragraph 27 of FASB Statement No. 106 says that the benefit obligation is measured as the actuarial present value of the benefits expected to be provided under the plan, reduced by the actuarial present value of contributions expected to be received from the plan participants during their remaining active service and postretirement.

A.07 AcSEC received twenty-two comment letters on its exposure draft. Many of those respondents believed that in many situations it would not be cost beneficial to require plans to calculate the gross measure of the postretirement benefits expected to be paid by the plan. That may be the case, for example, if the costs of the plan are shared by the plan's participating employer(s) and participants through contributory plans, such as "capped" plans, "defined dollar" benefit plans, "reimbursement plans," or through "retiree-pay-all" plans. In addition, because plans may have different contribution requirements for different groups of participants (for example, employees who retired before 1991, employees who retired between 1991 and 1998, and employees who retired after 1998), comparing the "gross" and "net" measures of the benefit obligations may not provide a relevant comparison of how the plan costs are shared by the plan's participating employer(s) and various groups of retired participants. After consultation with some of the respondents to the exposure draft, AcSEC concluded that information about the portion of the plan's estimated cost that is funded by retiree contributions could be provided more cost-effectively through additional financial statement disclosures.

A.08 In practice, many multiemployer plans negotiate participating employer and participant contribution rates that are intended to fund the benefits expected to be paid in the current period. As a result of the nature of those plans, many plan administrators believe that the plans have no legal liability to provide benefits to their participants beyond the periods specified by the terms of their contract. Therefore, plan trustees, administrators, and participants may find the note disclosure of benefit obligations due during the contract period, in addition to the plan's benefit obligations, useful in assessing the plan's funded status.

Presentation of Benefit Obligations Information

A.09 AcSEC has been asked whether certain kinds of benefit obligations, as described in paragraph 41 of SOP 92-6 [section 10,530.41] (as amended) and paragraph 4.40 of the Guide, may be aggregated for reporting purposes. The intent of SOP 92-6 [section 10,530] was that benefit obligations with similar characteristics may be aggregated. That is why, in part, three major classifications of benefit obligations were identified in paragraph 55 of SOP 92-6 [section 10,530.55] (as amended) and paragraph 4.56 of the Guide. Those classifications include claims payable and premiums due to insurance companies, claims incurred but not reported (IBNR) and accumulated eligibility credits, and postretirement benefit obligations.

A.10 AcSEC believes claims payable and premiums due to insurance companies may be aggregated because they are known, determinable amounts as of the plan's year end, and are not estimates. In addition, AcSEC believes that claims IBNR may be aggregated with those amounts because sufficient data on actual costs incurred usually are available before issuance of the plan's financial statements. At that time, the characteristics of claims payable and claims IBNR may be similar. The claims IBNR amount reported as of the plan's year end usually is adjusted to reflect the actual cost incurred. Accumulated eligibility credits and the obligation for postemployment benefits are usually estimated amounts as of the plan's year end. As such, measurement of the obligation may encompass various assumptions. For that reason, AcSEC believes the obligation for those benefits should be presented as a separate classification.

A.11 FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, allows defined benefit pension plans to present information about the actuarial present value of accumulated plan benefits and changes therein in either the financial statements or in the notes. AcSEC believes similar alternatives should be provided for the presentation of information about benefit obligations and changes in benefit obligations of defined benefit health and welfare plans.

Accounting for and Reporting of Postemployment Benefits

A.12 FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*, requires employers to quantify the promises they make to employees to provide them with benefits after employment but before retirement. Those benefits are referred to as postemployment benefits.

A.13 Previously, there was no similar requirement to quantify postemployment benefits at the plan level. However, AcSEC believes that to the extent that plans provide for postemployment benefits, those promises represent obligations of the plan and should be reported in the plan's financial statements or notes to financial statements. Although FASB Statement No. 112 does not require discounting of the employer's obligation, this SOP requires that the plan's postemployment benefit obligation be discounted, consistent with the measurement of all other benefit obligations of the plan. AcSEC believes that a comparison of plan assets with an undiscounted measure of the obligation would be misleading. AcSEC recognizes the issuance of FASB Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, which sets forth a different basis for discounting the benefit obligation. However, AcSEC believes it is preferable to retain an approach to selecting the discount rates that is consistent with the rates required to be used in other measures of plans' and for employers' benefit obligations. AcSEC also considered requiring the disclosure of the portion of the plan's estimated cost of postemployment benefits funded by active or inactive participants' contributions. After deliberation, AcSEC rejected this requirement because it decided that this particular disclosure was not cost beneficial to the users of plan financial statements.

Measurement Date for Benefit Obligations

A.14 Paragraph 41 of SOP 92-6 [section 10,530.41] (as amended) and paragraph 4.40 of the Guide say that benefit obligations should be reported as of the end of the plan year. Paragraph 72 of FASB Statement No. 106 permits employers to determine their postretirement benefit obligations as of a date not more than three months before year end, provided that the determination is made consistently from year to year. The intent of footnote 17 of SOP 92-6 [section 10,530.41] (as amended) and footnote 28 of chapter 4 of the Guide was to incorporate that same concept for the determination of benefit obligations at the plan level.

A.15 The financial status of the plan considers assets and obligations as of the same date. Because plan assets are required to be presented as of the plan's year end, AcSEC believes benefit obligations (both postretirement and postemployment) also should be presented as of the plan's year end.

A.16 Benefit obligations are estimates based on various assumptions. Because of the inherent uncertainties surrounding those assumptions, AcSEC believes that the most recent information rolled forward to the plan's year end is permissible provided that it is reasonable to expect that the results will not be materially different from the results of an actuarial valuation at the plan's year end. A valuation rolled forward to the plan's year end should consider such factors as additional employee service, the time value of money, changes in the number of participants, actuarial experience and per capita claims costs, and benefits paid since the valuation date. A valuation rolled forward to the plan's year end would not be appropriate if there has been a material amendment to the plan or other significant changes unless the actuary has adjusted for the effects of those changes on the benefit obligation.

Investment Transactions

A.17 Paragraph 58 of SOP 92-6 [section 10,530.58] (as amended) and paragraph 4.59 of the Guide require the health and welfare plan's financial statements to identify and disclose investments that represent 5 percent or more of total plan assets. However, it was noted that the disclosure of investments of defined benefit and defined contribution plans is based on 5 percent of the net assets, as listed in the plan's statement of net assets available for plan benefits as of the end of the year. AcSEC believes that the disclosures should be consistent among plans. Therefore, this SOP requires health and welfare plans to identify and disclose investments that represent 5 percent or more of the net assets available for plan benefits as of the end of the year.

Effective Date and Transition

A.18 A cumulative effect adjustment normally would be required to reflect the effect of changes in accounting. However, AcSEC concluded that because of the nature of a plan's financial statements and the changes required by this SOP, restatement of prior periods presented for comparative purposes is more appropriate.

.34

Appendix B

Illustrative Financial Statements of a Supplemental Unemployment Benefit Plan

B.01 This Appendix illustrates certain applications of the provisions of this Statement of Position (SOP) that apply to the annual financial statements of a hypothetical supplemental unemployment benefit plan. It does not illustrate other provisions of this SOP that might apply in circumstances other than those assumed in this example. It also does not illustrate all disclosures required for a fair presentation in conformity with generally accepted accounting principles (GAAP). The formats presented and the wording of the accompanying notes are illustrative and are not necessarily the only possible presentations.

B.02 Although GAAP does not require comparative financial statements, the Employee Retirement Income Security Act of 1974 (ERISA) requires a comparative statement of net assets available for benefits. The illustrative financial statements are intended to comply with the requirements of ERISA.

B.03 ERISA and U.S. Department of Labor (DOL) regulations require that certain information be included in supplemental schedules, which are not required under GAAP. See appendix A of AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* for a further discussion of the ERISA and DOL requirements.

Supplemental Unemployment Benefit Plan for Employees of ABC Company Established Pursuant to Agreement With United Workers of America
Statements of Net Assets Available for Benefits
December 31, 20X1 and 20X0

	20X1	*20X0*
Assets		
Investments	$10,605	$ 80,750
Cash and cash equivalents	1,025	19,400
Accrued interest receivable	100	125
TOTAL ASSETS	11,730	100,275
Liability		
Accrued investment trustee fees	265	265
NET ASSETS AVAILABLE FOR BENEFITS	$11,465	$100,010

The accompanying notes are an integral part of the financial statements.

Supplemental Unemployment Benefit Plan for Employees of ABC Company Established Pursuant to Agreement With United Workers of America
Statement of Changes in Net Assets Available for Benefits
Year Ended December 31, 20X1

Additions:	
Contributions	$1,366,065
Interest income	1,960
TOTAL ADDITIONS	1,368,025
Deductions:	
Benefit payments	1,455,460
Investment trustee fees	1,110
TOTAL DEDUCTIONS	1,456,570
NET DECREASE DURING THE YEAR	(88,545)
Net assets available for benefits	
Beginning of year	100,010
End of year	$ 11,465

The accompanying notes are an integral part of the financial statements.

Supplemental Unemployment Benefit Plan for Employees of ABC Company Established Pursuant to Agreement with United Workers of America Notes to Financial Statements

NOTE 1: DESCRIPTION OF PLAN

In connection with a negotiated contract, the Supplemental Unemployment Benefit Plan for Employees of ABC Company Established Pursuant to Agreement With United Workers of America (the Plan) provides for payment of supplemental unemployment benefits to covered employees who have completed two years of continuous service. Payments are made to (*a*) employees on layoff and (*b*) certain employees who work less than 32 hours in any week. The following description is provided for general information purposes. The Plan document should be referred to for specific information regarding benefits and other Plan matters.

NOTE 2: SUMMARY OF ACCOUNTING POLICIES

Basis of Accounting. The financial statements of the Plan are prepared under the accrual method of accounting.

Investment Valuation. The Plan's investments consist of shares of a money market portfolio. The investments are reported at fair value.

Use of Estimates. The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Benefit Obligations. The Plan's obligation for accumulated eligibility credits is discounted using a weighted-average assumed rate of 7½ percent.

NOTE 3: FUNDING AND OPERATION OF THE PLAN

Funding of the Plan. Contributions funded by ABC Company, the Plan's sponsor, pursuant to the Plan are invested in assets held in a trust fund (the Fund). General Bank, the trustee of the Fund (the Trustee), invests the Fund's money as set forth in the Plan document. Investments consist of money market funds and are reported in the accompanying financial statements at fair value. Interest income from investments is recognized when earned.

Administration. The ABC Company Benefit Plan Administrative Committee has responsibility for administering the Plan. The ABC Company Benefit Plan Asset Review Committee has responsibility for the management and control of the assets of the Trust.

Benefits Under the Plan. The Plan provides for the payment of weekly and short-week supplemental unemployment benefits. The benefits payable are reduced by any state unemployment benefits or any other compensation received. Also, a "waiting-week" benefit of $100 will be payable if a participant fails to receive a state unemployment benefit solely because of the state's waiting-week requirement. Benefits paid for any week for which the employee received state unemployment benefits are limited to $180. Benefits paid for all other weeks are limited to $235. The Plan provides for a possible reduction of weekly benefits for employees with less than twenty years of service based upon a percentage determined generally by dividing the net assets of the Plan, as defined in the Plan document, by the "maximum financing" (see "ABC's Obligations Under the Plan"). Employees earn one-half credit unit for each week in which hours are worked or, in some situations, in which hours are not worked (vacation, disability, serving on grievance committee, and so on) up to a maximum of fifty-two credit units for employees with less than twenty years of service and 104 credit units for employees with twenty or more years of service. Generally, one credit unit is canceled for each weekly benefit paid and one-half credit unit is canceled for each short-week benefit paid.

ABC's Obligations Under the Plan. The "maximum financing" of the Plan at any month end is the lesser of (*a*) the product of $.40 and the number of hours worked by covered employees during the first twelve of the fourteen months next preceding the first day of the month and (*b*) 100 times the sum of the monthly benefits paid for the sixty of the preceding sixty-two months divided by sixty. ABC's monthly contribution to the Plan is computed as the lesser of (*a*) the product of $.175 and the number of hours worked by covered employees in the month and (*b*) the amount that, when added to the net assets of the Plan, as defined by the Plan document, as of the end of the preceding month, will equal the "maximum financing." In addition, ABC contributes an income security contribution of $.25 per hour worked by covered employees in the month. In the event of a plan deficit, ABC intends to make sufficient contributions to fund benefits as they become payable.

The following tables present the components of the plan's benefit obligations and the related changes in the plan's benefit obligations.

Benefit Obligations
December 31, 20X1 and 20X0

	20X1	*20X0*
Accumulated eligibility credits and total benefit obligations	$1,107,777	$1,095,620

Changes in Benefit Obligations
Year Ended December 31, 20X1

Benefit obligations, beginning of year	$1,095,620
Benefits earned	1,390,330
Interest	77,287
Claims paid	(1,455,460)
Benefit obligations, end of year	$1,107,777

Plan Expenses. ABC bears all administrative costs, except trustee fees, that are paid by the Plan.

NOTE 4: TAX STATUS

The Plan obtained its latest determination letter in 1990, in which the Internal Revenue Service stated that the Plan, as then designed, was in compliance with the applicable requirements of the Internal Revenue Code (IRC). The Plan has been amended since receiving the determination letter. Plan management and Plan's tax counsel believe that the Plan is currently designed and being operated in compliance with the applicable requirements of the IRC. Therefore, no provision for income taxes has been included in the Plan's financial statements.

NOTE 5: TRANSACTIONS WITH PARTIES IN INTEREST

ABC provides to the Plan certain accounting and administrative services for which no fees are charged.

NOTE 6: TERMINATION OF THE PLAN

Under certain conditions, the Plan may be terminated. Upon termination, the assets then remaining shall be subject to the applicable provisions of the Plan then in effect and shall be used until exhausted to pay benefits to employees in the order of their entitlement.

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The Health and Welfare Statement of Position Task Force acknowledges the contributions of former employee benefit plans committee members; Linda Delahanty, technical manager, AICPA Accounting & Auditing Publications; and the Office of Chief Accountant, Pension and Welfare Benefits Administration of the U.S. Department of Labor.

[The next page is 80,901.]

Section 10,840

Statement of Position 01-5 Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification

December 14, 2001

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This AICPA Statement of Position (SOP) amends AICPA SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises* [section 10,630], as a result of the completion of the National Association of Insurance Commissioners (NAIC) Codification of statutory accounting practices for certain insurance enterprises.

The amendments to SOP 94-5 [section 10,630] included in this SOP require insurance enterprises to disclose, at the date each balance sheet is presented, beginning with financial statements for fiscal years ending on or after December 15, 2001, a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed statutory accounting practices or NAIC statutory accounting practices. Retroactive application is not permitted.

Those disclosures should be made if (*a*) state prescribed statutory accounting practices differ from NAIC statutory accounting practices or (*b*) permitted state statutory accounting practices differ from either state prescribed statutory accounting practices or NAIC statutory accounting practices, and the use of prescribed or permitted statutory accounting practices (individually or in the

aggregate) results in reported statutory surplus or risk-based capital that is significantly different from the statutory surplus or risk-based capital that would have been reported had NAIC statutory accounting practices been followed.

Those disclosures should be applied by a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, if the enterprise prepares U.S. generally accepted accounting principles (GAAP) financial statements. If a foreign insurance enterprise that does not have a U.S. insurance subsidiary prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, the notes to the financial statements should disclose permitted regulatory accounting practices that significantly differ from the prescribed regulatory accounting practices of its respective regulatory authority and their monetary effects.[*]

This SOP also includes the following auditing guidance that has been updated as a result of the completion of the NAIC Codification: AICPA SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises* [section 14,310]; SOP 94-1, *Inquiries of State Insurance Regulators* [section 14,290]; and AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of Statement on Auditing Standards (SAS) No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60–.81). The included auditing guidance has been approved by the Auditing Standards Board.

This SOP is effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements. If comparative financial statements are presented for fiscal years ending before December 15, 2001, the disclosure provisions of SOP 94-5 [section 10,630] effective prior to this SOP apply to permitted statutory accounting practices by the regulatory authority.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing a final document.

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[*] It should be noted that the language of this Statement of Position (SOP) assumes for simplicity that the reporting entity is a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, that prepares U.S. generally accepted accounting principles (GAAP) financial statements. Clarification of the disclosure requirements for a foreign insurance enterprise that does not have a U.S. insurance subsidiary and prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, is noted in footnote 1 of paragraph 8 of the amended SOP 94-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises* [section 10,630.09].

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.

2. The proposal will result in an improvement in practice.

3. The AICPA demonstrates the need for the proposal.

4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Background and Basis for Conclusions

.01 In 1999, the National Association of Insurance Commissioners (NAIC) completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. The insurance laws and regulations of most states require insurance enterprises domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as prescribed or permitted by state law.

.02 Prescribed statutory accounting practices are practices incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. States may adopt the revised Manual in whole, or in part, as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence.

.03 Permitted statutory accounting practices include practices not prescribed by the domiciliary state, but allowed by the domiciliary state regulatory authority. An insurance enterprise may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (*a*) if it wishes to depart from the prescribed statutory accounting practice or (*b*) if prescribed statutory accounting practices do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

.04 The revised Manual is effective for implementation on January 1, 2001, as the foundation for statutory accounting practices. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual.

.05 This Statement of Position (SOP) amends the guidance in AICPA SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises* [section 10,630], for changes related to the NAIC Codification. The amendments to SOP 94-5 [section 10,630] included in this SOP require a U.S.

insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, that prepares U.S. generally accepted accounting principles (GAAP) financial statements to disclose, at the date each balance sheet is presented, beginning with financial statements for fiscal years ending on or after December 15, 2001, a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed statutory accounting practices or NAIC statutory accounting practices.[1] The Accounting Standards Executive Committee (AcSEC) believes that this disclosure is useful because it distinguishes both prescribed and permitted practices of insurers by state, and presents statutory surplus of insurers on a comparable basis. AcSEC is aware that certain insurance enterprises domiciled in Bermuda, the Cayman Islands, and other foreign jurisdictions may prepare financial statements in accordance with accounting principles generally accepted in the United States of America even though such enterprises do not conduct business in the United States. Additionally, a U.S.-based enterprise may have a foreign domiciled insurance subsidiary and a foreign-based enterprise may have a U.S.-domiciled insurance subsidiary. Because foreign insurance operations (whether they are in a foreign subsidiary of a U.S.-based enterprise, the foreign insurance operations of a foreign-based enterprise that has U.S.-domiciled operations or the foreign insurance operations of a foreign-based enterprise that does not have U.S.-domiciled insurance operations) are not subject to the United States regulatory framework, AcSEC does not believe it is appropriate for those enterprises to determine how the NAIC Codification would affect foreign insurance operations. With respect to their foreign insurance operations, those enterprises should disclose a description of and related monetary effect of any permitted regulatory accounting practices granted by their respective regulatory authority. The disclosure requirements need not apply to a foreign parent that files financial statements in accordance with home country GAAP that are reconciled to accounting principles generally accepted in the United States.

.06 This SOP also includes the following auditing guidance that has been updated based on the completion of the NAIC Codification: AICPA SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises* [section 14,310]; AICPA SOP 94-1, *Inquiries of State Insurance Regulators* [section 14,290]; and AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of Statement on Auditing Standards No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60–.81). The included auditing guidance has been approved by the Auditing Standards Board.

.07 AcSEC believes it is appropriate to have all accounting and auditing guidance that changes due to the completion of the NAIC Codification in one document, because it is easier for readers to review all relevant changes related to this topic. This SOP includes complete sets of updated accounting and auditing guidance, marked to show additions and deletions for changes related

[1] The language of this Statement of Position (SOP) assumes for simplicity that the reporting entity is a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, that prepares U.S. generally accepted accounting principles (GAAP) financial statements. If a foreign insurance enterprise that does not have a U.S. insurance subsidiary prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, the notes to the financial statements should disclose permitted regulatory accounting practices that significantly differ from the prescribed regulatory accounting practices of its respective regulatory authority and their monetary effects.

to the NAIC Codification. In April 2001, AcSEC issued for public comment an exposure draft of a proposed SOP, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*. During the forty-five-day comment period, AcSEC received two comment letters.

Amendments to SOP 94-5 [section 10,630]

.08 The following replaces or modifies several paragraphs of SOP 94-5 [section 10,630] as a result of the completion of the NAIC Codification. New language is underlined; deleted material is in strikethrough. The changes are effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date. There are no changes to the original paragraphs 9 and 11 [section 10,630.10 and .12]; those paragraphs are included here for completeness.

~~**Introduction**~~

~~**.01** Most of the accounting principles related to disclosures for insurance enterprises were promulgated over twenty years ago when the insurance regulatory and business environments were less complex and volatile. Accordingly, the AICPA Accounting Standards Executive Committee (AcSEC) added a project to its agenda to consider whether new disclosures should be required in insurance enterprises' financial statements. This statement of position (SOP) is a result of that project.~~

Scope

.01 ~~**.02**~~ This <u>Statement of Position</u> (SOP) applies to annual and complete sets of interim financial statements prepared in conformity with generally accepted accounting principles (GAAP) of life and health insurance enterprises (including mutual life insurance enterprises), property and casualty insurance enterprises, reinsurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, financial guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies. ~~Furthermore, AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis" (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60-.79), requires auditors to apply the same disclosure evaluation criteria for statutory financial statements as they do for financial statements prepared in conformity with GAAP.~~

<u>**Applicability to Statutory Financial Statements**</u>

<u>**.02** AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of Statement on Auditing Standards No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60–.81), requires auditors to apply the same disclosure evaluation criteria for statutory financial statements and for financial statements prepared in conformity with GAAP.</u>

Relationship to Other Pronouncements

.03 In some circumstances, the disclosure requirements in this SOP may be similar to, or overlap, the disclosure requirements in certain other authoritative accounting pronouncements issued by the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), ~~and~~ <u>or</u> the Securities and Exchange Commission (SEC). For example—

- FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, requires certain disclosures related to loss contingencies, including catastrophe losses of property and casualty insurance companies.

- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, requires certain disclosures about liabilities for unpaid claims and claim adjustment expenses and statutory capital.

- FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, requires certain disclosures about reinsurance transactions.

- AICPA SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* [section 10,640], requires disclosures about certain significant estimates.

- The SEC Securities Act Guide 6, *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters*, requires disclosures of information about liabilities for unpaid claims and claim adjustment expenses.

The disclosure requirements in this SOP supplement the disclosure requirements in other authoritative pronouncements. This SOP does not alter the requirements of any FASB or SEC pronouncement.

Conclusions

.04 The disclosure requirements in this section should be read in conjunction with appendix A, "Illustrative Disclosures," item A-2 [paragraph .15], and appendix B, "Discussion of Conclusions," item B-1 [paragraph .16]. ~~of this SOP.~~

~~Permitted~~ Statutory Accounting Practices

.05 ~~Insurance enterprises currently prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the insurance department of their state of domicile. The National Association of Insurance Commissioners (NAIC) currently has a project under way to codify statutory accounting practices through a complete revision of its *Accounting Practices and Procedures Manuals*, that, when complete, is expected to replace prescribed or permitted statutory accounting practices as the statutory basis of accounting for insurance enterprises (referred to hereafter as the "codification"). Therefore, the codification will likely result in changes to what is currently considered a prescribed statutory accounting practice. Furthermore, postcodification-permitted statutory accounting practices will be exceptions to the statutory basis of accounting~~. The insurance laws and regulations of most states require insurance enterprises domiciled in those states to comply with the guidance provided in the National Association of Insurance Commissioners (NAIC) *Accounting Practices and Procedures Manual*, except as prescribed or permitted by state law. In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual. Auditors of insurance enterprises should monitor the status of the adoption of the revised Manual by the various state regulatory authorities.

.06 Prescribed ~~precodification~~ statutory accounting practices ~~include~~ are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state~~;~~. ~~*NAIC Annual Statement Instructions*; the *NAIC Accounting Practices and Procedures Manuals*; the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the NAIC *Examiners' Handbook*.~~ A state may adopt the revised Manual in whole, or in part, as an element of prescribed statutory accounting practices. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state.

.07 Permitted statutory accounting practices include practices not prescribed by the domiciliary state as described in paragraph .06 above, but allowed by the domiciliary state ~~insurance department~~ regulatory authority. An ~~I~~insurance enterprises may request permission from the domiciliary state ~~insurance department~~ regulatory authority to use a specific accounting practice in the preparation of ~~their~~ the enterprise's statutory financial statements (*a*) ~~when the enterprise~~ if it wishes to depart from the prescribed statutory accounting practices, or (*b*) ~~when~~ if prescribed statutory accounting practices do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

.08 The disclosures in this paragraph should be made ~~for permitted statutory accounting practices for the most recent fiscal year presented, regardless of when the permitted statutory accounting practice was initiated~~. if (*a*) state prescribed statutory accounting practices differ from NAIC statutory accounting practices or (*b*) permitted state statutory accounting practices differ from either state prescribed statutory accounting practices or NAIC statutory accounting practices. The disclosures should be made if the use of prescribed or permitted statutory accounting practices (individually or in the aggregate) results in reported statutory surplus or risk-based capital that is significantly different from the statutory surplus or risk-based capital that would have been reported had NAIC statutory accounting practices been followed. If an insurance enterprise's risk-based capital would have triggered a regulatory event had it not used a permitted practice, that fact should be disclosed in the financial statements. Insurance enterprises should disclose, at the date each financial statement is presented, a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed statutory accounting practices or NAIC statutory accounting practices.[1] ~~Insurance enterprises should disclose the following information about permitted statutory accounting practices that individually or in the aggregate materially affect statutory surplus or risk-based capital, including GAAP practices when the permitted practices differ from the prescribed statutory accounting practices:~~

~~*a.* A description of the permitted statutory accounting practice~~

~~*b.* A statement that the permitted statutory accounting practice differs from prescribed statutory accounting practices~~

~~*c.* The monetary effect on statutory surplus~~

~~Insurance enterprises should disclose the following information about permitted statutory accounting practices, excluding GAAP practices used, when prescribed statutory accounting practices do not address the accounting for the transaction:~~

~~*a.* A description of the transaction and of the permitted statutory accounting practice used~~

~~*b.* A statement that prescribed statutory accounting practices do not address the accounting for the transaction~~

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[1] Disclosures in this paragraph should be applied by a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, if the enterprise prepares U.S. generally accepted accounting principles (GAAP) financial statements. If a foreign insurance enterprise that does not have a U.S. insurance subsidiary prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, the notes to the financial statements should disclose permitted regulatory accounting practices that significantly differ from the prescribed regulatory accounting practices of its respective regulatory authority and their monetary effects.

Liability for Unpaid Claims and Claim Adjustment Expenses

.09 The liability for unpaid claims and claim adjustment expenses represents the amounts needed to provide for the estimated ultimate cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the statement of financial position date). The estimated liability includes the amount of money that will be required for future payments of (*a*) claims that have been reported to the insurer, (*b*) claims related to insured events that have occurred but that have not been reported to the insurer as of the date the liability is estimated, and (*c*) claim adjustment expenses. Claim adjustment expenses include costs incurred in the claim settlement process such as legal fees; outside adjuster fees; and costs to record, process, and adjust claims.

.10 Financial statements should disclose for each fiscal year for which an income statement is presented the following information about the liability for unpaid claims and claim adjustment expenses:

a. The balance in the liability for unpaid claims and claim adjustment expenses at the beginning and end of each fiscal year presented, and the related amount of reinsurance recoverable

b. Incurred claims and claim adjustment expenses with separate disclosure of the provision for insured events of the current fiscal year and of increases or decreases in the provision for insured events of prior fiscal years

c. Payments of claims and claim adjustment expenses with separate disclosure of payments of claims and claim adjustment expenses attributable to insured events of the current fiscal year and to insured events of prior fiscal years

Also, insurance enterprises should discuss the reasons for the change in ~~the provision for~~ incurred claims and claim adjustment expenses recognized in the income statement attributable to insured events of prior fiscal years and should indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects.

.11 In addition to the disclosures required by FASB Statement No. 5 and other accounting pronouncements, insurance enterprises should disclose management's policies and methodologies for estimating the liability for unpaid claims and claim adjustment expenses for difficult-to-estimate liabilities, such as for claims for toxic waste cleanup, asbestos-related illnesses, or other environmental remediation exposures.

Effective Dates and Transition

.12 ~~This~~ The provisions of this SOP as originally issued in 1994 are ~~is~~ effective for annual and complete sets of interim financial statements for periods ending after December 15, 1994. Disclosures of information required by paragraph .10 should be included for each fiscal year for which an income statement is presented.

.13 The provisions of this SOP as amended by AICPA SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification* [section 10,840], are effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date. Disclosures of information required by amended paragraph .08 and item A-2 in appendix A [paragraph .15] should be included for each fiscal year for which a balance sheet is presented. In the initial year of implementation of those disclosures, prior year amounts for the effect of permitted practices and prescribed practices should be disclosed as required by the SOP prior to those amendments. Retroactive application of the amendments is not permitted.

Amendments to SOP 94-5, Appendix A [section 10,630.15]

.09 The following is from SOP 94-5, appendix A, "Illustrative Disclosures" [section 10,630.15]. There are no changes to the original paragraph A-4 [section 10,630.15]. That paragraph is included here for completeness. The changes require insurance enterprises to disclose information per item A-2 [section 10,630.15], for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date. New language is underlined; deleted material is in strikethrough.

Illustrative Disclosures

A-1. The illustrations included in this appendix are guides to implementation of the disclosures required by this SOP. Insurance enterprises are not required to display the information contained herein in the specific manner or in the degree of detail illustrated. Alternative disclosure presentations are permissible if they satisfy the disclosure requirements of this Statement of Position (SOP).

Prescribed or Permitted Statutory Accounting Practices

A-2. ~~The f~~Following ~~is an~~ are two examples of illustrative~~on of~~ disclosures that an insurance enterprise ~~would~~ could make ~~before the codification is complete~~, to meet the requirements of paragraph .08, item 8, of this SOP.

Note X. ~~Permitted~~ Statutory Accounting Practices

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department. [*State of domicile*] has adopted the National Association of Insurance Commissioners' statutory accounting practices (NAIC SAP) as the basis of its statutory accounting practices, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of [*state of domicile*] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP. This accounting practice increased statutory capital and surplus by $2.5 million and $2.3 million at December 31, 20X2 and 20X1, respectively, over what it would have been had the permitted practice not been allowed. The Company's statutory capital and surplus, including the effects of the permitted practice, was $30.0 million and $27.9 million at December 31, 20X2 and 20X1, respectively.

Had the Company amortized its goodwill over ten years and recorded its home office property at depreciated cost, in accordance with NAIC SAP, the Company's capital and surplus would have been $29.9 million and $27.7 million at December 31, 20X2 and 20X1, respectively.

~~Property and Casualty Company, Inc., domiciled in ABC State, prepares its statutory financial statements in accordance with accounting practices prescribed or permitted by the ABC State Insurance Department. Prescribed statutory accounting practices include a variety of publications of the National Association of Insurance Commissioners (NAIC), as well as state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed.~~

~~The company received written approval from the ABC State Insurance Department to discount loss reserves at a rate of X percent for statutory accounting purposes, which differs from prescribed statutory accounting practices. Statutory accounting practices prescribed by ABC state require that loss reserves be discounted at Y percent. As of December 31, 19X3, that permitted transaction increased statutory surplus by $XX million over what it would have been had prescribed accounting practice been followed.~~[‡]

‡ ~~If an insurance company's risk-based capital (RBC) would have triggered a regulatory event had it not used a permitted practice, that fact should be disclosed in the financial statements.~~

Note X. Statutory Accounting Practices

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department. [*State of domicile*] has adopted the National Association of Insurance Commissioners' statutory accounting practices (NAIC SAP) as the basis of its statutory accounting practices, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of the [*state of domicile*] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP.

The monetary effect on statutory capital and surplus of using accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department is as follows:

	December 31	
	20x2	20x1
	$m	$m
Statutory capital and surplus per statutory financial statements	$30.0	$27.9
Effect of permitted practice of recording home office property at estimated fair value	(2.5)	(2.3)
Effect of [*state of domicile's*] prescribed practice of immediate write-off of goodwill[1]	2.4	2.1
Statutory capital and surplus in accordance with the NAIC statutory accounting practices[2]	$29.9	$27.7

1 This amount compared to the prior year reflects the net impact of an additional year's amortization and the fact that admitted goodwill is based on the level of statutory capital and surplus and thus can fluctuate.

2 In the initial year of implementation of this disclosure, prior year amounts for the effect of permitted practices and prescribed practices should be disclosed as required under the original SOP.

Liability for Unpaid Claims and Claim Adjustment Expenses

A-3. The following is an illustration of information an insurance enterprise would disclose to meet the requirements of paragraph .10 of this SOP. (This illustration presents amounts incurred and paid net of reinsurance. The information may also be presented before the effects of reinsurance with separate analysis of reinsurance recoveries and recoverables related to the incurred and paid amounts.)

Note X. Liability for Unpaid Claims and Claim Adjustment Expenses

Activity in the liability for unpaid claims and claim adjustment expenses is summarized as follows.

	~~19X5~~ 20X2	~~19X4~~ 20X1
Balance at January 1	$7,030	$6,687
Less reinsurance recoverables	1,234	987
Net Balance at January 1	5,796	5,700
Incurred related to:		
Current year	2,700	2,600
Prior years	(171)	96
Total incurred	2,529	2,696
Paid related to:		
Current year	781	800
Prior years	2,000	1,800
Total paid	2,781	2,600
Net Balance at December 31	5,544	5,796
Plus reinsurance recoverables	1,255	1,234
Balance at December 31	$6,799	$7,030

As a result of changes in estimates of insured events in prior years, the ~~provision of~~ claims and claim adjustment expenses (net of reinsurance recoveries of $X and $X in ~~19X5~~20X2 and ~~19X4~~20X1, respectively) decreased by $171 million in ~~19X5~~20X2 ~~because of~~ reflecting lower-than-anticipated losses on Hurricane Howard, and increased by $96 million in ~~19X4~~20X1 ~~because of~~ reflecting higher-than-anticipated losses and related expenses for claims for asbestos-related illnesses, toxic waste cleanup, and workers' compensation.

A-4. The following is an illustration of an insurance enterprise disclosure designed to meet the requirements of paragraph .11 of this SOP. (Additional disclosures about the liabilities for unpaid claims and claim adjustment expenses may be required under FASB Statement No. 5, FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, AICPA SOP 94-6 [section 10,640], and SEC requirements.)

Note X. Environmental-Related Claims

In establishing the liability for unpaid claims and claim adjustment expenses related to asbestos-related illnesses and toxic waste cleanup, management considers facts currently known and the current state of the law and coverage litigation. Liabilities are recognized for known claims (including the cost of related litigation) when sufficient information has been developed to indicate the involvement of a specific insurance policy, and management can reasonably estimate its liability. In addition, liabilities have been established to cover additional exposures on both known and unasserted claims. Estimates of the liabilities are reviewed and updated continually. Developed case law and adequate claim history do not exist for such claims, especially because significant uncertainty exists about the outcome of coverage litigation and whether past claim experience will be representative of future claim experience.

Amendments to SOP 94-5, Appendix B [section 10,630.16]

.10 The following is from SOP 94-5, appendix B, "Discussion of Conclusions," [section 10,630.16] when the SOP was originally issued in 1994. Sections B-1, B-4, B-5, B-6, B-7, and B-14 [section 10,630.16] have been revised as a result of the completion of the NAIC Codification. The remaining sections are included for background information about prior AcSEC discussions. New language is underlined; deleted material is in strikethrough.

Discussion of Conclusions

B-1. <u>In 1999, the National Association of Insurance Commissioners (NAIC) completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. This SOP was updated in 2001 to conform to the revised Manual</u>. This section discusses factors that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this SOP <u>when it was originally issued in 1994</u>. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

B-2. The business and regulatory environment of insurance enterprises has become more complex and volatile, and therefore riskier. Accordingly, AcSEC believed the need existed to reconsider the disclosures made in the financial statements of insurance enterprises.

B-3. <u>Financial Accounting Standards Board (</u>FASB) Statement of Financial Accounting Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, states financial reporting should "provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions" (paragraph 34). Further, the Concepts Statement says that to support that decision-making process, financial reports should help such users "assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprises" (paragraph 37) by providing "information about the economic resources of an enterprise, the claims to those resources. . . and the effects of transactions, events, and circumstances that change resources and claims to those resources" (paragraph 40).

B-4. AcSEC considered a wide variety of potential disclosures, and tried to identify the areas of importance to insurance enterprises for which the current disclosures were lacking. AcSEC concluded that additional disclosures in the financial statements of insurance enterprises about regulatory risk-based capital, the liability for unpaid claims, and certain accounting methods permitted by state ~~insurance departments~~ regulatory authorities would help insurance enterprises better meet the objectives of financial reporting in their financial statements. After the completion of the NAIC codification, AcSEC concluded that additional disclosures reconciling statutory surplus between statutory financial statements (including permitted practices), state prescribed basis, and in accordance with NAIC statutory accounting practices would be useful to the reader of generally accepted accounting principles (GAAP) financial statements. AcSEC is aware that certain insurance enterprises domiciled in Bermuda, the Cayman Islands, and other foreign jurisdictions may prepare financial statements in accordance with accounting principles generally accepted in the United States even though such enterprises do not conduct business in the United States. Additionally, a U.S.-based enterprise may have a foreign-domiciled insurance subsidiary and a foreign-based enterprise may have a U.S.-domiciled insurance subsidiary. Because the foreign insurance operations of such enterprises (whether they are in a foreign subsidiary of a U.S.-based enterprise, the foreign insurance operations of a foreign-based enterprise that has U.S.-domiciled operations or the foreign insurance operations of a foreign-based enterprise that does not have U.S.-domiciled insurance operations) are not subject to the United States regulatory framework, AcSEC does not believe it is appropriate for those enterprises to determine how the NAIC codification would affect foreign insurance operations. With respect to their foreign insurance operations, those enterprises should disclose a description of and related monetary effect of any permitted regulatory accounting practices granted by their respective regulatory authority. The disclosure requirements need not apply to a foreign parent that files financial statements in accordance with home country GAAP that are reconciled to accounting principles generally accepted in the United States.

Risk-Based Capital

B-5. Insurance enterprises operate in a highly regulated environment directed primarily toward safeguarding policyholders' interests and maintaining public confidence in the safety and soundness of the insurance system. Historically, regulation of insurance enterprises has monitored solvency by focusing on their capital. One of the primary tools used by state ~~insurance departments~~ regulatory authorities for ensuring that their objectives are being met is risk-based capital (RBC).

B-6. The NAIC has developed an RBC program that is used by state regulatory authorities ~~insurance departments~~ to enable them to take appropriate and timely regulatory actions relating to insurers that show signs of weak or deteriorating financial conditions. This program is encompassed in the RBC Model Acts for life and property and casualty insurers, which have been or are intended to be adopted by most of the states. RBC is a series of dynamic surplus-related formulas set forth in the NAIC's RBC instructions for life and health and for property and casualty insurance enterprises. The formulas contain a variety of weighing factors that are applied to financial balances or to levels of activity based on the perceived degree of certain risks, such as asset risk, credit risk, interest rate risk (life insurance enterprises only), underwriting risk, and other business risks, such as risks related to management, regulatory action, and contingencies. The amount determined under such formulas, the authorized control level risk-based capital, is required to be disclosed in life insurance enterprises' statutory filings starting for the year ended December 31, 1993, and in property and casualty insurance enterprises' statutory filings starting for the year ended December 31, 1994.

B-7. The exposure draft of the SOP that was originally issued in 1994 contained a requirement that insurance enterprises that are required to calculate RBC should disclose in their financial statements the ratio of total adjusted capital to authorized control level RBC and the amount of total adjusted capital for each fiscal year for which a statement of financial position is presented.

B-8. However, the NAIC's RBC Model Acts for both life and property and casualty insurers have a confidentiality provision, which states:

> [E]xcept as otherwise required under the provisions of this Act [that is, in the annual financial reports filed with state insurance departments], the making, publishing, disseminating, circulation, or placing before the public, or causing, directly or indirectly to be made, placed before the public, in a newspaper, magazine or other publication . . . with regard to the RBC levels of any insurer . . . would be misleading and is therefore prohibited.

B-9. Prior to issuing the exposure draft, based on discussions with the drafters of the RBC Model Acts and some state insurance regulators, and based on the fact that the information is already in the public domain, AcSEC believed that the confidentiality provisions were not intended to apply to disclosures in financial statements. However, a number of respondents to the exposure draft stated that they believe disclosing RBC levels in financial statements would be illegal in states that have enacted the RBC Model Acts. They point out that words in the RBC Model Acts appear to be intended to restrict *all* other disclosure of RBC levels, including in insurers' financial statements.

B-10. AcSEC continues to believe, because of the importance of RBC in the regulatory oversight of insurance enterprises, that its disclosure would improve the relevance and usefulness of insurance enterprises' financial statements, and, therefore, it should be disclosed in the financial statements. Nevertheless, AcSEC concluded the legal issues require further consideration.

B-11. AcSEC decided that this SOP should not be delayed while the legal issues regarding RBC disclosures are considered. A separate SOP on RBC disclosures will be considered at a later date.

B-12. Nevertheless, AcSEC encourages insurance enterprises to disclose RBC levels if they are domiciled in states that have not adopted the RBC Model Acts, or if they have otherwise determined that it is legal to make such disclosures in their financial statements.

B-13. The exposure draft also required insurance enterprises whose level of RBC has triggered a regulatory event[21] to disclose certain information in their financial statements. Delaying the issuance of the RBC guidance does not change the fact that under Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), auditors must consider the need for disclosures about the principal conditions and events that triggered the regulatory event and the possible effects of such conditions and events, as well as management's plans.

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[21] Under the NAIC's RBC Model Acts, when the ratio of total adjusted capital to authorized control level RBC is less than or equal to 2 or less than or equal to 2.5 with negative trends for life insurance enterprises, a regulatory event exists—that is, the insurance enterprise would fail to meet the minimum RBC requirements. There are four types of regulatory events, ranging from least to most serious: company action level event, regulatory action level event, authorized control level event, and mandatory control level event.

Permitted Statutory Accounting Practices

B-14. Permitted statutory accounting practices historically have not been disclosed in the notes to the financial statements, except to the extent that they have been disclosed in the accounting practices and procedures note to the statutory financial statements. With increasing frequency, insurance enterprises have transactions that are not explicitly addressed by prescribed accounting practices, or for which no analogous prescribed accounting practices exist. Furthermore, insurance enterprises often request exceptions from certain prescribed accounting practices. Permitted statutory accounting practices may differ from state to state, and from company to company within a state, and may change in the future. Moreover, permitted statutory accounting practices have been used to enhance insurance enterprises' surplus positions. For example, some state ~~insurance departments~~ regulatory authorities have permitted certain insurance enterprises to adjust home office facilities to appraised values even though the states' prescribed statutory accounting practices require that such assets be carried at depreciated historical cost.

B-15. AcSEC believes the required disclosure of permitted statutory accounting practices will enhance the relevance of the financial statements and fulfill the financial reporting objective of providing current and potential investors, creditors, policyholders, and other users of an insurance enterprise's financial statements with useful information. Not only will such disclosures identify situations in which permitted statutory accounting practices enhance an insurance enterprise's statutory capital and RBC position, but they also will improve the comparability of insurance enterprises' financial statements.

Liability for Unpaid Claims and Claim Adjustment Expenses

B-16. Insurance enterprises estimate their liability for unpaid claims and claim adjustment expenses for reported and unreported claims incurred as of the end of the accounting period in accordance with FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. The liability is estimated based on past loss experience, adjusted for current trends and other factors that will modify past experience. The liability may be calculated using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models.

B-17. FASB Concepts Statement No. 1, paragraph 21, states:

> The information provided by financial reporting largely reflects the financial effects of transactions and events that have already happened. Management may communicate information about its plans or projections, but financial statements and most other financial reporting are historical . . . Estimates resting on expectations of the future are often needed in financial reporting, but their major use, especially of those formally incorporated in financial statements, is to measure financial effects of past transactions or events or the present status of an asset or liability . . . . To provide information about the past as an aid in assessing the future is not to imply that the future can be predicted merely by extrapolating past trends or relationships. Users of the information need to assess the possible or probable impact of factors that may cause change and form their own expectations about the future and its relation to the past.

B-18. AcSEC believes that disclosures about an insurance enterprise's liabilities for unpaid claims and claim adjustment expenses development are useful in understanding the insurance enterprise's liabilities and results of operations. Furthermore, AcSEC notes the disclosures are the same as some of the loss reserve development disclosures that the SEC requires registrants to file with the commission under Securities Act Guide 6.

B-19. Paragraph 60(a) of FASB Statement No. 60~~, *Accounting and Reporting by Insurance Enterprises*~~, requires all insurance enterprises to disclose the basis for estimating the liabilities for unpaid claims and claim adjustment expenses. Furthermore, FASB Statement No. 5, *Accounting for Contingencies*, requires disclosure of loss contingencies not accrued, for which it is at least reasonably possible that a loss has been incurred. Because of the relatively high degree of coverage litigation and the lack of historical information regarding the amount and nature of both known and unasserted claims relating to difficult-to-estimate liabilities (such as those related to environmental related illness claims and toxic-waste cleanup claims), traditional loss reserving techniques may not be used in estimating such liabilities. Therefore, a high degree of judgment is needed in estimating the amount of losses, and practice is developing in the area. Accordingly, AcSEC believes financial statement users will benefit from disclosure of the policies and methods management has used for estimating these amounts.

Discussion of Comments Received on Exposure Draft

B-20. An exposure draft of a~~n~~ S~~s~~tatement of P~~p~~osition (SOP), *Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises*, was issued on April 20, 1994, and distributed to a variety of interested parties to encourage comment by those that would be affected by the proposal. Forty comment letters were received on the exposure draft.

Risk-Based Capital

B-21. A number of comments were received on the risk-based capital disclosures. As discussed in paragraphs B-5 through B-13, AcSEC decided to consider a separate SOP at a later date on risk-based capital disclosures. The comments will be addressed at that time.

Permitted Statutory Accounting Practices

B-22. A number of respondents to the exposure draft of the SOP requested that the disclosure requirements for permitted statutory accounting practices be postponed until after the codification is complete. AcSEC believes that the disclosures are especially important before codification to improve understanding of the factors that affect comparability among the statutory capital of insurance enterprises.

B-23. Respondents asked for clarification of how disclosure of the monetary effect of statutory surplus would be calculated, particularly when there is no prescribed accounting practice to compare with the permitted practice. AcSEC agreed and revised the exposure draft to state that for permitted statutory accounting practices used when prescribed accounting practice is silent, a description of the transaction is sufficient. Respondents also asked for clarification about whether there should be disclosure of GAAP-permitted practices when there is no prescribed statutory accounting. If an insurance company uses a GAAP practice in its statutory financial statements when there is no prescribed practice, that is still considered a permitted statutory accounting practice. However, AcSEC agreed that no disclosures should be made for GAAP practices that are used when prescribed statutory practices do not specify the accounting for the transaction.

B-24. Respondents suggested that the requirement in the exposure draft to make a statement about the codification be eliminated. AcSEC agreed the disclosure might be confusing to users of financial statements, and eliminated the requirement.

Liability for Unpaid Claims and Claim Adjustment Expenses

B-25. The exposure draft would have required disclosure of information about actuarial adjustments made for nonrecurring or abnormal experience. A number of respondents suggested that that disclosure requirement be eliminated. AcSEC was persuaded that such actuarial adjustments are a normal part of making estimates that should not be disclosed in the financial statements and eliminated the requirement.

Amendments to SOP 95-5 [section 14,310]

.11 The following replaces or modifies several paragraphs of SOP 95-5 [section 14,310] as a result of the completion of the NAIC Codification, as well as other conforming changes, including SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532), and SAS No. 93, *Omnibus Statement on Auditing Standards—2000* (AICPA, *Professional Standards*, vol. 1, AU secs. 315, 508, and 622). New language is underlined; deleted material is in strikethrough. The changes are effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001. There are no changes to the original paragraph 23 [section 14,310.26]; that paragraph is included here for completeness.

Introduction and Background

.01 All states require domiciled insurance enterprises to submit to the state insurance commissioner an annual statement on forms developed by the National Association of Insurance Commissioners (NAIC). The states also require that audited statutory financial statements be provided as a supplement to the annual statements. ~~Currently, s~~Statutory financial statements are prepared using accounting principles and practices "prescribed or permitted by the ~~insurance department~~ regulatory authority of the state of domicile," referred to in this Statement of Position (SOP) as ~~*prescribed or permitted*~~ *statutory accounting practices*. Statutory accounting practices are considered an other comprehensive basis of accounting (OCBOA) as described in Statement on Auditing Standards (SAS) No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623).

.02 ~~The NAIC is in the process of codifying statutory accounting practices for certain insurance enterprises. When the NAIC completes the codification of statutory accounting practices (the codification), it is expected that the states will require that statutory financial statements be prepared using accounting practices "prescribed in the NAIC's *Accounting Practices and Procedures Manual*," referred to in this SOP as *NAIC codified statutory accounting*~~. The insurance laws and regulations of most states require insurance companies domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as otherwise prescribed by state law. In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual. Auditors of an insurance enterprise should monitor the status of the adoption of the revised Manual by the various state regulatory authorities.

~~**.03** This SOP is intended to apply to audits of statutory financial statements pre- and post-codification. The term statutory basis of accounting is used in this SOP to refer to whatever is accepted as the statutory basis of accounting; currently, that is prescribed-or-permitted statutory accounting. When codification is complete, it is expected that the statutory basis of accounting will be NAIC-codified statutory accounting.~~

Prescribed-or-Permitted Statutory Accounting Practices

.03 ~~**.04**~~ Prescribed statutory accounting practices ~~currently~~ are those practices that are incorporated directly or by reference ~~included~~ in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state.~~; t. The NAIC *Annual Statement Instructions*; the NAIC *Accounting Practices and Procedures Manuals*; the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the NAIC *Examiner's Handbook*.~~ States may adopt the revised Manual in whole or in part as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state.

.04 ~~**.05**~~ Permitted statutory accounting practices include practices not prescribed ~~in the sources~~ by the domiciliary state as described in paragraph ~~.04~~ .03, above, but allowed by the domiciliary state ~~insurance department~~ regulatory authority. An ~~I~~insurance enterprises may request permission from the domiciliary state ~~insurance department~~ regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (*a*) ~~when~~ if it wishes to depart from the state prescribed statutory accounting practices, or (*b*) ~~when~~ if prescribed statutory accounting practices do not address the accounting for the transaction~~(s)~~. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

~~*NAIC-Codified Statutory Accounting*~~

~~**.06** The NAIC undertook the project to codify statutory accounting practices because the current prescribed-or-permitted statutory accounting model results in practices that may vary widely—not only from state to state, but for insurance enterprises within a state. The codification is expected to result in a hierarchy of statutory accounting practices that will provide a comprehensive basis of accounting that can be applied consistently to all insurance enterprises. Current statutory accounting practices are considered an other comprehensive basis of accounting (OCBOA) under Statement on Auditing Standards (SAS) No. 62, *Special Reports*. When codification is complete, it is anticipated that a statutory basis of accounting for insurance enterprises other than NAIC-codified statutory accounting will be considered neither generally accepted accounting principles (GAAP) nor OCBOA.[‡] SAS No. 62, paragraphs 27 to 30, provides guidance on reporting on financial statements prepared on a basis of accounting prescribed in an agreement that results in a presentation that is not in conformity with GAAP or OCBOA. That guidance is for financial statements prepared in accordance with an agreement (for example, a loan agreement) and that form of report should not be used for statutory financial statements of insurance enterprises.~~

~~‡ When the codification is complete, certain amendments to SAS No. 62 would be required.~~

Other Relevant AICPA Pronouncements

.05 ~~**.07**~~ During 1994, the AICPA issued the following two pronouncements that address statutory accounting practices and statutory financial statements. These documents were amended by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification* [section 10,840].

a. SOP 94-1, *Inquiries of State Insurance Regulators* [section 14,290], requires, for each audit, auditors to obtain sufficient competent evidential matter to corroborate management's assertion that permitted statutory accounting practices that are material to an insurance enterprise's financial statements are permitted by the ~~insurance department~~ regulatory authority of the state of domicile.

b. SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises* [section 10,630], requires insurance enterprises to disclose information about prescribed and permitted statutory accounting practices in their financial statements.

Applicability

.06 ~~.08~~ This SOP applies to all audits of statutory financial statements of insurance enterprises that file financial statements with state regulatory authorities ~~insurance departments~~, including stock and mutual insurance enterprises. Insurance enterprises that prepare statutory financial statements include life and health insurance enterprises, property and casualty insurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or inter-insurance exchanges, pools, syndicates, captive insurance companies, financial guaranty insurance enterprises, health maintenance organizations, and hospital, medical, and dental service or indemnity corporations.

.07 ~~.09~~ This SOP supersedes SOP 90-10, *Reports on Audited Financial Statements of Property and Liability Insurance Companies*. It also amends the AICPA Audit and Accounting Guides *Audits of Property and Liability Insurance Companies* and *Life and Health Insurance Entities*. ~~the AICPA Industry Audit Guide Audits of *Stock Life Insurance Companies*.~~[2]

~~[2] The AICPA is revising the Audit and Accounting Guide *Audits of Life and Health Insurance Entities*, which will incorporate this SOP.~~

Conclusions

***Superseding Statement of Position 90-10*, Reports on Audited Financial Statements of Property and Liability Insurance Companies**

.08 ~~.10~~ Auditors should not issue reports on statutory financial statements as to fair presentation in conformity with ~~the~~ statutory accounting practices ~~basis of accounting~~ that include a disclaimer of opinion as to fair presentation in conformity with generally accepted accounting principles (GAAP).

General-Use ~~Distribution~~ Reports

.09 ~~.11~~ ~~Under SAS No. 62, i~~If an insurance enterprise's statutory financial statements are intended for distribution other than for filing with the regulatory authorities ~~insurance departments~~ to whose jurisdiction the insurance enterprise is subject, the auditor of those statements should use the general-use ~~distribution~~ form of report for financial statements that lack conformity with GAAP (SAS No. 62, *Special Reports* [AICPA, *Professional Standards*, vol. 1, AU sec. 623]). ~~Paragraph .04 in~~ SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, "Lack of Conformity With Generally Accepted Accounting Principles," AU sec. 544.04)~~*Lack of Conformity With Generally Accepted Accounting Principles*, (AICPA, *Professional Standards*, vol. 1, AU sec. 544)~~, requires the auditor to use the standard form of report described in SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), modified as appropriate because of departures from GAAP.

.10 ~~.12~~ Although it may not be practicable to determine the amount of difference between GAAP and ~~the~~ statutory accounting practices ~~basis of accounting~~, the nature of the differences is known. The differences generally exist in significant financial statement items, and are believed to be material and pervasive to most insurance enterprises' financial statements. Therefore, there is a rebuttable presumption that the differences between GAAP and ~~the~~ statutory accounting practices ~~basis of accounting~~ are material and pervasive.

~~Therefore, a~~Auditors should express an adverse opinion with respect to conformity with GAAP ~~(refer to SAS No. 58, paragraph 67)~~, unless the auditor determines the differences between GAAP and ~~the~~ statutory accounting practices ~~basis of accounting~~ are not material and pervasive.

.11 ~~**.13**~~ ~~Paragraphs 68 and 69 in SAS No. 58 requires an~~ The auditor, when expressing an adverse opinion, is required to disclose in a separate explanatory paragraph(s) preceding the opinion paragraph in his or her report (*a*) all of the substantive reasons for the adverse opinion, and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable[~~3~~1] (AU sec. 508.59 and .60). If the effects are not reasonably determinable, the report should so state, and also should state that the differences are presumed to be material. Furthermore, the notes to the statutory financial statements should discuss ~~the~~ statutory accounting practices ~~basis of accounting~~ and describe how those practices differ from GAAP.

.12 ~~**.14**~~ After expressing an ~~adverse or qualified~~ opinion on the statutory financial statements as to conformity with GAAP, auditors may express an opinion on whether the statutory financial statements are presented in conformity with ~~the~~ statutory accounting practices. ~~basis of accounting under SAS No. 1, section 544. If, as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, an accounting practice that departs from that basis of accounting, regardless of whether required by state law or permitted by state regulators, would be considered an exception to the statutory basis of accounting. Accordingly~~, If ~~such~~ departures from statutory accounting practices are found to exist and are considered to be ~~are~~ material, the auditors should express a qualified or adverse opinion on the statutory financial statements just as they would under SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 508) regarding conformity with GAAP.[~~4~~]

.13 ~~**.15**~~ Following is an illustration of an independent auditor's report on the general-use ~~distribution statutory~~ financial statements of an insurance enterprise prepared in conformity with ~~prescribed-or-permitted~~ statutory accounting practices, which contains an adverse opinion as to conformity with GAAP, and an unqualified opinion as to conformity with ~~the~~ statutory accounting practices ~~basis of accounting~~. In this illustrative report, it is assumed that the effects on the statutory financial statements of the differences between GAAP and ~~the~~ statutory accounting practices ~~basis of accounting~~ are not reasonably determinable.

[~~3~~1] SAS No. 32, *Adequacy of Disclosure in the Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 431), defines practicable as "the information is reasonably obtainable from management's accounts and records and that providing the information in his report does not require the auditor to assume the position of a preparer of financial information." For example, if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the audit, the information should be presented in the auditor's report.

[~~4~~] ~~See footnote 1~~.

Independent Auditor's Report

To the Board of Directors
ABC Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of ABC Insurance Company as of December 31, ~~19~~20X2 and ~~19~~20X1, and the related statutory statements of income and changes in surplus, and cash flows for the years then ended.

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with ~~generally accepted~~ auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note X to the financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of [*state of domicile*],[5] which practices differ from generally accepted accounting principles. The effects on the financial statements of the variances between ~~the~~ statutory accounting practices ~~basis of accounting~~ and ~~generally accepted~~ accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with ~~generally accepted~~ accounting principles generally accepted in the United States of America, the financial position of ABC Insurance Company as of December 31, 20~~19~~X2 and 20~~19~~X1, or the results of its operations or its cash flows for the years then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of ABC Insurance Company as of December 31, 20~~19~~X2 and 20~~19~~X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

~~5~~ ~~If, as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, this paragraph should be modified to state that the company prepared the financial statements using accounting practices "prescribed by the NAIC's Accounting Practices and Procedures Manual," or other appropriate language~~.

Limited-Use ~~Distribution~~ Reports

.14 ~~**.16**~~ Prescribed-or-permitted statutory accounting practices for insurance enterprises ~~currently is~~ are considered an OCBOA as described in SAS No. 62 (AICPA, *Professional Standards*, vol. 1, AU sec. 623). If an insurance enterprise's statutory financial statements are intended solely for filing with state regulatory authorities ~~insurance departments~~ to whose jurisdiction the insurance enterprise is subject, the auditor may use the form of report for financial statements prepared in accordance with a comprehensive basis of accounting other than GAAP. ~~Paragraph .05f of SAS No. 62 recognizes that~~Such reporting is appropriate even though the auditor's report may be made a matter of public record (AU sec. 623.05*f*). However, that paragraph further states that limited-use ~~distribution~~ reports may be used only if the financial statements and report are intended solely for filing with the regulatory agencies to whose jurisdiction the insurance enterprise is subject. The auditor's report should contain a statement that there is a restriction on ~~distribution~~ the use of the statutory financial statements to those within the insurance enterprise and for filing with the state regulatory authorities ~~insurance departments~~ to whose jurisdiction the insurance enterprise is subject.

.15 ~~.17~~ Although auditing standards do not prohibit an auditor from issuing limited-use ~~distribution~~ and general-use ~~distribution~~ reports on the same statutory financial statements of an insurance enterprise, it is preferable to issue only one of those types of reports. Few, if any, insurance enterprises that do not prepare financial statements in ~~accordance~~ conformity with GAAP will be able to fulfill all of their reporting obligations with limited-use ~~distribution~~ statutory financial statements.

.16 ~~.18~~ Following is an illustration, adapted from paragraph 8 of SAS No. 62 (AICPA, *Professional Standards*, vol. 1, AU sec. 623.08), of an unqualified auditor's report on limited-use ~~distribution statutory~~ financial statements prepared in conformity with ~~prescribed-or-permitted~~ statutory accounting practices.

Independent Auditor's Report

To the Board of Directors
XYZ Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 20~~19~~X2 and 20~~19~~X1, and the related statutory statements of income and changes in surplus, and cash flows, for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with ~~generally accepted~~ auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note X to the financial statements, these financial statements were prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of [*state of domicile*],[6] which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 20~~19~~X2 and 20~~19~~X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and the management of XYZ Insurance Company and state insurance departments to whose jurisdiction the company is subject and is not intended to be and should not be used by anyone other than these specified parties.

~~6~~ ~~If, as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, this paragraph should be modified to state that the company prepared the financial statements using accounting practices "prescribed by the NAIC's Accounting Practices and Procedures Manual," or other appropriate language~~.

~~**.19** In accordance with paragraph 10 of SAS No. 62, the notes accompanying an insurance enterprise's statutory financial statements should contain a summary of significant accounting policies that discusses the statutory basis of accounting and describes how the basis differs from GAAP. However, the effects of the differences need not be quantified.~~

General-Use and Limited-Use ~~Distribution~~ Reports

.17 The notes accompanying an insurance enterprise's statutory financial statements should contain a summary of significant accounting policies that discuss statutory accounting practices and describe how this basis differs from GAAP (AU sec. 623.10). In general-use statutory financial statements, the effects of the differences should be disclosed, if quantified. However, in limited-use statutory financial statements, the effects of the differences need not be quantified or disclosed.

.18 ~~**.20**~~ The auditor should consider the need for an explanatory paragraph (or other explanatory language) under the circumstances described in ~~paragraph 11 of~~ SAS No. 58 (AU sec. 508.11)and ~~paragraph 31 of~~ SAS No. 62 (AU sec. 623.31) regardless of any of the following:

a. The type of report—general-use or limited-use ~~distribution~~

b. The opinion expressed—unqualified, qualified, or adverse

c. Whether the auditor is reporting as to conformity with GAAP or conformity with the statutory accounting practices ~~basis of accounting~~

For example, in a general-use ~~distribution~~ report, an auditor may express an adverse opinion as to conformity with GAAP and an unqualified opinion as to conformity with the statutory accounting practices ~~basis of accounting~~, and also conclude there is a need to add an explanatory paragraph regarding substantial doubt about the insurance enterprise's ability to continue as a going concern; such paragraph should follow both opinion paragraphs.

.19 ~~**.21**~~ ~~As discussed in paragraph 37 of SAS No. 58 and paragraph 31 of SAS No. 62, in a separate paragraph of the auditors report, t~~The auditor may wish to emphasize a matter in a separate paragraph of the auditor's report [AU sections 508.37 and 623.31]. When an insurance enterprise prepares its financial statements using accounting practices prescribed or permitted by the ~~insurance department~~ regulatory authority of the state of domicile and has significant transactions that it reports using permitted accounting practices that materially affect the insurance enterprise's statutory capital,~~[7]~~ the auditor is strongly encouraged to include an emphasis-of-a-matter paragraph in the report describing the permitted practices and their effects on statutory capital.

~~[7] If, as anticipated, NAIC-codified statutory accounting replaces the prescribed or permitted statutory basis of accounting, such permitted practices would be considered departures from the statutory basis of accounting~~.

.20 ~~**.22**~~ An example of an emphasis-of-a-matter paragraph follows:

> As discussed in Note X to the financial statements, the Company received permission from the Insurance Department of the [*state of domicile*] in 20~~19~~XX to write up its home office property to appraised value; under prescribed statutory accounting practices home office property is carried at depreciated cost. As of December 31, 20~~19~~X5, that permitted accounting practice increased statutory surplus by $XX million over what it would have been had the prescribed accounting practices been followed.

.21 If subsequent to the initial adoption of the revised Manual there has been a change in accounting principles or in the method of their application that has a material effect on the comparability of the company's financial statements, the auditor should refer to the change in an explanatory paragraph of the report (AU sec. 508.16). The explanatory paragraph (following the opinion paragraph) should identify the nature of the change and refer to the note in the financial statements that discusses the change. The auditor's concurrence with a change is implicit, unless the auditor takes exception to the change in expressing the opinion as to the fair presentation of the financial statements in conformity with GAAP or the statutory accounting practices.

.22 An example of an explanatory paragraph follows:

> As discussed in Note X to the financial statements, the Company changed its method of accounting for guaranty funds and other assessments.

Mutual Life Insurance Enterprises

.23 In April 1993, the Financial Accounting Standards Board (FASB) issued Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, which concludes that mutual life insurance enterprises can no longer issue statutory financial statements that are described as "in conformity with generally accepted accounting principles." Interpretation No. 40, as amended by FASB Statement of Financial Accounting Standards No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, is effective for financial statements issued for fiscal years beginning after December 15, 1995. (FASB Statement No. 120 does not change the disclosure and other transition provisions of Interpretation No. 40.) For statutory financial statements of mutual life insurance enterprises issued before that effective date, auditors may report on the statutory financial statements as being in conformity with generally accepted accounting principles.

Effective Dates

.24 ~~This~~The provisions of this SOP as originally issued in 1995 should be applied to audits of statutory financial statements for years ended on or after December 31, 1996. The amendments to this SOP are effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001. Retroactive application is not permitted.

Amendments to SOP 94-1 [section 14,290]

.12 The following replaces or modifies several paragraphs of SOP 94-1 [section 14,290] as a result of the completion of the NAIC Codification. New language is underlined; deleted material is in strikethrough. The changes are effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001. There are no changes to the original paragraphs 1 [section 14,290.01] and 4 [section 14,290.05]; those paragraphs are included here for completeness.

Introduction

.01 This S~~s~~tatement of P~~p~~osition (SOP) addresses the auditor's consideration of regulatory examinations as a source of evidential matter in conducting an audit of an insurance enterprise's financial statements and the auditor's evaluation of material permitted statutory accounting practices.

Applicability

.02 This SOP applies to audits of financial statements of life insurance enterprises,[1] property and casualty insurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies. It amends chapters 2 ("Audit Considerations") of the AICPA Audit and Accounting Guides *Audits of Property and Liability Insurance Companies* and *Life and Health Insurance Entities*~~chapter 9 ("Auditing Procedures") of the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*.~~~~[2]~~

[1] FASB Intrepretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, clarifies that FASB Statements and Interpretations and Accounting Principles Board (APB) Opinions apply to mutual life insurance enterprises, except when specifically exempted, that prepare financial statements in conformity with generally accepted accounting principles. This SOP applies to audits of mutual life insurance enterprises.

~~[2] The AICPA's Insurance Companies Committee technical agenda includes a project to supersede the Industry Audit Guide Audits of Stock Life Insurance Companies. The new Audit and Accounting Guide Audits of Life and Health Insurance Enterprises will include the guidance contained in this SOP.~~

.03 The insurance laws and regulations of most states require insurance companies domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as prescribed by state law. In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual. Auditors of an insurance enterprise should monitor the status of the adoption of the revised Manual by the various state regulatory authorities.

Auditor's Consideration of State Regulatory Examinations

.04 ~~**.03**~~ ~~Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates*, states that t~~The auditor should consider evaluating "information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies~~.~~" (Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates,* AICPA, *Professional Standards*, vol. 1, AU sec. 342). ~~SAS No. 54, Illegal Acts by Clients, notes that "t~~The auditor may encounter specific information that may raise a question concerning possible illegal acts, such as . . . violations of laws or regulations cited in reports of examinations by regulatory agencies that have been available to the auditor~~.~~" (SAS No. 54, *Illegal Acts by Clients,* AICPA, *Professional Standards*, vol. 1, AU sec. 317). Accordingly, it is appropriate that the auditor review examination reports and related communications between regulators and the insurance enterprise to obtain competent evidential matter.

.05 ~~**.04**~~ The auditor should review reports of examinations and communications between regulators and the insurance enterprise and make inquiries of the regulators. The auditor should—

- Request that management provide access to all reports of examinations and related correspondence including correspondence relating to financial conditions.

- Read reports of examinations and related correspondence between regulators and the insurance enterprise during the period under audit through the date of the auditor's report.
- Inquire of management and communicate with the regulators, with the prior approval of the insurance enterprise, when the regulators' examination of the enterprise is in process or a report on an examination has not been received by the insurance enterprise regarding conclusions reached during the examination.

.06 ~~**.05**~~ A refusal by management to allow the auditor to review communications from, or to communicate with, the regulator would ordinarily be a limitation on the scope of the audit sufficient to preclude an unqualified opinion. (~~See~~ SAS No. 58, *Reports on Audited Financial Statements*, (AICPA, *Professional Standards*, vol. 1, AU sec. 508). A refusal by the regulator to communicate with the auditor may be a limitation on the scope of the audit sufficient to preclude an unqualified opinion, depending on the auditor's assessment of other relevant facts and circumstances.

Auditor's Consideration of Permitted Statutory Accounting Practices

.07 ~~**.06**~~ Prescribed statutory accounting practices ~~currently include~~ are those practices incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. ~~; the National Association of Insurance Commissioners (NAIC) Annual Statement Instructions; the NAIC *Accounting Practices and Procedures Manuals*; the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the *NAIC Examiners' Handbook*~~. States may adopt the revised Manual in whole, or in part, as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state.

.08 ~~**.07**~~ Permitted statutory accounting practices include practices not prescribed by the domiciliary state, as described in paragraph ~~.06~~ .07 above, but allowed by the domiciliary state ~~insurance department~~ regulatory authority. An insurance enterprise~~s~~ may request permission from the domiciliary state ~~insurance department~~ regulatory authority to use a specific accounting practice in the preparation of ~~their~~ the enterprise's statutory financial statements (*a*) ~~when the enterprise~~ if it wishes to depart from the prescribed statutory accounting practices, or (*b*) ~~when~~ if prescribed statutory accounting practices do not address the accounting for the transaction~~(s)~~. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

.09 ~~**.08**~~ Auditors should exercise care in concluding that an accounting treatment is *permitted*, and should consider the adequacy of disclosures in the financial statements regarding such matters.[3] For each examination, auditors should obtain sufficient competent evidential matter to corroborate management's assertion that permitted statutory accounting practices that are ~~material~~ significant to an insurance enterprise's financial statements are permitted by the domiciliary state ~~insurance department~~ regulatory authority.

~~3 The AICPA has issued an exposure draft of a statement of position, *Disclosures of Certain Matters in Financial Statements of Insurance Enterprises*, that would require insurance enterprises to disclose information about permitted statutory accounting practices in their financial statements prepared in conformity with generally accepted accounting principles~~.

.10 ~~.09~~ Sufficient competent evidential matter consists of any one or combination of—

- Written acknowledgment sent directly from the regulator to the auditor. (This type of corroboration includes letters similar to attorneys' letters and responses to confirmations.)
- Written acknowledgment prepared by the regulator, but not sent directly to the auditor, such as a letter to the client.
- Direct oral communications between the regulator and the auditor, supported by written memorandum. (If the auditor, rather than the regulator, prepares the memorandum, the auditor should send such memorandum to the regulator to make sure it accurately reflects the communication.)

Auditors should use judgment to determine the type of corroboration that is necessary in the circumstances.

.11 ~~.10~~ If the auditor is unable to obtain sufficient competent evidential matter to corroborate management's assertion regarding a permitted statutory accounting practice that is material to the financial statements, the auditor should qualify or disclaim an opinion on the statutory financial statements because of the limitation on the scope of the audit~~.~~ (~~See~~ SAS No. 58 [AICPA, *Professional Standards*, vol. 1, AU sec. 508]~~, *Reports on Audited Financial Statements.*~~).

Effective Dates

.12 ~~.11~~ ~~This~~The provisions of this SOP as originally issued in 1994 should be applied to audits of financial statements performed for periods ending on or after December 15, 1994. The amendments to this SOP are effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001. Retroactive application is not permitted.

Amendments to Interpretation No. 12 of SAS No. 62 [AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60–.81]

.13 The following replaces or modifies several paragraphs of Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60–.81), as a result of the completion of the NAIC Codification. New language is underlined; deleted language is in strikethrough.

Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis

.60 *Question*—Insurance enterprises issue financial statements prepared in accordance with accounting practices prescribed or permitted by insurance regulators (a "statutory basis") in addition to, or instead of, financial statements prepared in accordance with generally accepted accounting principles (GAAP). Effective January 1, 2001, most states are expected to adopt a comprehensively updated *Accounting Practices and Procedures Manual*, as revised by the National Association of Insurance Commissioners' (NAIC's) Codification project. The updated *Accounting Practices and Procedures Manual*, along with any subsequent revisions, is referred to as the revised Manual. The revised Manual contains extensive disclosure requirements. As a result, after a state adopts the revised Manual, its statutory basis of accounting will include informative disclosures appropriate for that basis of accounting. The NAIC Annual Statement Instructions prescribe the financial statements to be included in the annual audited financial report. Some states may not adopt the revised Manual or may adopt it with significant departures. How should auditors evaluate whether informative disclosures in financial statements prepared on a statutory basis are appropriate?[1]

[1] It is possible for one of three different situations to occur: The state adopted the revised Manual without significant departures, adopted the revised Manual with significant departures, or has not yet adopted the revised Manual.

.61 *Interpretation*—Financial statements prepared on a statutory basis are financial statements prepared on a comprehensive basis of accounting other than GAAP according to ~~section 623~~ SAS No. 62, *Special Reports*. ~~Section 623.09~~ SAS No. 62 (AU sec. 623.09) states that "When reporting on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used. The auditor should apply essentially the same criteria to financial statements prepared on an other comprehensive basis of accounting ~~as he or she does~~ as those applied to financial statements prepared in conformity with generally accepted accounting principles. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation as discussed in AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, paragraph .04.

.62 SAS No. 62 ~~Section~~ (AU sec. 623.02) states that generally accepted auditing standards apply when an auditor conducts an audit of and reports on financial statements prepared on an other comprehensive basis of accounting. Thus, in accordance with the third standard of reporting, "informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

.63 *Question*—What types of items or matters should auditors consider in evaluating whether informative disclosures are reasonably adequate?

.64 *Interpretation*—~~Section~~ SAS No. 62 (AU sec. 623.09 and .10) indicates that financial statements prepared on a comprehensive basis of accounting other than GAAP should include all informative disclosures that are appropriate for the basis of accounting used~~,~~. That includes ~~including~~ a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from GAAP. ~~Section~~ SAS No. 62 (AU sec. 623.10) also states that when "the financial statements [prepared on an other comprehensive basis of accounting] contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate."

~~**.65** In addition, in 1991, the National Association of Insurance Commissioners (NAIC) has adopted new Annual Statement instruction, Annual Audited Financial Reports, under which insurance enterprises are required to include in their statutory basis financial statements those disclosures that "are appropriate to a CPA audited financial report, based on applicability, materiality and significance, taking into account the subjects covered in the instructions to and illustrations of how to report information in the notes to the financial statements section of [the] Annual Statement instructions and any other notes required by generally accepted accounting principles. . . ." The laws and regulations of some individual states contain similar requirements.~~

~~**.66** Therefore, the auditor should also consider the disclosures and illustrations of how to report information in the notes to financial statements section of the Annual Statement instructions.~~

.65 ~~**.67**~~ *Question*—How does the auditor evaluate whether "similar informative disclosures" are appropriate for—

a. Items and transactions that are accounted for essentially the same or in a similar manner under a statutory basis as under GAAP?

b. Items and transactions that are accounted for differently under a statutory basis than under GAAP?

c. Items and transactions that are accounted for differently under requirements of the state of domicile than under the revised Manual?

.66 ~~**.68**~~ *Interpretation*—Disclosures in statutory basis financial statements for items and transactions that are accounted for essentially the same or in a similar manner under ~~a~~ the statutory basis as under GAAP should be the same as, or similar to, the disclosures required by GAAP unless the revised Manual specifically states the NAIC Codification rejected the GAAP disclosures. Disclosures should also include those required by the revised Manual. ~~Other disclosures considered necessary upon review of the Annual Statement instructions should also be made to the extent that such disclosures are significant to the statutory basis financial statements.~~

~~**.69** For example, disclosures in statutory basis financial statements concerning financial instruments should include the applicable disclosures required by FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk, FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, and FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities.~~

.67 ~~**.70**~~ Disclosures in statutory basis financial statements for items or transactions that are accounted for differently under ~~a~~ the statutory basis than under GAAP, but in accordance with the revised Manual, should be ~~the same as~~ the disclosures required by the revised Manual. ~~GAAP that are relevant to the statutory basis of accounting for that item. Such disclosures can be separated into two general categories, which are discussed in paragraphs .71–76 of this Interpretation. The examples presented are for illustrative purposes only and are not intended to be all-inclusive.~~

.68 ~~**.71** Specific disclosures are stated in GAAP literature for the accounting method used in the statutory basis financial statements, even though the item would be accounted for differently under GAAP. In such instances, the applicable GAAP disclosures should be made in addition to those disclosures considered necessary upon review of the Annual Statement instructions.~~ If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised Manual for that item or transaction, but it is in accordance with GAAP or superseded GAAP, the disclosures in statutory basis financial statements for that item or transaction should be the applicable GAAP disclosures for the GAAP or superseded GAAP. If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised Manual, GAAP or superseded GAAP, sufficient relevant disclosures should be made.

~~**.72** For example, certain leases entered into by a lessee insurance enterprise that would be accounted for as capital leases under GAAP are accounted for as operating leases by insurance enterprises in their statutory basis financial statements. In such instances, the applicable disclosures for operating leases required by FASB Statement No. 13, Accounting for Leases, should be made in the statutory basis financial statements.~~

~~**.73** Another example is reinsurance transactions. Certain reinsurance contracts are permitted to be accounted for as reinsurance transactions in statutory basis financial statements but would be accounted for as financing transactions under GAAP. In such instances, the applicable disclosures for the contracts accounted for as reinsurance transactions that are required by FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, should be made in statutory basis financial statements.~~

~~**.74** Specific disclosures are not stated in current GAAP literature for the accounting method used in the statutory basis financial statements. If statutory accounting principles (SAP) permit insurance enterprises to use an accounting method that has been superseded under GAAP literature, disclosures that were required under the superseded GAAP literature should be made.~~

~~**.75** For example, some insurance companies are permitted to account for pensions in their statutory basis financial statements using the same method as required under APB Opinion No. 8, Accounting for the Cost of Pension Plans, which was amended by FASB Statement No. 36, Disclosure of Pension Information. (APB Opinion No. 8 and FASB Statement No. 36 were superseded by FASB Statement No. 87, Employers' Accounting for Pensions [AC section P16], for fiscal years that began after December 15, 1986.) In addition to disclosing the accounting policy for pensions, insurance companies should make the disclosures contained in APB Opinion No. 8 and FASB Statement No. 36 in their statutory basis financial statements. If a company is accounting for pensions using another method of measurement, such as tax, it should make informative disclosures, at a minimum, such as type of benefit formula, funding policy, fair value of plan assets, and amount of pension costs.~~

~~**.76** A final example is deferred acquisition costs (DAC). Acquisition costs are expensed when paid under SAP and are capitalized and amortized under GAAP. FASB Statement No. 60 [AC section In6] requires certain disclosures about DAC—the nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period. Because DAC are not capitalized under SAP, such disclosures, other than a description of the accounting policy used, are unapplicable.~~

.69 ~~**.77**~~ When evaluating the adequacy of disclosures, the auditor should also consider disclosures related to matters that are not specifically identified on the face of the financial statements, such as (*a*) related party transactions, (*b*) restrictions on assets and owners' equity, (*c*) subsequent events, and (*d*) uncertainties. Other matters should be disclosed if such disclosures are necessary to keep the financial statements from being misleading.

.70 *Question*—There may also be instances in which state requirements have not been revised to reflect a new GAAP disclosure requirement. What are the disclosure requirements in those situations?

.71 *Interpretation*—Until state requirements are determined, the statutory basis financial statements should include disclosures required by new GAAP requirements that are relevant and significant to the statutory basis of accounting, pending acceptance or rejection for inclusion in the revised Manual.

Effective Date and Transition

.14 This SOP is effective for annual financial statements for fiscal years ending on or after December 15, 2001, complete sets of interim financial statements for periods beginning on or after that date, and audits of those financial statements. Disclosures of information required by the amendment of SOP 94-5 [section 10,630], in paragraph 8, item 8 [section 10,630.09], and paragraph

9 [section 10,630.10], item A-2 [section 10,630.15] of this SOP, should be included for each fiscal year for which a balance sheet is presented. Retroactive application is not permitted. If comparative financial statements are presented for fiscal years ending before December 15, 2001, the disclosure provisions of SOP 94-5 [section 10,630], as effective prior to this SOP, apply to permitted statutory accounting practices by the domiciliary state regulatory authority.

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Section 10,850

Statement of Position 01-6 Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others

December 26, 2001

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

What This Statement of Position Means for All Entities

This Statement of Position (SOP) applies to any entity that lends to or finances the activities of others. For example, that arrangement may be a secured mortgage loan, an unsecured commercial loan or a financing arrangement that only involves extending credit to trade customers resulting in trade receivables. Those financing activities of all entities are included in the scope of this SOP. Consistent with the approach taken in the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide *Audits of Finance Companies* (FC Guide), such financing activities will remain subject to those provisions, as modified by this SOP, to which they were subject under that Guide. This SOP provides specific guidance for other types of transactions, such as securities purchases, for certain financial institutions listed in the scope paragraphs of the SOP. To the extent an entity is not considered such a financial institution, as described in those paragraphs, the other guidance provided is not applicable. In other words, only the guidance in this SOP related to the financing and lending activities is applicable for entities not considered to be financial institutions.

What This SOP Means for Entities With Trade Receivables

Entities that extend trade credit to customers were included in the scope of the FC Guide and accordingly are also included in the scope of this SOP. The FC Guide covered all financing activities of business enterprises designed to encourage customers to purchase products and services. This included financings of different types and duration, from shorter term trade financings to extended term arrangements both for an entity's own products and services as well as for the products and services sold by unaffiliated businesses. While the Accounting Standards Executive Committee (AcSEC) does not believe the recognition and measurement provisions within this SOP will result in a change in practice for trade receivables, entities should carefully consider those provisions of this SOP. This SOP provides certain presentation and disclosure changes for entities with trade receivables as part of the objective of requiring consistent accounting and reporting for like transactions. This SOP also provides specific guidance for other types of transactions specific to certain financial institutions. To the extent an entity is not considered such a financial institution, the other guidance provided is not applicable.

What This SOP Means for Corporate Credit Unions and Mortgage Companies

Corporate credit unions and mortgage companies are included in the scope of this SOP. Corporate credit unions were previously explicitly not subject to the provisions of the AICPA Audit and Accounting Guide *Audits of Credit Unions* (CU Guide). Mortgage companies were previously not explicitly subject to the provisions of the AICPA Audit and Accounting Guide *Banks and Savings Institutions* (BSI Guide). Under this SOP, corporate credit unions and mortgage companies are explicitly subject to new accounting and reporting provisions and disclosure requirements, including disclosures about regulatory capital and net worth requirements.

What This SOP Means for Insurance Companies

Insurance companies were explicitly excluded from the scope of the FC Guide. Consistent with the objective of providing consistent guidance, lending and financing activities of insurance companies are included in this SOP. Additional guidance provided for financial entities, such as deposit liability disclosures, are not applicable to insurance companies.

Why Issued

In the past, the AICPA has issued Audit and Accounting Guides providing industry-specific guidance for preparers and auditors of financial statements of banks, savings institutions, credit unions, finance companies, and other entities with financing activities (including trade receivables). Although many of the transactions covered by the Guides were similar, over time the accounting guidance varied. Divergence in accounting practices among certain elements of the financial services industry for similar transactions has resulted in the need for a reconciliation of existing guidance. This SOP reconciles and conforms, as appropriate, the accounting and financial reporting provisions established by the BSI Guide, CU Guide, and FC Guide (the Guides). This SOP also explicitly incorporates mortgage companies, corporate credit unions, and certain activities of insurance companies in its scope. This SOP will be incorporated in a new AICPA Audit and Accounting Guide, which will supersede the existing Guides.

The AICPA Industry Audit and Accounting Guides are included in category (*b*) of generally accepted accounting principles (GAAP) in the hierarchy established by AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1, AU sec. 411).

This SOP eliminates differences in accounting established by the Guides where such differences are not warranted. In addition, the SOP carries forward accounting guidance for transactions unique to certain financial entities. Most of the differences between the respective Guides represent presentation or disclosure requirements; for example, one of the more important differences involves disclosure about regulatory capital requirements. The BSI Guide requires such disclosures, but the CU Guide does not. Under the SOP, regulatory capital disclosures are required for credit unions. Many of the other presentation and disclosure differences are similarly reconciled.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, before clearance, the FASB will propose suggestions, many of which are included in the documents.

Introduction

.01 Most lending and deposit-taking transactions are similar and should be accounted for similarly. Prior to this Statement of Position (SOP), certain differences in accounting for similar transactions existed among banks, savings institutions, credit unions, and finance companies (including entities with trade receivables). That banks, savings institutions, credit unions, and finance companies are organized differently is less relevant to the accounting and financial reporting of underlying transactions than that each primarily extends credit or takes deposits (or both).

.02 Therefore, this SOP clarifies that accounting and financial reporting practices for lending and financing activities should be the same regardless of the type of entity engaging in those activities. Second, this SOP eliminates potentially confusing distinctions in the former American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide *Audits of Finance Companies* (FC Guide) between what constituted a "finance company" and "financing activities." Last, this SOP conforms, where appropriate, differences among the accounting and financial reporting provisions previously established by the AICPA Audit and Accounting Guides *Banks and Savings Institutions* (BSI Guide), *Audits of Credit Unions* (CU Guide), and the FC Guide. The SOP provides for the resolution of accounting differences for similar transactions. As a result, it will improve the consistency in accounting and reporting by those entities. This SOP carries forward accounting guidance for transactions by differently organized entities determined to have unique transactions. The SOP also explicitly incorporates mortgage companies, corporate credit unions, and certain activities of insurance companies in its scope.

Scope

.03 This SOP applies to all banks, savings institutions, credit unions, finance companies, and other entities (including entities with trade receivables) subject to the existing AICPA Audit and Accounting Guides: BSI Guide, CU Guide, and FC Guide, respectively. That population includes the following:

a. Finance companies, including finance company subsidiaries

b. Entities that do not consider themselves to be finance companies that engage in transactions that involve lending to or financing the activities of others (including trade receivables and independent and captive financing activities of all kinds of entities)[1]

c. Depository institutions insured by the Federal Deposit Insurance Corporation's (FDIC's) Bank Insurance Fund (BIF) or Savings Association Insurance Fund (SAIF), or the National Credit Union Administration's (NCUA's) National Credit Union Share Insurance Fund (NCUSIF)

d. Bank holding companies

e. Savings and loan association holding companies

f. Branches and agencies of foreign banks regulated by U.S. federal banking regulatory agencies

g. State-chartered banks, credit unions, and savings institutions that are not federally insured

h. Foreign financial institutions whose financial statements are purported to be prepared in conformity with accounting principles generally accepted in the United States

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[1] The term *enterprises* is used in practice as business enterprises organized for profit. To the extent that a not-for-profit organization, as defined in Appendix D of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, conducts activities in the scope of paragraph .03, provisions of this SOP should be applied. The AICPA Industry Audit Guide *Not For Profit Organizations* provides such guidance in Appendix D, paragraph 1.27 as follows: "However, some not-for-profit organizations conduct activities in some of those industries and should apply the guidance concerning recognition and measurement of assets, liabilities, revenues, expenses, gains and losses in those pronouncements to the transactions unique to those industries."

.04 This SOP also applies to the following:

a. Mortgage companies

b. Entities that do not consider themselves to be mortgage companies that engage in transactions that involve mortgage activities or transactions

.05 Corporate credit unions are explicitly included in the scope of this SOP.

.06 Financing and lending activities of insurance companies are explicitly included in the scope of this SOP.

.07 This SOP does not apply to the following:

a. Investment companies, broker-dealers in securities, employee benefit plans and similar entities that carry loans and trade receivables at fair value with the unrealized gains and losses included in earnings

b. Governmental or federal entities that follow the principles of the Governmental Accounting Standards Board (GASB) or the Federal Accounting Standards Advisory Board (FASAB)

c. Financing and lending transactions that are subject to category (*a*) of generally accepted accounting principles (GAAP) in the hierarchy established by AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AU 411),[2] if the category (*a*) guidance differs from the guidance in this SOP

Conclusions

Recognition and Measurement for All Entities

.08 Entities within the scope of paragraphs .03 to .06 are subject to the following recognition and measurement principles.

a. *Loans and Trade Receivables Not Held For Sale*. Loans and trade receivables that management has the intent and ability to hold for the foreseeable future or until maturity or payoff should be reported in the balance sheet at outstanding principal adjusted for any chargeoffs, the allowance for loan losses (or the allowance for doubtful accounts), any deferred fees or costs on originated loans, and any unamortized premiums or discounts[3] on purchased loans.[4]

b. *Nonmortgage Loans Held For Sale*. Nonmortgage loans held for sale should be reported at the lower of cost or fair value.[5]

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[2] For example, Accounting Principles Bulletin (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, provides accounting guidance for stock loans and accordingly, such transactions are not in the scope of this SOP.

[3] Discounts offered as a result of the pricing of a sale or a product or service may be termed *sales discounts*. This SOP does not address these discounts.

[4] The Accounting Standards Executive Committee (AcSEC) expects to issue an SOP, *Accounting for Loans and Certain Debt Securities Acquired in a Transfer*, in the first quarter of 2002. The SOP updates Practice Bulletin No. 6, *Amortization of Discounts on Certain Acquired Loans* [section 12,060], and is effective for transfers of loans acquired in fiscal years beginning after June 15, 2002.

[5] This paragraph applies to nonmortgage loans. Readers should refer to FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, as amended by FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained After the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise, an Amendment of FASB Statement No. 65,* for mortgage loans classified as held for sale. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 134.]

c. *Sales of Loans Not Held For Sale*. Once a decision has been made to sell loans not previously classified as held for sale, such loans should be transferred into the held-for-sale classification and carried at the lower of cost or fair value.[6] At the time of the transfer into the held-for-sale classification, any amount by which cost exceeds fair value should be accounted for as a valuation allowance.

d. *Credit Losses*. Credit losses for loans and trade receivables, which may be for all or part of a particular loan or trade receivable, should be deducted from the allowance.[7] The related loan or trade receivable balance should be charged off in the period in which the loans or trade receivables are deemed uncollectible. Recoveries of loans and trade receivables previously charged off should be recorded when received.[8]

e. *Credit Losses on Off-Balance-Sheet Instruments*. An accrual for credit loss on a financial instrument with off-balance-sheet risk should be recorded separate from a valuation account related to a recognized financial instrument. Credit losses for off-balance-sheet financial instruments should be deducted from the liability for credit losses in the period in which the liability is settled.[9]

f. *Standby Commitments to Purchase Loans*. Entities sometimes enter into forward standby commitments to purchase loans at a stated price in return for a standby commitment fee. In such an arrangement, settlement of the standby commitment is at the option of the seller of the loans and would result in delivery to the entity only if the contract price equals or exceeds the market price of the underlying loan or security on the settlement date. A standby commitment differs from a mandatory commitment in that the entity assumes all the market risks of ownership but shares in none of the rewards. A standby commitment is, in substance, a written put option that will be exercised only if the value of the loans is less than or equal to the strike price. Many entities use standby commitments to supplement their normal loan origination volume. If the settlement date is within a reasonable period (for example, a normal loan commitment period) and the entity has the intent and ability to accept delivery without selling assets, standby commitments are generally viewed as part of the normal production of loans, and entities record loans purchased under standby commitments at cost on the settlement date, net of the standby commitment fee received, in conformity with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. However, if the settlement date is not within

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[6] This paragraph applies to both mortgage and nonmortgage loans.

[7] AcSEC has a project that is addressing certain issues related to the allowance for credit losses. Readers should be alert to any final pronouncement.

[8] AcSEC recognizes that practices differ between entities as some industries typically credit recoveries directly to earnings while financial institutions typically credit the allowance for loan losses for recoveries. AcSEC reevaluated this practice as part of this project. AcSEC decided not to amend this practice because the combination of this practice and the practice of frequently reviewing the adequacy of the allowance for loan losses results in the same credit to earnings in an indirect manner.

[9] *Off-balance-sheet financial instruments* refers to off-balance-sheet loan commitments, standby letters of credit, financial guarantees, and other similar instruments with off-balance-sheet credit risk except for instruments within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

a reasonable period, or the entity does not have the intent and ability to accept delivery without selling assets, the standby commitment generally is accounted for as a written put option. In that case, the option premium received (standby commitment fee) should be recorded as a liability representing the fair value of the standby commitment on the trade date. Thereafter, the liability should be accounted for at the greater of the initial standby commitment fee or the fair value of the written put option. Unrealized gains (that is, recoveries of unrealized losses) or losses should be credited or charged to current operations.[10]

g. *Criteria for Sale of Servicing Rights*. Criteria that should be considered when evaluating whether a transfer of servicing rights qualifies as a sale are the guidance, as applicable, in Emerging Issue Task Force (EITF) Issue No. 95-5 "Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights,"[11] and the following:

- Whether the seller has received written approval from the investor if required
- Whether the buyer is a currently approved seller/servicer and is not at risk of losing approved status
- In the event of a sale in which the seller finances a portion of the sales price, whether an adequate nonrefundable down payment has been received (necessary to demonstrate the buyer's commitment to pay the remaining sales price) and whether the note receivable from the buyer provides full recourse to the buyer. Nonrecourse notes or notes with limited recourse (such as to the servicing) do not satisfy this criterion
- Also, temporary servicing performed by the transferor for a short period of time should be compensated in accordance with a subservicing agreement that provides adequate compensation.

h. *Sales of Servicing Rights*. Sales of servicing rights relating to loans previously sold should be recognized in income subject to the considerations above. Sales of servicing rights relating to loans that are retained should also be recognized in income subject to the considerations above and at the date of sale, the carrying amount should be allocated between the servicing rights and loans retained using relative fair values in a manner consistent with paragraph 10(b) of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.*[12]

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[10] This paragraph applies only to standby commitments to purchase loans. It does not apply to other customary kinds of commitments to purchase loans, nor does it apply to commitments to originate loans. The FASB staff has issued tentative guidance in Statement 133 Implementation Issue No. C13, "When a Loan Commitment Is Included in the Scope of Statement 133," regarding the circumstances in which a loan commitment or other credit arrangement should be accounted for as a derivative under FASB Statement No. 133. Readers should be alert to any final guidance.

[11] EITF Issue No. 95-5 provides guidance for determining whether a transfer of servicing rights should be accounted for as a sale.

[12] FASB Statement No. 140 does not address transfers of servicing rights because they are not financial assets. However, this SOP addresses transactions in which loans are transferred with servicing retained, and governs allocation of basis between loans and servicing rights for those transactions.

i. *Federal Home Loan Bank or Federal Reserve Bank Stock*. Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock should be classified as a restricted investment security, carried at cost, and evaluated for impairment. Both cash and stock dividends[13] received on FHLB stock are reported as income. The stock dividends are redeemable at par value. FHLB stock is generally viewed as a long-term investment. Accordingly, when evaluating FHLB stock for impairment, its value should be determined based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The determination of whether the decline affects the ultimate recoverability is influenced by criteria such as the following:

- The significance of the decline in net assets of the FHLBs as compared to the capital stock amount for the FHLBs and the length of time this situation has persisted
- Commitments by the FHLBs to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLBs
- The impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLBs
- The liquidity position of the FHLBs

j. *Delinquency Fees*. Delinquency fees should be recognized in income when chargeable, assuming collectibility is reasonably assured.

k. *Prepayment Fees*. Prepayment penalties should not be recognized in income until loans (or trade receivables, if applicable) are prepaid, except that the existence of prepayment penalties may affect the accounting resulting from the application of paragraph 18(a) of FASB Statement No. 91.

l. *Rebates*. Rebates represent refunds of portions of the precomputed finance charges on installment loans (or trade receivables, if applicable) that occur when payments are made ahead of schedule. Rebate calculations generally are governed by state laws and may differ from unamortized finance charges on installment loans or trade receivables because many states require rebate calculations to be based on the Rule of 78s or other methods instead of the interest method. Accrual of interest income on installment loans or trade receivables should not be affected by the possibility that rebates may be calculated on a method different from the interest method, except that the possibility of rebates affects the accounting resulting from the application of paragraph 18(a) of FASB Statement No. 91. Differences between rebate calculations and accrual of interest income merely adjust original estimates of interest income and should be recognized in income when loans or trade receivables are prepaid or renewed.

m. *Factoring Arrangements*. Transfers of receivables under factoring arrangements meeting the sale criteria of paragraph 9 of FASB Statement No. 140 are accounted for by the factor as purchases of

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[13] Chapter 7 of Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, provides guidance for stock-splits.

receivables. The acquisition of receivables and accounting for purchase discounts such as factoring commissions should be recognized in accordance with FASB Statement No. 91 or AICPA Practice Bulletin No. 6, *Amortization of Discounts on Certain Acquired Loans* [section 12,060], as applicable.[14] Transfers not meeting the sale criteria in FASB Statement No. 140 are accounted for as secured loans (that is, loans collateralized by customer accounts or receivables). Paragraph 15 of FASB Statement No. 140 provides additional guidance in those situations. Factoring commissions under these arrangements should be recognized over the period of the loan contract in accordance with FASB Statement No. 91. That period begins when the finance company (or an entity with financing activities [including trade receivables]) funds a customer's credit and ends when the customer's account is settled.

Recognition and Measurement for Financial Institutions[15] and Entities With Financing or Mortgage Activities

.09 *Insurance Commissions.* For entities within the scope of paragraphs .03 to .05, income from experience-rated or retrospective commission arrangements should be recognized over the applicable insurance risk period.

Recognition and Measurement for Financial Institutions

.10 Entities within the scope of paragraphs .03 (excluding .03*b*) and .04 (excluding .04*b*) and .05 are subject to the following recognition and measurement principles.

a. *Regular-Way Securities.* Regular-way[16] purchases and sales of securities should be recorded on the trade date. Gains and losses from regular-way security sales or disposals should be recognized as of the trade date in the statement of operations for the period in which securities are sold or otherwise disposed of.

b. *Short Sales of Securities.* The obligations incurred in short sales[17] should be reported as liabilities and adjusted to fair value through the income statement at each reporting date. Such liabilities are generally called "securities sold, not yet purchased." The fair value adjustment should be classified in the income statement with gains and losses on securities. Interest on the short positions should be accrued periodically and reported as interest expense.

c. *Deposits.* The institution's liability for deposits originates and should be recognized at the time deposits are received rather than when the institution collects the funds. Checks that are deposited by customers and that are in the process of collection and are currently

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[14] See footnote 4.

[15] For purposes of this SOP, *financial institution* (or *institution*) denotes a bank, credit union, finance company, mortgage company, or savings institution.

[16] In paragraph 275 of FASB Statement No. 133, *regular-way* is defined as follows:

> Regular-way security trades are those that are completed (or settled) within the time period generally established by regulations and conventions in the marketplace or by the exchange on which the transaction is being executed.

[17] Paragraph 59(d) of FASB Statement No. 133 discusses short sales.

not available for withdrawal (deposit float) should be recorded as assets and liabilities. Deposits should not be recorded based solely on collections.

Recognition and Measurement for Credit Unions

.11 The following are accounting practices unique to credit unions that were initially established by the CU Guide and are carried forward to this SOP. Credit unions within the scope of paragraph .03*c* of this SOP and corporate credit unions within the scope of paragraph .05 of this SOP are subject to the following recognition and measurement provisions:

a. *NCUSIF Deposit*. Amounts deposited with the NCUSIF should be accounted for and reported as assets as long as such amounts are fully refundable. The refundability of NCUSIF deposits should be reviewed for impairment. When the refundability of a deposit is evaluated, the financial condition of both the credit union and of the NCUSIF should be considered. Deposits may be returned to solvent credit unions for a number of reasons, including termination of insurance coverage, conversion to insurance coverage from another source, or transfer of operations of the insurance fund from the NCUA Board. However, insolvent or bankrupt credit unions are not entitled to a return of their deposits. To the extent that NCUSIF deposits are not refundable, they should be charged to expense in the period in which the deposits are made or the assets become impaired.

b. In years in which the equity of the NCUSIF exceeds "normal operating levels," the NCUA Board is required to make distributions to insured credit unions to reduce the equity of the NCUSIF to normal operating levels. Such distributions may be in the form of a waiver of insurance premiums, premium rebates, or cash payments. Distributions in connection with that reduction in the equity of the NCUSIF should be reported in the income statement in the period in which it is determined that a distribution will be made.

c. The system of savings account insurance established by the recapitalization of the NCUSIF, which provided for reserves of 1 percent of insured deposits, is based on the concept that the required deposits create a fund with an earning potential sufficient to provide for the risk of losses in the credit union system. In years in which the earnings of the fund have been adequate to provide insurance protection and cover all expenses and losses incurred by the fund, the NCUA Board has elected to waive the insurance premiums due from insured credit unions. In those years, it has been industry practice to net imputed earnings on the insurance deposits against imputed premium expense rather than present them as gross amounts on the statement of income. In years in which the insurance premiums are not waived by the NCUA Board, the premiums should be expensed in the period to which they relate. To the extent that the NCUA Board assesses premiums to cover prior operating losses of the insurance fund or to increase the fund balance to "normal operating levels," credit unions should expense those premiums when assessed.

d. *Member Deposits.* Generally accepted accounting principles (GAAP)[18] require that all member deposit accounts of credit unions, including member shares, be reported unequivocally as liabilities in the statement of financial condition.[19] The statement of financial condition either (1) presents deposit accounts as the first item in the liabilities and equity section or (2) includes deposit accounts within a captioned subtotal for total liabilities. An unclassified presentation whereby all liabilities and equity are shown together under one subheading and savings accounts are presented as the last item before retained earnings is not an acceptable presentation. The interest paid or accrued on these accounts, commonly referred to as *dividends*, should be reported as an expense on the statement of income, and the amount of interest payable to members should be included as a liability in the statement of financial condition. This is the same position that the EITF reached in EITF Issue No. 89-3, "Balance Sheet Presentation of Savings Accounts in Financial Statements of Credit Unions."

Recognition and Measurement for Finance Companies and Entities With Financing Activities (Including Entities With Trade Receivables)

.12 *Favorable Financing Arrangements.* For entities within the scope of paragraphs .03*a* and .03*b*, transactions in which captive finance companies offer favorable financing to increase sales of related companies are not exempted from the scope of Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*, by paragraph 3(d) of that Opinion. APB Opinion 21 provides accounting guidance to use if the face amount of the note does not reasonably represent the present value of the consideration given or received in an exchange.

Presentation and Disclosure for All Entities

.13 Entities within the scope of paragraphs .03 to .06 are subject to the following presentation and disclosure principles.

a. *Accounting Policies for Loans and Trade Receivables.* The summary of significant accounting policies should include the following:

(1) The basis for accounting for loans, trade receivables, and lease financings, including those classified as held for sale

(2) The method used in determining the lower of cost or fair value of nonmortgage loans held for sale (that is, aggregate or individual asset basis)[20]

(3) The classification and method of accounting for interest-only strips, loans, other receivables, or retained interests in securiti-

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[18] The Credit Union Membership Access Act (CUMAA) (H.R. 1151) was passed into law in August 1998. This legislation requires all federally insured credit unions with assets of $10 million and over to follow generally accepted accounting principles (GAAP).

[19] In October 2000, the FASB issued an exposure draft of a proposed Statement, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*, and an exposure draft of a proposed amendment to FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, entitled *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities*. Readers should be alert to any final pronouncements.

[20] A similar requirement exists for mortgage loans held for sale. See paragraph 29 of FASB Statement No. 65.

zations that can be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment[21, 22, 23]

(4) The method for recognizing interest income on loan and trade receivables, including a statement about the entity's policy for treatment of related fees and costs, including the method of amortizing net deferred fees or costs.

b. *Accounting Policies for Credit Losses and Doubtful Accounts*. In addition to disclosures required by FASB Statements No. 5, *Accounting for Contingencies* 114, *Accounting by Creditors for Impairment of a Loan*,[24] and 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, a description of the accounting policies and methodology the entity used to estimate its allowance for loan losses, allowance for doubtful accounts,[25] and any liability for off-balance-sheet credit losses[26] and related charges for loan, trade receivable or other credit losses should be included in the notes to the financial statements. Such a description should identify the factors that influenced management's judgment (for example, historical losses and existing economic conditions) and may also include discussion of risk elements relevant to particular categories of financial instruments.

c. *Accounting Policies for Nonaccrual and Past Due Loans and Trade Receivables*. The summary of significant accounting policies should include the following:

(1) The policy for placing loans (and trade receivables if applicable) on nonaccrual status (or discontinuing accrual of interest) and recording payments received on nonaccrual loans (and trade receivables if applicable), and the policy for resuming accrual of interest

(2) The policy for charging off uncollectible loans and trade receivables

(3) The policy for determining past due or delinquency status (that is, whether past due status is based on how recently payments have been received or contractual terms)

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[21] This disclosure requirement applies to instruments within the scope of paragraph 14 of FASB Statement No. 140. The FASB plans to provide guidance on (*a*) which types of instruments qualify for the exception in paragraph 14 of FASB Statement No. 133 and (*b*) whether beneficial interests in securitized financial assets that are subordinated to other interests meet FASB Statement No. 133's definition of derivative instrument. Statement 133 Implementation Issue No. D1, "Recognition and Measurement of Derivatives: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets" provides interim guidance. Readers should be alert to any final guidance.

[22] See footnote 4.

[23] Footnote 17 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, states that "The *recorded investment in the receivable* is the face amount increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges, or acquisition costs and may also reflect a previous write-down of the investment."

[24] FASB Statement No. 114 states in paragraph 4 "For purposes of this Statement, a loan is a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. Examples include but are not limited to accounts receivable (with terms exceeding one year) and notes receivable."

[25] See footnote 7.

[26] *Off-balance-sheet credit losses* refers to losses on off-balance-sheet loan commitments, standby letters of credit, financial guarantees, and other similar instruments, except for instruments within the scope of FASB Statement No. 133.

d. *Sales of Loans and Trade Receivables*. The aggregate amount of gains or losses on sales of loans or trade receivables (including adjustments to record loans held for sale at the lower of cost or fair value) should be presented separately in the financial statements or disclosed in the notes to the financial statements.[27]

e. *Loans or Trade Receivables*. Loans or trade receivables may be presented on the balance sheet as aggregate amounts. However, such receivables held for sale should be a separate balance-sheet category. Major categories of loans or trade receivables should be presented separately either in the balance sheet or in the notes to the financial statements. The allowance for credit losses, the allowance for doubtful accounts, and, as applicable, any unearned income, any unamortized premiums and discounts,[28] and any net unamortized deferred fees and costs, should be disclosed in the financial statements.

f. *Foreclosed and Repossessed Assets*. Foreclosed and repossessed assets should be classified as a separate balance-sheet amount or included in other assets on the balance sheet with separate disclosures in the notes to the financial statements. Certain returned or repossessed assets, such as inventory, should not be classified separately if the assets subsequently are to be utilized by the entity in operations.

g. *Nonaccrual and Past Due Loans and Trade Receivables*. The recorded investment[29] in loans (and trade receivables if applicable) on nonaccrual status as of each balance-sheet date should be disclosed in the notes to the financial statements. The recorded investment in loans (and trade receivables if applicable) past due ninety days or more and still accruing should also be disclosed. For trade receivables that do not accrue interest until a specified period has elapsed, nonaccrual status would be the point when accrual is suspended after the receivable becomes past due.

h. *Securities on Deposit*. Insurance subsidiaries may be required to deposit securities with state regulatory authorities. If so, the carrying amount of securities deposited should be disclosed.

i. *Assets Serving as Collateral*. The carrying amount of loans, trade receivables, securities and financial instruments that serve as collateral for borrowings, should be disclosed pursuant to paragraphs 18 and 19 of FASB Statement No. 5.

Presentation and Disclosure for Financial Institutions

.14 Entities within the scope of paragraphs .03 (excluding .03*b*), .04 (excluding .04*b*), and .05 are subject to the following presentation and disclosure principles.

a. *Cash Restrictions*. Restrictions on the use or availability of certain cash balances, such as deposits with an FRB, FHLB, or correspondent financial institutions to meet reserve requirements or deposits under formal compensating balance agreements, should be disclosed in the notes to the financial statements.

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[27] AcSEC acknowledges that many financial institutions currently present such gains or losses separately on the face of the income statement. By requiring financial statement disclosure, AcSEC is not suggesting that this industry practice should be discontinued.

[28] See footnote 4.

[29] See footnote 23.

b. *Reciprocal Balances and Related Overdrafts*. A financial institution that accepts deposits may have balances due from the same financial institution from which it has accepted a deposit. Those account balances, also called reciprocal balances, should be offset if they will be offset in the process of collection or payment. Overdrafts of such accounts should be reclassified as liabilities, unless the financial institution has other accounts at the same financial institution against which such overdrafts can be offset.

c. *Sales of Premises and Equipment*. For premises and equipment, net gains or net losses on dispositions should be included in noninterest income or noninterest expense.

d. *Securities*. The carrying amount of investment assets that serve as collateral to secure public funds, securities sold under repurchase agreements, and other borrowings, that are not otherwise disclosed under FASB Statement No. 140, should be disclosed in the notes to the financial statements.

e. *Deposits*. Disclosures about deposit liabilities should include the following:

   (1) The aggregate amount of time deposit accounts (including certificates of deposit) in denominations of $100,000 or more at the balance-sheet date

   (2) Securities, mortgage loans, or other financial instruments that serve as collateral for deposits, that are otherwise not disclosed under FASB Statement No. 140

   (3) The aggregate amount of any demand deposits that have been reclassified as loan balances, such as overdrafts, at the balance-sheet date

   (4) Deposits that are received on terms other than those available in the normal course of business.

f. *Borrowings*. Significant categories of borrowings should be presented as separate line items in the liability section of the balance sheet, or as a single line item with appropriate note disclosure of components. Institutions may, alternatively, present debt based on the debt's priority (that is, senior or subordinated) if they also provide separate disclosure of significant categories of borrowings.

g. *Long-Term Obligations*. Accounting and reporting requirements for long-term obligations are the same for financial institutions as for other entities. If the financial institution has an unclassified balance sheet, there is no need to separate balances into current and long-term portions.[30]

h. *Debt*. For debt, the notes to the financial statements should describe the principal terms of the respective agreements including but not limited to the title or nature of the agreement, or both; the interest rate (and whether it is fixed or floating); the payment terms and maturity date(s); collateral; conversion or redemption features; whether it is senior or subordinated; and restrictive covenants (such as dividend restrictions), if any.

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[30] FASB Statement No. 47, *Disclosure of Long Term Obligations*, requires disclosure of future payments on long-term borrowings.

i. *Secured Borrowings.* Transfers of mortgages accounted for under FASB Statement No. 140 as secured borrowings of the issuing institution should be classified as debt on the institution's balance sheet. Such mortgage-backed bonds should be classified separately from advances, other notes payable, and subordinated debt.

j. *Offsetting Amounts in the Balance Sheet for Credit Life and Credit Accident and Health Policies.* Unearned premiums and unpaid claims on certain insurance coverage issued to finance customers by a subsidiary may represent intercompany items because premiums are added to the consumer loan account, which is in turn classified as a receivable until paid, and most or all of the payments on claims are applied to reduce the related finance receivables. Therefore, unearned premiums and unpaid claims on certain credit life and credit accident and health insurance policies issued to finance customers should be deducted from finance receivables in the consolidated balance sheet. Alternatively, the balance sheet may present only the net finance receivables if the notes to the financial statements contain sufficient disclosure of unearned premiums and unpaid claims and the allowance for losses. Unearned premiums and unpaid claims for credit life and accident and health coverage should not be applied in consolidation against related finance receivables for which the related receivables are assets of unrelated entities. In those circumstances, such amounts should be presented as liabilities.

k. *Offsetting Amounts in the Balance Sheets for Property Insurance and Term Life Policies.* In the consolidated financial statements, unpaid claims for property insurance and level term life insurance, however, should not be offset against related finance receivables because finance companies generally do not receive substantially all proceeds of such claims. That prohibition also applies to credit life and accident and health coverage written on policies for which the related receivables are assets of unrelated entities. In those circumstances, such amounts should be presented as liabilities.

l. *Redeemable Preferred Stock Dividends.* For redeemable preferred stock of a subsidiary accounted for as a liability in a parent's consolidated financial statements, dividends should be included in the determination of income as interest expense. For redeemable preferred stock of a subsidiary accounted for as a minority interest in a subsidiary in a parent's consolidated financial statements, the dividends should be presented as minority interest in income of a subsidiary. For redeemable preferred stock of a parent treated as capital, but displayed in the balance sheet as mezzanine capital, dividends should be included in the statement of changes in shareholders' equity.[31]

m. *Off-Balance-Sheet Credit Risk.* For financial instruments with off-balance-sheet credit risk,[32] except for those instruments within the scope of FASB Statement No. 133, an entity should disclose the following information:

(1) The face or contract amount

(2) The nature and terms, including, at a minimum, a discussion of the:

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[31] See footnote 19.

[32] *Off-balance-sheet credit risk* refers to credit risk on off-balance-sheet loan commitments, standby letters of credit, financial guarantees, and other similar instruments, except for instruments within the scope of FASB Statement No. 133.

(i) Credit and market risk of those instruments

(ii) Cash requirements of those instruments

(iii) Related accounting policy pursuant to APB Opinion 22, *Disclosure ofAccounting Policies*

(3) The entity's policy for requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

Examples of activities and financial instruments with off-balance-sheet credit risk include obligations for loans sold with recourse (with or without a floating-interest-rate provision), fixed-rate and variable-rate loan commitments, financial guarantees,[33] note issuance facilities at floating rates, and letters of credit.

.15 Entities within the scope of paragraphs .03 and .05 of this SOP are subject to the following presentation and disclosure principles.

a. *Regulatory Capital Disclosures for Branches of Foreign Institutions.* Branches of foreign financial institutions, while they do not have regulatory capital requirements, may be required to maintain capital-equivalent deposits and, depending on facts and circumstances, supervisory-mandated reserves. These requirements carry regulatory uncertainty of a nature similar to that posed by the regulatory capital rules in that failure to meet such mandates can result in supervisory action and ultimately going-concern questions. Accordingly, branches should disclose such requirements. Quantitative disclosure should be made, highlighting mandated deposit or reserve requirements and actual balances in those reserve or deposit accounts at the balance-sheet date(s) reported.

Further, if an uncertainty exists related to a parent that creates a higher-than-normal risk as to the viability of a branch or subsidiary, then that matter should be adequately disclosed in the notes to the financial statements of the branch or subsidiary. If factors do not exist that indicate a higher than normal amount of risk or uncertainty regarding parent capital and other regulatory matters, then disclosures of capital and supervisory issues of the parent would not be required.

b. *Regulatory Capital Disclosures for Trust Operations.* If an institution is subject to capital requirements based on trust assets under management, a discussion of the existence of these requirements, ramifications of failure to meet them, and a measurement of the entity's position relative to imposed requirements should be disclosed in the notes to the financial statements.

c. *Regulatory Capital Disclosures for Business Combinations.* [34] Following a business combination accounted for as a pooling of interests, the prior-year disclosures should—

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[33] A guarantor is required to disclose and account for a financial guarantee under EITF Issue 85-20, "Recognition of Fees for Guaranteeing a Loan."

[34] In June 2001, the FASB issued FASB Statement No. 141, *Business Combinations*, which supersedes APB Opinion 16, *Business Combinations*. FASB Statement No. 141, which applies to all business combinations except those between not-for-profit enterprises, requires that all business combinations initiated after June 30, 2001 be accounted for using the purchase method. The provisions of FASB Statement No. 141 are applicable to business combinations accounted for by the purchase method completed after June 30, 2001. Effective for business combinations for which the acquisition date is on or after the beginning of the first annual

(1) Contain quantitative disclosures limited to the combined Tier I, Tier II, and total capital, or net worth, as applicable, and related assets or risk-weighted assets, as applicable, and the ratios derived therefrom

(2) Not compare such ratios to either statutory or regulatory capital adequacy or prompt corrective action minimums, the mandated minimums of either premerged entity, or a composite of the premerged entities' mandated minimums

(3) Include a discussion of whether the entities, precombination, were required to hold capital in excess of statutory regulatory minimums in order to be considered well and/or adequately capitalized, and the reasons for those amended minimums

(4) Include a statement that there was not a determination by regulatory authorities as to the capital adequacy or prompt corrective action category of the combined entity relative to the premerger combined amounts and ratios presented

d. Following a business combination accounted for as a purchase,[*] because prior capital position can be less relevant as a result of capital repatriation to former owners and the effects of purchase accounting adjustments and the push-down of basis, judgment should be used as to relevant disclosures. Minimum disclosures should include the capital position of the purchaser at the prior period end and information to highlight comparability issues, such as significant capital requirements imposed or agreed to during the regulatory approval process, and the effects of purchase accounting, if any, on regulatory capital determination.

Presentation and Disclosure for Credit Unions

.16 *Regulatory Capital Disclosures for Credit Unions.* The following are regulatory capital disclosure requirements for credit unions (within the scope of paragraph .03*c* or .03*g* of this SOP) and corporate credit unions (within the scope of paragraph .05 of this SOP).

a. Noncompliance with regulatory capital requirements could materially affect the economic resources of a credit union and claims to those resources. Accordingly, at a minimum, the institution should disclose the following in the notes to the financial statements:[35]

(1) A description of the regulatory requirements (*a*) for capital adequacy purposes and (*b*) prompt corrective action

(2) The actual or possible material effects of noncompliance with those requirements

reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141 (revised 2007), *Business Combinations*, should be applied and accounted for under the acquisition method. [Footnote revised, May 2008, due to the issuance of FASB Statement No. 141(R).]

[*] Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141(R) should be applied with business combinations accounted for under the acquisition method. [Footnote added, May 2008, due to the issuance of FASB Statement No. 141(R).]

[35] Disclosures should also be presented for any state-imposed capital requirements that are more stringent than or significantly different from federal requirements.

(3) Whether the institution is in compliance with the regulatory capital requirements, including, as of each balance-sheet date presented, the following with respect to quantitative measures:

(i) Whether the institution meets the definition of a complex credit union as defined by the National Credit Union Administration[36]

(ii) The institution's required and actual capital ratios and required and actual capital amounts

(iii) Factors that may significantly affect capital adequacy, such as potentially volatile components of capital, qualitative factors, or regulatory mandates

(4) As of each balance-sheet date presented, the prompt corrective action category in which the institution was classified

(5) If, as of the most recent balance-sheet date or issuance of the financial statements, the institution is not in compliance with capital adequacy requirements, the possible material effects of such conditions on amounts and disclosures in the financial statements

(6) Whether subsequent to the balance-sheet date and prior to issuance of the financial statements, management believes any events or changes have occurred to change the institution's prompt corrective action category.

b. Noncompliance with regulatory capital requirements may, when considered with other factors, raise substantial doubt about a credit union's ability to continue as a going concern for a reasonable period of time. Additional information that might be disclosed in situations in which there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time may include the following:

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time
- Possible effects of such conditions and events
- Management's evaluation of the significance of those conditions and events and any mitigating factors
- Possible discontinuance of operations
- Management's plans (including any relevant financial information)
- Information about the recoverability or classification of recorded asset amounts or the amounts or classifications of liabilities

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[36] The NCUA Board adopted prompt corrective action rules in response to the CUMAA requirement that the NCUA adopt a system to restore the net worth of inadequately capitalized federally insured credit unions. In conjunction with the adopted Prompt Corrective Action Rule, the NCUA Board also issued a rule, which defines a "complex" credit union and establishes risk-based net worth requirements. Readers should refer to the NCUA Regulations for the risk-based net worth and prompt corrective action requirements.

Presentation and Disclosure for Mortgage Companies and Activities

.17 *Capital Requirements by Mortgage Companies and Entities With Mortgage Banking Activities.* The following are capital disclosure requirements for mortgage companies and other activities within the scope of paragraph .04 of this SOP.

a. Noncompliance with minimum net worth (capital) requirements imposed by secondary market investors or state-imposed regulatory mandates could materially affect the economic resources of a mortgage banking entity and claims to those resources. To the extent an entity is subject to such requirements, the entity should disclose the following in the notes to the financial statements:

 (1) A description of the minimum net worth requirements related to:

  (i) secondary market investors and

  (ii) state-imposed regulatory mandates

 (2) The actual or possible material effects of noncompliance with those requirements

 (3) Whether the entity is in compliance with the regulatory capital requirements, including, as of each balance-sheet date presented, the following with respect to quantitative measures:

  (i) The entity's required and actual net worth amounts

  (ii) Factors that may significantly affect adequacy of net worth such as potentially volatile components of capital, qualitative factors, or regulatory mandates

 (4) If, as of the most recent balance-sheet date, the entity is not in compliance with capital adequacy requirements, the possible material effects of such conditions on amounts and disclosures in the notes to the financial statements.

b. Further, noncompliance with minimum net worth requirements may, when considered with other factors, raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. Additional information that might be disclosed in situations where there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time may include the following:

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time
- Possible effects of such conditions and events
- Management's evaluation of the significance of those conditions and events and any mitigating factors
- Possible discontinuance of operations
- Management's plans (including any relevant financial information)
- Information about the recoverability or classification of recorded asset amounts or the amounts or classifications of liabilities

c. Servicers with net worth requirements from multiple sources should disclose, in the notes to the financial statements, the net worth requirement of the following:

(1) Significant servicing covenants with secondary market investors with commonly defined servicing requirements[37]

(2) Any other secondary market investor where violation of the requirement would have a significant adverse effect on the business

(3) The most restrictive third-party agreement if not included above

Impact on Other Literature

.18 The provisions of this SOP supersede the relevant accounting and financial reporting provisions of the AICPA Audit and Accounting Guides *Banks and Savings Institutions* (May 2000), *Audits of Credit Unions* (May 2000), and *Audits of Finance Companies* (May 2000).

Effective Date and Transition

.19 References in this SOP to other literature do not change the effective date specified in that other literature. Except as described in paragraph .20, changes in accounting and financial reporting required by this SOP should be applied prospectively and shall be effective for annual and interim financial statements issued for fiscal years beginning after December 15, 2001. As described in the following paragraph, the cumulative effect should be determined and reported in conformity with paragraph 20 of APB Opinion 20, *Accounting Changes*. No proforma effects need be disclosed. Earlier application is encouraged.

.20 The following paragraphs outline the recognition and measurement transition guidance for each type of entity covered by this SOP.

a. *Banks and Savings Institutions.* If initial application of paragraph .08*h*, "Sales of Servicing Rights," or paragraph .09, "Insurance Commissions," results in changes in accounting, the cumulative effect should be included in income in the year in which this SOP is first applied and reported in conformity with paragraph 20 of APB Opinion 20.

b. *Credit Unions.* If initial application of the following paragraphs results in changes in accounting, the cumulative effect should be included in income in the year in which this SOP is first applied and reported in conformity with paragraph 20 of APB Opinion 20:

(1) Paragraph .08*b*, "Nonmortgage Loans Held for Sale"

(2) Paragraph .08*f*, "Standby Commitments to Purchase Loans"

(3) Paragraph .08*h*, "Sales of Servicing Rights"

(4) Paragraph .08*i*, "FHLB and FRB Stock"

(5) Paragraph .09, "Insurance Commissions"

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[37] At the time of issuance of this SOP, common secondary market investors include the U.S. Department of Housing and Urban Development (HUD), Federal National Mortgage Association (FNMA), Government National Mortgage Association (GNMA), and Federal Home Loan Mortgage Corporation (FHLMC).

(6) Paragraph .10*b*, "Short Sales of Securities"

(7) Paragraph .10*c*, "Deposits"

(8) Paragraph .14*l*, "Redeemable Preferred Stock Dividends"

c. *Finance Companies.* If initial application of the following paragraphs results in changes in accounting, the cumulative effect should be included in income in the year in which this SOP is first applied and reported in conformity with paragraph 20 of APB Opinion 20:

(1) Paragraph .08*a*, "Loans and Trade Receivables Not Held for Sale"

(2) Paragraph .08*b*, "Nonmortgage Loans Held for Sale"

(3) Paragraph .08*c*, "Sales of Loans Not Held for Sale"

(4) Paragraph .08*f*, "Standby Commitments to Purchase Loans"

(5) Paragraph .08*h*, "Sales of Servicing Rights"

(6) Paragraph .08*i*, "FHLB and FRB Stock"

(7) Paragraph .09, "Insurance Commissions"

(8) Paragraph .10*a*, "Regular-Way Securities"

(9) Paragraph .10*b*, "Short Sales of Securities"

(10) Paragraph .10*c*, "Deposits"

(11) Paragraph .14*l*, "Redeemable Preferred Stock Dividends"

d. *Financing Activities (including Trade Receivables).* If initial application of the following paragraphs results in changes in accounting, the cumulative effect should be included in income in the year in which this SOP is first applied and reported in conformity with paragraph 20 of APB Opinion 20:

(1) Paragraph .08*a*, "Loans and Trade Receivables Not Held for Sale"

(2) Paragraph .08*b*,"Nonmortgage Loans Held for Sale"

(3) Paragraph .08*c*, "Sales of Loans Not Held for Sale"

(4) Paragraph .08*f*, "Standby Commitments to Purchase Loans"

(5) Paragraph .08*h*, "Sales of Servicing Rights"

(6) Paragraph .08*i*, "FHLB and FRB Stock"

e. *Corporate Credit Unions.* If initial application of the following paragraphs results in changes in accounting, the cumulative effect should be included in income in the year in which this SOP is first applied and reported in conformity with paragraph 20 of APB Opinion 20:

(1) Paragraph .08*a*, "Loans and Trade Receivables Not Held for Sale"

(2) Paragraph .08*b*, "Nonmortgage Loans Held for Sale"

(3) Paragraph .08*c*, "Sales of Loans Not Held for Sale"

(4) Paragraph .08*f*, "Standby Commitments to Purchase Loans"

(5) Paragraph .08*h*, "Sales of Servicing Rights"

(6) Paragraph .08*i*, "FHLB and FRB Stock"

(7) Paragraph .09, "Insurance Commissions"

(8) Paragraph .10*a*, "Regular-Way Securities"

(9) Paragraph .10*b*, “Short Sales of Securities”

(10) Paragraph .10*c*, “Deposits”

(11) Paragraph .11*a*, “NCUSIF Deposit”

(12) Paragraph .14*l*, “Redeemable Preferred Stock Dividends”

f. *Mortgage Companies.* If initial application of the following paragraphs results in changes in accounting, the cumulative effect should be included in income in the year in which this SOP is first applied and reported in conformity with paragraph 20 of APB Opinion 20:

(1) Paragraph .08*a*, “Loans and Trade Receivables Not Held for Sale”

(2) Paragraph .08*b*, “Nonmortgage Loans Held for Sale”

(3) Paragraph .08*c*, “Sales of Loans Not Held for Sale”

(4) Paragraph .08*f*, “Standby Commitments to Purchase Loans”

(5) Paragraph .08*h*, “Sales of Servicing Rights”

(6) Paragraph .08*i*, “FHLB and FRB Stock”

(7) Paragraph .09, “Insurance Commissions”

(8) Paragraph .10*a*, “Regular-Way Securities”

(9) Paragraph .10*b*, “Short Sales of Securities”

(10) Paragraph .10*c*, “Deposits”

(11) Paragraph .14*l*, “Redeemable Preferred Stock Dividends”

g. *Mortgage Activities.* If initial application of the following paragraphs results in changes in accounting, the cumulative effect should be included in income in the year in which this SOP is first applied and reported in conformity with paragraph 20 of APB Opinion 20:

(1) Paragraph .08*a*, “Loans and Trade Receivables Not Held for Sale”

(2) Paragraph .08*b*, “Nonmortgage Loans Held for Sale”

(3) Paragraph .08*c*, “Sales of Loans Not Held for Sale”

(4) Paragraph .08*f*, “Standby Commitments to Purchase Loans”

(5) Paragraph .08*h*, “Sales of Servicing Rights”

(6) Paragraph .08*i*, “FHLB and FRB Stock”

h. *Insurance Companies.* If initial application of the following paragraphs results in changes in accounting, the cumulative effect should be included in income in the year in which this SOP is first applied and reported in conformity with paragraph 20 of APB Opinion 20:

(1) Paragraph .08*a*, “Loans and Trade Receivables Not Held for Sale”

(2) Paragraph .08*b*, “Nonmortgage Loans Held for Sale”

(3) Paragraph .08*c*, “Sales of Loans Not Held for Sale”

(4) Paragraph .08*f*, “Standby Commitments to Purchase Loans”

(5) Paragraph .08*h*, “Sales of Servicing Rights”

(6) Paragraph .08*i*, “FHLB and FRB Stock”

(7) Paragraph .08*j* to 8*m*, “Fees, Rebates, and Factoring Arrangements”

.21 For entities following transition paragraphs .20*a* to .20*d*, the paragraphs not enumerated are those that such entities should have been following prior to this SOP. Accordingly, an initial application of the paragraphs not included in paragraph .20 should be reported as a correction of an error. In applying these provisions to paragraph .08*h*, "Sales of Servicing Rights," previously deferred gains on the sale of servicing rights should be recognized at transition. Paragraphs .11 and .12 of this SOP represents specialized industry practices and should have already been followed by entities subject to this guidance.

.22 In initially applying this SOP for financial statements issued for the fiscal year beginning after December 15, 2001, the disclosures required by paragraphs .13 to .17 of this SOP need not be included in prior fiscal years' financial statements that are presented for comparative purposes. For all subsequent years, the requirements of paragraphs .13*d*, "Sales of Loans and Trade Receivables," and .14*c*, "Sales of Premises and Equipment," of this SOP should be included in each year for which an income statement is presented and all other information required to be disclosed should be applied for each year for which a statement of financial condition is presented. Earlier application of the disclosure provisions of paragraphs .13 to .17 is encouraged.

The provisions of this Statement of Position need not be applied to immaterial items.

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Appendix A

Background Information and Basis for Conclusions

Background

A.1. In the past, the American Institute of Certified Public Accountants (AICPA) has issued Audit and Accounting Guides that provide industry-specific guidance for preparers and auditors of financial statements of banks, savings institutions, credit unions, finance companies, and entities with financing activities (including trade receivables). Divergence in accounting practices for similar transactions has resulted in the need for a reconciliation of existing guidance.

A.2. At its May 19, 1993 meeting, the Financial Accounting Standards Board (FASB) did not object to a prospectus for an Accounting Standards Executive Committee (AcSEC) project to combine and revise the AICPA Industry Audit and Accounting Guide *Audits of Banks* (Bank Guide) with the AICPA Audit and Accounting Guide *Audits of Savings Institutions* (Savings Institutions Guide).[1] AcSEC initiated the project in response to diversity in practice for similar transactions by entities covered by these guides.

A.3. In preparing the 1993 prospectus, the AICPA Banking and Savings Institutions Committees considered including the AICPA Audit and Accounting Guide *Audits of Credit Unions* (CU Guide) in the project's scope. The Committee did not consider whether to include finance companies in the project's scope.

A.4. As explained in the 1993 prospectus, credit unions ultimately were excluded as a result of the following:

- *a.* Issuance in late 1992 of a revised CU Guide
- *b.* Concerns that due process for a combined Guide would delay banking guidance
- *c.* The AICPA Credit Unions Committee's conclusion that a combined Guide was not likely to be as useful to auditors and preparers of credit-union financial statements as the existing stand-alone CU Guide

The prospectus explained that the accounting guidance established in the new Guide would be used to conform the CU Guide for transactions similar among banks, savings institutions, and credit unions.

A.5. At the FASB's May 1993 meeting, the chair of AcSEC agreed, as a condition for clearance, that AcSEC would debate any identified accounting differences between credit unions and banks and savings institutions, and pursue a Statement of Position (SOP) to amend the CU Guide to conform the accounting.

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[1] For ease of reference, the proposed AICPA Audit and Accounting Guide is also referred to as *new Guide* or *combined Guide* in this SOP. The existing AICPA Audit and Accounting Guide *Banks and Savings Institutions* is referred to as the *BSI Guide*. The AICPA Audit and Accounting Guide *Audits of Credit Unions* is referred to as the *CU Guide*. The AICPA Audit and Accounting Guide *Audits of Finance Companies* is referred to as the *FC Guide*.

A.6. At its April 22, and June 4, 1996, meetings, AcSEC's Planning Subcommittee (PSC) reconsidered the approach to conforming the accounting for similar transactions and agreed to create a single Guide that also would include finance companies. The PSC concluded that, though certain accounting guidance on unique transactions may be preserved, most lending and deposit-taking transactions are similar and should be accounted for similarly. Further, the PSC believed the issuance of FASB Statement of Financial Accounting Standards No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (which was later superseded by FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*), would increase accounting consistency.

A.7. At its December 4, 1996 meeting, the FASB did not object to the AICPA's project to combine the existing AICPA Audit and Accounting Guide *Banks and Savings Institutions* (BSI Guide), the CU Guide, and the Audits of Finance Companies (FC Guide).

Approach and Background on the Combined Guide for Financial Institutions

A.8. As the November 1996 prospectus was being developed, the National Credit Union Administration (NCUA), the Credit Union National Association (CUNA), and various preparers and auditors of credit union financial statements expressed concern to the AICPA and the FASB about including credit unions in a combined Guide. They were concerned primarily that a combined Guide would eliminate needed focus on the uniqueness of the credit union industry and, thus, would be a less effective tool for preparers and auditors because a combined Guide would address certain transactions or issues (for example, taxation) that are not applicable to credit unions.

A.9. AcSEC believes the revised Guide should include credit unions to reconcile accounting principles, end accounting inconsistencies that are not justified, and prevent future anomalies. That credit unions, banks, savings institutions, and finance companies are organized differently is less relevant to the preparation and audit of their financial statements than that each primarily lends or takes deposits (or both). Also, as with the existing standalone Guides, preparers and auditors need not read and act on guidance involving transactions in which the entity does not engage.

A.10. Though most lending and deposit-taking activities are the same, some transactions addressed will be irrelevant to one or more entities. For example, credit unions are not subject to income taxes, not every community bank or thrift has or would be permitted to have transactions involving certain trading securities or futures contracts, and finance companies do not take deposits. However, existing Guides have been effective for entities having different levels of assets or complexity. AcSEC believes a single Guide that addresses comprehensively transactions that may be encountered by financial institutions best serves preparers and auditors of financial statements.

A.11. AcSEC does not intend to seek formal comments on the combined Guide. The starting point for the redrafting of the chapters for the combined Guide was the BSI Guide. The BSI Guide had recently been exposed for comment and contained more guidance than the CU Guide or the FC Guide. AcSEC solicited feedback from interested parties during the drafting of the combined Guide chapters.

Approach and Background on the SOP

A.12. AcSEC took the approach of reconciling the differences by including in the exposure draft only the accounting and reporting literature of the respective Guides that did not exist in other authoritative literature.

A.13. AcSEC believed this approach was preferable for several reasons. The SOP includes guidance for all entities engaged in lending and financing activities (including trade receivables). Although this was not an expansion of scope from the existing Guides, AcSEC believed this guidance should stand alone in an SOP. By including such guidance in the combined Guide only, AcSEC was concerned the preparers and auditors would focus on the organizational structure of an entity rather than the activities of the entity. In other words, auditors and preparers might potentially overlook guidance contained in an industry-focused Guide. That such entities are organized differently is less relevant to the accounting and financial reporting of underlying transactions than that each primarily lends or takes deposits (or both) and, accordingly, the guidance is provided based on the activity rather than the entity. Accordingly, this SOP will not only be included in the combined Guide but will provide guidance for all entities (including entities with trade receivables) through the creation of this stand-alone SOP rather than an AICPA Industry Guide. Second, as a condition for clearance of the prospectus, as described in paragraph A.5, AcSEC agreed to reconcile and expose for comment the accounting and reporting differences in the SOP.

A.14. AcSEC issued an exposure draft of a proposed SOP, *Accounting by Certain Financial Institutions and Entities That Lend to or Finance the Activities of Others*, on May 30, 2000. The original comment period ended August 31, 2000. Several respondents commented that the scope, particularly relating to the inclusion of insurance companies, was unclear. AcSEC agreed and extended the comment period to October 31, 2000, to solicit additional views. AcSEC received eighteen comment letters in response to the exposure draft.

Scope

A.15. *Entities With Trade Receivables.* The scope of the FC Guide included not only finance companies but also those entities that lend to or finance the activities of others. Those financing arrangements include extending credit to trade customers to purchase goods or services resulting in trade receivables. Although AcSEC does not envision that the recognition and measurement provisions within this SOP will result in a change in practice for trade receivables, those provisions should be carefully considered for impact.

A.16. *Finance Companies.* In deliberating the scope of the SOP and combined Guide, AcSEC determined that settling on a precise definition of a finance company was difficult. The FC Guide applies to both "independent and captive financing activities of other companies," and AcSEC agreed with this approach. That is, the activities of companies engaged in financing activities are more important for determining the scope of the SOP and combined Guide, rather than the kind of company that the entity purports to be. Accordingly, paragraph .03*b* of this SOP indicates that the SOP should apply to both "independent and captive financing activities of all kinds of entities."

A.17. *Entities With Financing Activities.* In preparing this SOP, AcSEC considered the inherent overlaps resulting from reconciling the accounting and disclosure principles in the Guides based on *kinds of activities* instead of the *nature of entities* in an Audit and Accounting Guide that is prepared for specific entities. AcSEC intends that all entities with financing activities follow the accounting and reporting provisions of this SOP for *those activities*. There was no further attempt to distinguish between *lending activities* and *financing activities*, because no practical distinction could be made for purposes of determining whether provisions of this SOP should apply. However, AcSEC did not intend to expand the applicability of all of the provisions of this SOP to all transactions of an entity that is not considered to be a finance company or mortgage company but engages in such lending or financing activities. Accordingly, AcSEC concluded that an entity that has a portion of its business in lending or financing activities (as defined in paragraphs .03*b*, .04*b*, and .06), but does not meet the provisions of paragraphs .03 (other than .03*b*), .04 (other than .04*b*) and .05 of this SOP, is not subject to the other provisions of this SOP, such as trade date accounting for regular way securities transactions, solely through application of the SOP. In other words, to the extent an entity is not considered such a financial institution, the other guidance provided is not applicable. For certain of these areas, other accounting literature may provide guidance.

A.18. *Insurance Companies*. All entities that lend to or finance the activities of others, not just finance companies, have been subject to the provisions of the existing FC Guide. However, the scope of the FC Guide explicitly excluded insurance companies. AcSEC considered the scope exception and agreed this SOP should apply to all similar transactions and found no conceptual reason to exclude financing and lending transactions of insurance companies. Based on the objective of consistent guidance for similar transactions, this SOP includes the financing and lending activities of insurance companies.

A.19. *Corporate Credit Unions*. Corporate credit unions were previously excluded from the scope of the CU Guide. In its project to reconcile the accounting and reporting for entities under the BSI Guide, CU Guide, and FC Guide, AcSEC reconsidered the exclusion of corporate credit unions from the SOP and combined Guide. AcSEC decided to include corporate credit unions in the scope because the nature of the activities and financial statements of corporate credit unions are essentially the same as other financial institutions covered by this SOP. Therefore, inclusion would meet the objective of reconciling and having in one place accounting guidance for financial entities whose primary activities are lending money or taking deposits, or both.

A.20. *Mortgage Companies*. Mortgage companies were not explicitly noted in the scope of the previous BSI Guide or CU Guide. However, in practice, many mortgage companies followed the provisions of these Guides. Given that the combined Guide covers the primary activities of mortgage companies, AcSEC concluded that these companies should be explicitly included in the scope of the SOP and combined Guide.

A.21. *Higher Level Guidance*. Financing and lending transactions subject to category (a) of generally accepted accounting principles (GAAP) in the hierarchy established by AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1, AU sec. 411), are not in the scope of this SOP. For example, Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, provides accounting guidance for stock loans and, accordingly, the accounting for stock loans is not in the scope of this SOP.

A.22. Those entities, such as investment companies, broker-dealers, and employee benefit plans, that carry loans and trade receivables at fair value, with unrealized gains and losses included in earnings, are excluded from this SOP.

Recognition and Measurement

A.23. The BSI Guide was generally the most comprehensive of the three Guides in addressing activities and related accounting and disclosure requirements that affect many types of financial institutions. In many cases, recognition and measurement guidance established by the BSI Guide was not addressed in the CU Guide and the FC Guide. Transactions encountered by banks and savings institutions may not be applicable or relevant to credit unions or finance companies. In other more limited situations, principles in the FC Guide were not addressed in the recognition and measurement guidance in the BSI or CU Guides. Again, such guidance may not be applicable or relevant to the other entities.

A.24. Regardless of the relative applicability of individual elements of guidance, AcSEC believes it was appropriate to carry forward such guidance from the BSI Guide and the FC Guide, so that the combined Guide would continue to be comprehensive and address transactions that may be encountered by each kind of entity. The accounting and reporting provisions in the BSI Guide and the FC Guide were generally carried forward to this SOP without significant modification. Guidance in the following paragraphs of this SOP generally represents application or formalization of existing recognition and measurement provisions. AcSEC believes these provisions are straightforward and do not require further elaboration.

a. Paragraph .08*a*, "Loans and Trade Receivables Not Held For Sale"

b. Paragraph .08*b*, "Nonmortgage Loans Held For Sale"

c. Paragraph .08*c*, "Sales of Loans Not Held For Sale"

d. Paragraph .08*g*, "Criteria for Sales of Servicing Rights"

e. Paragraph .08*i*, "FHLB and FRB Stock"

f. Paragraphs .08*j*-.08*l*, "Fees and Rebates"

g. Paragraph .10*b*, "Short Sales of Securities"

h. Paragraph .10*c*, "Deposits"

i. Paragraph .11*d*, "Member Deposits"

Recognition and Measurement for All Entities

A.25. *Entities With Trade Receivables.* Entities with trade receivables should follow the recognition and measurement guidance in paragraph .08 of this SOP to the extent the guidance is applicable. AcSEC does not envision the application of this guidance will result in a change in practice for such entities.

A.26. *Credit Losses.* Paragraph .08*d* of this SOP states that recoveries of receivables previously charged off should be recorded when received. Most financial institutions recognize such recoveries as an addition to the allowance for loan losses. Others generally recognize such recoveries as a direct credit to earnings. AcSEC reevaluated these practices as part of this project. AcSEC decided not to prescribe or proscribe a particular practice because the practice of frequently reviewing the adequacy of the allowance results in the same credit to earnings either directly or indirectly.

A.27. *Credit Losses on Off-Balance-Sheet Instruments*. The guidance in the BSI Guide provided that credit losses for off-balance-sheet financial instruments should be deducted from the liability for credit losses in the period in which the liability is settled[2] and that an accrual for credit loss on a financial instrument with off-balance-sheet risk should be recorded separate from a valuation account (allowance for loan losses or doubtful accounts) related to a recognized financial instrument was based on guidance in paragraph 92 of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*. Because FASB Statement No. 105 was superseded by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and the guidance in paragraph 92 of FASB Statement No. 105 was not included in FASB Statement No. 133, AcSEC included the language in the former paragraph 92 of FASB Statement No. 105 in paragraph .08*e* of this SOP to clarify its requirements.

A.28. *Standby Commitments to Purchase Loans*. The BSI Guide addressed accounting for forward standby commitments to purchase loans. Essentially, this guidance requires such commitments to be accounted for either as a commitment fee in accordance with paragraph 8 of FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, or at the higher of fair value or historical proceeds depending on whether settlement date is within a reasonable period and certain other factors. AcSEC considered whether the BSI Guide should be modified by requiring standby commitments to purchase loans to be accounted for at fair value in all cases. However, no practical distinction could be made between forward standby commitments to purchase receivables and other commitments to purchase or originate receivables. Accordingly, AcSEC decided to retain the existing guidance of the BSI Guide and carry it forward in paragraph .08*f* of this SOP.

A.29. *Sales of Servicing Rights*. Paragraph 8.20 of the BSI Guide stated that: "Sales of servicing rights relating to loans that are retained should not be recognized in income at the time of sale. The proceeds from such sales should be accounted for in a manner similar to loan discounts and amortized using the interest method as an adjustment to the yield of the related loans." FASB Statement No. 140 governs transfers of loans and other financial assets but does not address transfers of servicing rights because servicing rights are not considered financial assets. Under FASB Statement No. 140, when loans are sold with servicing retained, the previous carrying amount (or basis) is allocated to separate components—that is, loans (without servicing) and servicing rights—based on their relative fair values at date of sale. AcSEC concluded that paragraph 8.20 of the BSI Guide should be revised to follow a "basis allocation" approach similar to FASB Statement No. 140, once it has been determined that a transfer of servicing rights qualifies as a sale and, accordingly, included this guidance in paragraph .08*h* of this SOP. This conclusion does not affect FASB Emerging Issues Task Force (EITF) Issue No. 95-5, "Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights," and other related guidance that addresses whether a transfer of servicing rights should be accounted for as a sale.

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[2] *Off-balance-sheet financial instruments* refers to off-balance-sheet loan commitments, standby letters of credit, financial guarantees, and other similar instruments with off-balance-sheet credit risk except for instruments within the scope of FASB Statement No. 133.

A.30. *Factoring Arrangements.* Paragraph 2.24 of the FC Guide has been modified in paragraph .08*m* of this SOP to clarify that FASB Statement No. 91 may apply to the accounting for factoring commissions. Paragraph 2.24 addresses accounting for factoring commissions but does not distinguish between accounting for commissions when receivables are purchased versus when receivables are financed. AcSEC concluded that the accounting for factoring commissions would depend on whether the receivables were purchased or financed, and that the sales criteria in paragraph 9 of FASB Statement No. 140 should be used to make that distinction. When receivables are purchased by a finance company (factor), factoring commissions are in substance "interest adjustments," and are addressed by FASB Statement No. 91 or AICPA Practice Bulletin No. 6, *Amortization of Discounts on Certain Acquired Loans* [section 12,060].[3] When receivables are financed by a finance company (factor), factoring commissions should be recognized in accordance with FASB Statement No. 91.

Recognition and Measurement for Financial Institutions and Financing Activities

A.31. *Insurance Commissions.* Insurance companies are not subject to paragraph .09 of the SOP. Paragraph .09 provides guidance for income from experience-rated or retrospective commission arrangements. Insurance companies have guidance providing recognition and measurement guidance including FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises*; No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments;* and No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts;* and SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises* [section 10,650].

Recognition and Measurement for Financial Institutions

A.32. *Regular-Way Securities.* Paragraph 170 of FASB Statement No. 140 does not explicitly address when to recognize (or derecognize) contracts to purchase or sell securities in (or from) the balance sheet. FASB Statement No. 140 does not modify other GAAP, including AICPA Audit and Accounting Industry Guides for certain industries that require accounting at the trade date for certain contracts to purchase or sell securities. Guidance to that effect existed for banks, savings institutions, and credit unions in the respective Guides for those industries. The FC Guide did not explicitly address this issue. In keeping with the objective of this project to reconcile the accounting practices among similar financial institutions, AcSEC concluded that accounting for regular-way securities transactions at trade date should be required for finance companies.

Recognition and Measurement for Credit Unions

A.33. *National Credit Union Share Insurance Fund Deposit.* AcSEC concluded that it was appropriate to carry forward specific industry guidance for credit unions related to the National Credit Union Share Insurance Fund (NCUSIF) deposit. The credit union share insurance fund has unique legal and

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[3] AcSEC expects to issue an SOP, *Accounting for Loans and Certain Debt Securities Acquired in a Transfer*, in the first quarter of 2002. The SOP updates Practice Bulletin No. 6, *Amortization of Discounts on Certain Acquired Loans* [section 12,060], and is effective for transfers of loans acquired in fiscal years beginning after June 15, 2002.

operating aspects that make it different than the deposit insurance fund for banks and savings institutions. Most importantly, credit unions are entitled to a refund of their deposit in the share insurance fund, subject to certain limitations. Unique characteristics of the fund are discussed further below.

A.34. A federally insured credit union is required to maintain on deposit with the NCUSIF an amount equal to one percent of its total insured shares. The amount on deposit is adjusted periodically for changes in the amount of a credit union's insured shares. For example, if the insured shares decline, a pro rata portion of the amount on deposit with the NCUSIF is refunded to the credit union. This deposit would be refunded to a credit union if its insurance is terminated, it converts to insurance coverage from another source, or the operations of the fund are transferred from the NCUA Board.

A.35. The NCUA aims to keep the Fund's reserve ratio at or near 1.3 percent of insured deposits. The Fund's reserves consist of the 1 percent required deposit plus any additional amounts accumulated through interest earnings and insurance premiums. The reserves are invested in Treasury securities, and interest on those securities accrues to the Fund. In addition, the NCUA has discretion to impose an annual premium of 1/12 of 1 percent of insured deposits. If the Fund's reserve ratio exceeds 1.3 percent, the NCUA must pay the excess as a dividend on the credit unions' one percent deposit. To cover losses and operating expenses, the Fund first uses reserves in excess of the one percent deposit. However, if the Fund's reserve ratio ever falls below one percent, credit unions would be required to restore the deposit to one percent by January 1 of the following year.

A.36. The accounting for payments to the NCUSIF differs from the accounting for premiums paid to the Federal Deposit Insurance Corporation (FDIC) insurance fund. FDIC insured banks and thrifts expense their deposit insurance fund premiums when paid as these premiums are nonrefundable.

Recognition and Measurement for Finance Companies and Activities

A.37. *Favorable Financing Arrangements*. Paragraph 2.14 of the FC Guide stated that: "Captive finance companies that offer favorable financing to increase sales of related companies may present particular problems. APB Opinion 21, *Interest on Receivables and Payables*, provides accounting guidance to use if the face amount of a note does not reasonably represent the present value given or received in an exchange." That paragraph was modified by the FC Guide to clarify the application of APB Opinion 21 to captive finance companies. AcSEC believes that paragraph 3(d) of APB Opinion 21 was not intended to exempt "captive finance companies" from the Opinion's scope and accordingly included this interpretation in paragraph .12 of this SOP. Favorable financing offered by captive finance companies to increase sales of products of affiliated companies does not constitute customary cash lending activities or demand and savings deposit activities of a financial institution.

Guidance Eliminated for Finance Companies

A.38. *Advances and Overadvances to Factoring Clients*. Paragraphs 2.26 and 2.27 of the FC Guide described an accounting approach whereby finance companies buy loans but do not pay the full purchase price in cash to the seller. AcSEC concluded that such industry-specific guidance should not be carried forward to this SOP without substantial justification, and none was evident in this case. Further, AcSEC believes that the accounting for purchases of receivables and related advances and overadvances in factoring arrangements are sufficiently addressed in paragraph .08*m* of this SOP.

A.39. *Income Recognition on Impaired Loans for Finance Companies.* Paragraphs 2.15 and 2.17 of the FC Guide provided specific guidance on the recognition of interest income on impaired loans. The BSI and the CU Guides did not address this issue. In 1994, FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, was amended by FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, to delete guidance on income recognition. The Board concluded that those provisions (paragraph 17 to 19 of FASB Statement No. 114) were secondary in importance to provisions that address the measurement of loan impairment. In the earlier project to revise and combine the then-separate Bank Guide and Savings Institutions Guide, industry-specific guidance related to interest income recognition on impaired loans was not carried forward to the BSI Guide. At the time, AcSEC decided that specifying or illustrating certain income recognition methods could imply that one or more methods are preferable to others. AcSEC also recognized that FASB's financial instruments project would likely consider related issues, including present value-based measurements and income recognition. For purposes of this SOP, AcSEC concluded that industry-specific guidance should not be carried forward to this SOP for the same reasons. Because this SOP eliminates existing guidance on income recognition for impaired loans for finance companies, a finance company that makes a change in accounting with respect to income recognition for impaired loans must justify why the change is preferable in accordance with the requirements of APB Opinion 20, *Accounting Changes*.

Presentation and Disclosure

A.40. Disclosure and presentation principles established by the BSI Guide are also carried forward to this SOP, when not addressed in the CU Guide or the FC Guide, or when addressed in a very similar or identical fashion. However, due to differing levels of emphasis in the respective Guides for similar transactions and activities, underlying differences in the nature of the entities themselves, and perhaps for other reasons, disclosure and presentation principles were not always addressed similarly in the respective Guides. AcSEC evaluated those situations on a case-by-case basis, and decided the most appropriate guidance to carry forward to this SOP. In some cases, those evaluations resulted in the application of disclosures required for one or more kinds of entities to one or more other kinds. In some cases, the evaluations resulted in the elimination of disclosure requirements previously required for credit unions in lieu of applying them to banks, savings institutions, and finance companies. In one case, the evaluation resulted in a new disclosure for all entities.

A.41. Guidance in the following paragraphs of this SOP generally represent application or formalization of existing presentation and disclosure provisions. AcSEC believes these provisions are straightforward and do not require further elaboration.

a. Paragraph .13*a* (Items (1), (2), and (4)), "Accounting Policies for Loans and Trade Receivables"

b. Paragraph .13*b*, "Accounting Policies for Credit Losses and Doubtful Accounts"

c. Paragraph .13*c*, "Accounting Policies for Nonaccrual and Past Due Loans and Trade Receivables"

d. Paragraph .13*d*, "Sales of Loans and Trade Receivables" *e.* Paragraph .13*e*, "Loans or Trade Receivables"

f. Paragraph .13*h*, "Securities on Deposit"

g. Paragraph .13*i*, "Assets Serving as Collateral"

h. Paragraph .14*a*, "Cash Restrictions"

i. Paragraph .14*c*, "Sales of Premises and Equipment"

j. Paragraph .14*d*, "Securities"

k. Paragraph .14*e* (Items (2), (3), and (4)), "Deposits"

l. Paragraph .14*f*, "Borrowings"

m. Paragraph .14*g*, "Long-Term Obligations"

n. Paragraph .14*h*, "Debt"

o. Paragraph .14*i*, "Secured Borrowings"

p. Paragraph .14*l*, "Redeemable Preferred Stock Dividends"

Presentation and Disclosure for All Entities

A.42. *Entities With Trade Receivables.* Entities with trade receivables should follow the presentation and disclosure guidance in paragraph .13 to the extent the guidance is applicable. AcSEC does not envision the application of this guidance will result in a change in practice for such entities.

A.43. *Accounting Policies for Loans and Trade Receivables.* Paragraph .13*a*, item (3) of this SOP requires disclosure of classification and method of accounting for interest-only strips, loans, other receivables, or retained interests in securitizations that can be contractually prepaid or otherwise settled in a way that the holder would not recover all of its recorded investment pursuant to paragraph 14 of FASB Statement No. 140. Paragraph 6.74 of the BSI Guide prescribed accounting policy disclosure requirements for loans. However, this paragraph does not address accounting policy disclosure for instruments accounted for under paragraph 14 of FASB Statement No. 140. Further, no such disclosures are required by FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, or No. 140, or otherwise. Instruments within the scope of paragraph 14 of FASB Statement No. 140 may be classified as available-for-sale or trading, and further balance-sheet presentation may differ among various entities. Accordingly, AcSEC concluded that the disclosure of the classification and method of accounting for instruments accounted for under paragraph 14 of FASB Statement No. 140 would be informative for financial statement users.

A.44. *Foreclosed and Repossessed Assets.* Paragraph .13*f* of this SOP requires foreclosed and repossessed assets to be classified as a separate balance-sheet amount or included in other assets with separate disclosures in the notes to the financial statements. Certain returned or repossessed assets, such as inventory, should not be classified separately if the assets were sold by the entity to a third party and subsequently are to be resold by the entity to another third party.

A.45. *Nonaccrual Loans and Trade Receivables.* FASB Statement No. 118 requires entities to disclose the amount of loans[4] defined as "impaired" under

[4] FASB Statement No. 118 amended FASB Statement No. 114. FASB Statement No. 114 states in paragraph 4, "For purposes of this Statement, a loan is a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position."

paragraph 8 of FASB Statement No. 114. Further, FASB Statement No. 114 does not apply to "large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, which may include credit card, residential mortgage, and consumer installment loans." Significant portions of the portfolios of credit unions, finance companies, and entities with financing activities (including trade receivables) consist of smaller-balance homogeneous loans. Accordingly, credit unions and finance companies often disclosed insignificant amounts, or sometimes no amounts, of impaired loans in their financial statements. Credit unions, finance companies, and entities with financing activities continued to be required by their respective Guides to disclose the amount of nonaccrual loans and trade receivables, even after the effective date of FASB Statement No. 118. In keeping with the objective of this project to reconcile the accounting and disclosure practices among similar entities with similar transactions, AcSEC concluded that such guidance should be carried forward to paragraph .13*g* of this SOP and applied to banks and savings institutions as well.

A.46. *Past Due Loans and Trade Receivables*. Paragraph .13*g* of this SOP requires disclosure of loans and trade receivables past due ninety days or more and still accruing interest and the accounting policy for determining past due status. Some entities do not automatically place loans on nonaccrual once they become ninety days past due. Accordingly, AcSEC concluded that disclosure of both nonaccrual and past due ninety days or more and still accruing loans and trade receivables would provide more complete information about loan portfolio credit quality. Further, given this new requirement to disclose loans past due ninety days or more, AcSEC believed that it would be important for financial statement users to understand how past due status is determined by the entity.

Presentation and Disclosure for Financial Institutions

A.47. *Reciprocal Balances and Related Overdrafts*. The BSI Guide provided the following guidance: "Overdrafts of correspondents or other demand deposit accounts that represent borrowings rather than outstanding drafts should be reclassified as liabilities, unless the depositors have other accounts at the same depository institution for which there is the right of setoff. Balances due to and due from a single depository institution, also called reciprocal balances, should also be offset if right of setoff exists. FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, defines right of setoff and specifies conditions that must be met to have that right." The exposure draft of this SOP did not address whether the guidance in the BSI Guide for offsetting reciprocal balances and correspondent overdrafts should be applied to all financial institutions. AcSEC reasoned that, because FASB Interpretation No. 39 provided a scope exception for specified accounting that existed in AICPA Industry Audit Guides, discussion in this SOP was unnecessary. FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*, amended the Interpretation as follows: "In paragraph 7, *Industry Audit Guide, Audits of Banks* is replaced by *Audit and Accounting Guide, Banks and Savings Institutions*." Therefore, AcSEC reasoned that FASB Interpretation No. 39's scope would exclude any reciprocal balances and correspondent overdrafts of financial institutions. However, as one respondent suggested, because the reference in that Interpretation was only to the BSI Guide and because that guidance was absent in the CU Guide and FC Guide, the guidance should be included in this SOP. Additionally, corporate credit unions and mortgage companies, which were not included in an AICPA guide, are now included in this SOP. Accordingly, AcSEC decided to clarify the appropriateness of applying this guidance to all financial institutions that have reciprocal balances. AcSEC understands that the offsetting of reciprocal balances and correspondent overdrafts is current practice for financial institutions and, in keeping with the objective of consistent application of guidance regardless of entity type, agreed to apply that guidance to all financial institutions with such balances. In considering this issue, AcSEC revisited the original guidance in the Bank Guide and found that language preferable to the BSI Guide language. Accordingly, AcSEC revised the criteria in paragraph .14*b* to reflect current industry practice. AcSEC intends this guidance to be applied only to financial institutions and applying it in other situations may not be appropriate.

A.48. *Deposits*. Disclosures about deposit liabilities should include the aggregate amount of time deposit accounts (including certificates of deposit) in denominations of $100,000 or more at the balance-sheet date. This established practice is meaningful to readers as this amount gives an indication of potential liquidity concerns. The denomination of $100,000 represents a common threshold within FDIC insurance limits. Generally, deposits in excess of the insurance limits are considered to have a higher risk of withdrawal. AcSEC concluded that this information is meaningful to financial statement users and included this disclosure in paragraph .14*e*.

A.49. *Offsetting Amounts in the Balance Sheet*. FASB Interpretation No. 39 does not preclude the special balance-sheet offsetting established by paragraphs .14*j* and .14*k* of this SOP. Paragraph 7 of the Interpretation does not modify the accounting treatment for particular circumstances prescribed by AICPA SOPs.

A.50. *Off-Balance-Sheet Credit Risk*. Paragraph 6.78 of the BSI Guide addressed disclosure requirements of financial instruments with off-balance-sheet risk, specifically referring to FASB Statements No. 105 and 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*. Paragraphs 17 and 18 of FASB Statement No. 105, as amended by FASB Statement No. 119, required disclosure of the extent, nature, terms, and credit risk of financial instruments with off-balance-sheet credit risk. FASB Statements No. 105 and 119 were superseded by FASB Statement No. 133. Certain financial instruments with off-balance-sheet credit risk are not derivative instruments as defined in FASB Statement No. 133, and thus are not subject to its disclosure requirements. Examples of these instruments, commonly used by lending institutions, include off-balance-sheet loan commitments, financial guarantees, and letters of credit. AcSEC concluded that because disclosures about such off-balance-sheet instruments existed in the BSI Guide before FASB Statement No. 105, the disclosure requirements for such off-balance-sheet financial instruments, as previously addressed in FASB Statement No. 105, should still be applied to entities within the scope of this SOP and included the guidance in paragraph .14*m*.

A.51. *Regulatory Capital Disclosures for Branches of Foreign Institutions*. As discussed in the preface to the BSI Guide, the Guide applied to the preparation and audits of financial statements of entities regulated by the federal banking regulatory agencies, including branches and agencies of foreign banks. The existing disclosure requirements related to capital adequacy and prompt corrective action in the BSI Guide did not apply to branches of foreign banking organizations because such branches do not have capital. Foreign branches, while they do not have capital requirements, are required to maintain capital-equivalent deposits and, depending on facts and circumstances, supervisory-mandated reserves. These requirements carry regulatory uncertainty of a nature similar to that posed by the regulatory capital rules in that failure to meet such mandates can result in supervisory action and, ultimately, going-concern questions. Accordingly, AcSEC believes that those foreign bank branches should disclose such requirements and the degree of compliance therewith.

A.52. *Regulatory Capital Disclosures for Trust Operations*. Trust banks are required by certain federal regulators to hold capital as a percentage of discretionary and nondiscretionary assets under management. The percentages vary for each category. The percentages are not standardized as with other capital requirements and are communicated on an entity-by-entity basis in the application to obtain a trust charter or by other supervisory processes. Depending on the type of charter, these entities may be subject to risk-based standards as well. Because these are not published requirements, these guidelines are applied on a discretionary basis by the agencies and may not be uniformly applied to all entities. Because failure to meet capital requirements can have an adverse effect on the financial condition and results of operations of an entity, AcSEC concluded that, in cases in which these requirements are applied, a discussion of the existence of these requirements, ramifications of failure to meet them, and a measurement of the entity's position relative to imposed requirements should be disclosed.

A.53. *Regulatory Capital Disclosures for Business Combinations*.[5] The BSI Guide required that comparative disclosures be presented relating to regulatory capital compliance. In applying this requirement to entities that have completed a business combination, AcSEC recognized that special requirements were necessary. First, because the post-transaction capital of two entities combined through a purchase differs from that of the same two entities had the transaction been accounted for as a pooling, different approaches to comparative capital disclosures must be taken for pooling of interests and purchase business combinations. Second, the determination of regulatory capital position involves not only purely quantitative elements but also potentially highly subjective qualitative factors, such as relative operation risks, risks associated with nontraditional activities, and other factors, which may in turn be mitigated by the relative sophistication of management and systems. Finally, AcSEC believes it would not be representationally faithful to simply compare the combined capital and risk-weighted assets of the premerged entities, even in a pooling, to statutory capital adequacy and prompt corrective action minimums or to actual or composite adjusted minimums of the premerged entities. Such an approach might overlook mitigating factors that may have been enhanced or risks that may have been magnified and assessed differently in a combined entity rather than in separate entities and inappropriately suggest that the regulators may have reviewed and accepted such combined levels as adequate when they actually had never made such an evaluation. Accordingly, for these reasons, and those related to purchase business combinations described in paragraph .15*c* of this SOP, AcSEC believes that the required disclosures are the best means to achieve the objective of comparative presentations.

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[5] In June 2001, the FASB issued FASB Statement No. 141, *Business Combinations*, which supersedes APB Opinion 16, *Business Combinations*. FASB Statement No. 141, which applies to all business combinations except those between not-for-profit enterprises, requires that all business combinations initiated after June 30, 2001 be accounted for using the purchase method. The provisions of FASB Statement No. 141 are applicable to business combinations accounted for by the purchase method completed after June 30, 2001.

Presentation and Disclosure for Credit Unions

A.54. *Regulatory Capital Disclosures for Credit Unions.* The BSI Guide required that banks and savings institutions disclose in notes to their financial statements certain matters about the institution's capital adequacy relative to regulatory minimum capital standards and prompt corrective action requirements. The rationale for such disclosure requirements was that failure to comply with regulatory capital requirements could have a material adverse effect on the financial position and results of operations of affected institutions. The CU Guide did not contain such requirements. AcSEC believes that a credit union's relative compliance with minimum net worth and capital and prompt corrective action requirements is equally important to readers of credit union financial statements and thus similar disclosures by credit unions to those currently in place for banks and savings institutions should be required.

Presentation and Disclosure for Mortgage Activities

A.55. *Capital Disclosures by Mortgage Companies and Entities With Mortgage Banking Activities.* Failure to comply with minimum net worth (capital) requirements imposed by secondary market investors and regulators could have a material adverse effect on the financial position and results of operations of affected entities. In developing this SOP, AcSEC considered making these disclosures conditional, that is, not requiring them only when the risk of noncompliance is remote. However, AcSEC concluded that the compliance of a mortgage company or an entity with mortgage banking activities with minimum net worth requirements should be disclosed similar to the required disclosures for banks, savings institutions, and credit unions.

A.56. AcSEC was concerned with the volume of disclosures in instances in which an entity has multiple servicing arrangements with different investors. AcSEC decided to limit this requirement to the disclosures required by the most significant investor arrangement.

Guidance Eliminated for Credit Unions

A.57. Regarding the disclosures eliminated for credit unions as contained in the paragraph B.8. of Appendix B, "Amended Paragraphs of AICPA Industry Guides to Show Changes Made by This Statement" [paragraph .24] of this SOP, AcSEC believed that these disclosures were redundant and should be eliminated in the interest of disclosure effectiveness.

Effective Date and Transition

A.58. *Recognition and Measurement.* This SOP represents unique transition challenges. Certain recognition and measurement principles will be applied to certain entities for the first time. Some provisions may not require a change in accounting method for certain entities, particularly if no guidance existed on the subject for their industry, as the guidance in this SOP may have already been applied by analogy. AcSEC recognized that the application of the provisions in paragraphs .08 (except for paragraph .08*h*, "Sales of Servicing Rights"); .09, "Insurance Commissions;" and .10 result in a change in accounting method for entities not previously subject to this guidance.

A.59. *Financing Activities and Trade Receivables.* All entities, regardless of whether they were within the FC Guide, should have followed the FC Guide guidance if they engaged in kinds of transactions covered by paragraph .03*b*. The paragraphs not enumerated in the transition paragraphs in paragraphs

.20*c* and .20*d* are those that all entities with financing activities (including trade receivables) should have been following prior to this SOP. Accordingly, an initial application of the paragraphs not included in paragraphs .20*c* and .20*d* should be reported as a correction of an error. In applying these provisions to paragraph .08*h*, "Sales of Servicing Rights," previously deferred gains on the sale of servicing rights should be recognized at transition. Paragraph .12 of this SOP represents specialized industry practices and should have already been followed by entities subject to this guidance.

A.60. *Banks and Savings Institutions.* The paragraphs not enumerated in the transition paragraphs in paragraph .20*a* are those that such entities should have been following prior to this SOP. Accordingly, an initial application of the paragraphs not included in paragraph .20*a* should be reported as a correction of an error. In applying these provisions to paragraph .08*h*, "Sales of Servicing Rights," previously deferred gains on the sale of servicing rights should be recognized at transition.

A.61. *Credit Unions.* The paragraphs not enumerated in the transition paragraphs in paragraph .20*b* are those that such entities should have been following prior to this SOP. Accordingly, an initial application of the paragraphs not included in paragraph .20*b* should be reported as a correction of an error. In applying these provisions to paragraph .08*h*, "Sales of Servicing Rights," previously deferred gains on the sale of servicing rights should be recognized at transition. Paragraph .11 of this SOP represents specialized industry practices and should have already been followed by entities subject to this guidance.

A.62. *Presentation and Disclosure.* AcSEC concluded that, in the initial year of applying the provisions of this SOP, all new disclosures should be required only as of the most recent balance-sheet date. Disclosures of prior year information would be encouraged but not required. However, obtaining many of the prior year disclosures may be difficult for many entities, and the benefits of doing so may likely not justify the costs. AcSEC concluded that, after transition, comparative information should be provided.

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Appendix B

Amended Paragraphs of AICPA Industry Guides to Show Changes Made by This Statement of Position

B.1. This Statement of Position (SOP) reconciles and conforms, as appropriate, the accounting and financial reporting provisions established by the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guides *Banks and Savings Institutions* (BSI Guide), *Audits of Credit Unions* (CU Guide), and *Audits of Finance Companies* (FC Guide). For those entities subject to one of the previously issued AICPA Guides listed above, the Accounting Standards Executive Committee (AcSEC) included, by industry guide, the marked paragraphs to show the changes that were carried forward to this SOP as well as guidance eliminated. The paragraphs refer to the Guides in existence (with conforming changes as of May 1, 2000) at the date of issuance of this SOP.

Recognition and Measurement

Guidance from the BSI Guide

B.2. Recognition and measurement principles established by and carried forward from the BSI Guide to this SOP follow. Conforming changes are specifically noted by bold italicized or strike-through text. Reference to specific paragraphs within the respective Guides is noted parenthetically.

a. ***Regular-Way***[1] ~~P~~***p***urchases and sales of securities ***should be*** ~~are~~ recorded ~~in the balance sheet~~ on the trade date. Gains and losses from ***regular-way*** security sales or disposals should be recognized as of the trade date in the statement of operations for the period in which securities are sold or otherwise disposed of. (BSI Guide, paragraph 5.92; CU Guide, paragraph 4.21)

b. The obligations incurred in short sales[2] should be reported as liabilities and adjusted to fair value through the income statement at each reporting date. Such liabilities are generally called "securities sold, not yet purchased." ***The fair value adjustment should be classified in the income statement with gains and losses on securities***. Interest on the short positions should be accrued periodically and reported as interest expense. (BSI Guide, paragraph 5.93)

c. ~~Therefore~~, Federal Home Loan Bank (FHLB) ~~or~~ ***and*** Federal Reserve Bank (FRB) stock ***should be*** ~~is more properly~~ classified as a restricted investment security, carried at cost, and evaluated for impairment. (BSI Guide, paragraph 5.97) Both cash and stock dividends[3] ~~are~~ received on FHLB stock ~~and~~ are reported as income. The

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[1] In paragraph 275 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, *regular-way* is defined as follows:

> Regular-way security trades are those that are completed (or settled) within the time period generally established by regulations and conventions in the marketplace or by the exchange on which the transaction is being executed.

[2] Paragraph 59(d) of FASB Statement No. 133 addresses short sales.

[3] Chapter 7 of Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, provides guidance for stock-splits.

stock dividends are redeemable at par value. (BSI Guide, paragraph 5.99) ~~In evaluating the effects of legislation on the FHLBs, the independent accountant may that at least a temporary decline in value could have occurred if such legislation requires an FHLB to make payments to the Resolution Funding Corporation (REFCORP) or other entities in addition to the required payments to the Financing Corporation (FICO) and if these payments cause the FHLB's total equity to fall below its aggregate capital stock amount~~. FHLB stock is generally viewed as a long-term investment. Accordingly***, when evaluating FHLB stock for impairment,*** its value should be determined based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The determination of whether the decline ~~is other than temporary in nature~~ ***affects the ultimate recoverability*** is influenced by criteria such as ***the following***:

- The significance of the decline in net assets of the FHLBs as compared to the capital stock amount for the FHLBs and the length of time this situation has persisted
- Commitments by the FHLBs to make ~~future~~ payments ~~to REFCORP and other entities~~ ***required by law or regulation*** and the level of such payments in relation to the operating performance of the FHLBs
- The impact of legislative and regulatory changes on ~~the savings~~ institutions ~~industry~~ and, accordingly, on the customer base of the FHLBs
- The liquidity position of the FHLBs (BSI Guide, paragraph 5.100)

d. Loans ***and trade receivables*** that management has the intent and ability to hold for the foreseeable future or until maturity or payoff should be reported in the balance sheet at outstanding principal adjusted for any chargeoffs, the allowance for loan losses ***(or the allowance for doubtful accounts)***, any deferred fees or costs on originated loans, and any unamortized premiums or discounts[4] on purchased loans.[5] (BSI Guide, paragraph 6.48; CU Guide, paragraph 5.16)

e. ~~Other~~ ***Nonmortgage*** loans held for sale should be reported at the lower of cost or ~~market~~ ***fair*** value.[6] (BSI Guide, paragraph 6.49)

f. ~~Banks and savings institutions~~ ***Entities*** sometimes enter into forward standby commitments to purchase loans at a stated price in return for a standby commitment fee. In such an arrangement, settlement of the standby commitment is ***at*** the option of the seller ***of the loans*** and ***would*** result~~s~~ in delivery ***to the entity*** only if the

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[4] Discounts offered as a result of the pricing of a sale or a product or service may be termed *sales discounts*. This SOP does not address these discounts.

[5] AcSEC expects to issue an SOP, *Accounting for Loans and Certain Debt Securities Acquired in a Transfer*, in the first quarter of 2002. The SOP updates Practice Bulletin No. 6, *Amortization of Discounts on Certain Acquired Loans* [section 12,060], and is effective for transfers of loans acquired in fiscal years beginning after June 15, 2002.

[6] This paragraph applies to nonmortgage loans. Readers should refer to FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, for mortgage loans classified as held for sale.

contract price ***equals or*** exceeds the market price of the underlying loan or security on the settlement date. A standby commitment differs from a mandatory commitment in that the ~~institution~~ ***entity*** assumes all the market risks of ownership but shares in none of the rewards. A standby commitment is, in substance, a ***written*** put option ***that will be exercised only if the value of the loans is less than or equal to the strike price***. Many ~~institutions~~ ***entities*** use standby commitments to supplement their normal loan origination volume. If the settlement date is within a reasonable period (for example, a normal loan commitment period) and the ~~institution~~ ***entity*** has the intent~~ion~~ and ability to accept delivery without selling assets, standby commitments are generally viewed as part of the normal production of loans, and ~~institutions~~ ***entities*** record loans purchased under standby commitments at cost on the settlement date ~~and amortize~~***, net of*** the standby commitment fee ***received*** ~~over the estimated life of the loans~~, in conformity with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. However, if the settlement date is not within a reasonable period, or the ~~institution~~ ***entity*** does not have the intent~~ion~~ and ability to accept delivery without selling assets, the standby commitment generally is accounted for as a written put option. In that case, the option premium received (standby commitment fee) should be recorded as a liability representing the ***fair value*** ~~unrealized loss~~ of the standby commitment on the trade date. Thereafter, the liability should be accounted for at the greater of the ***initial standby commitment*** fee or ***the fair value of the written put option*** ~~unrealized loss~~. Unrealized gains (that is, recoveries of unrealized losses) or losses should be credited or charged to current operations.[7] (BSI Guide, paragraph 6.72)

g. ~~Actual~~ ***C***~~c~~redit losses for loans ***and trade receivables***, which may be for all or part of a particular loan ***or trade receivable***, should be deducted from the allowance.[8] ~~and t~~***T***he related loan ***or trade receivable*** balance should be charged off in the period in which ~~they~~ ***the loans or trade receivables*** are deemed uncollectible. Recoveries of loans ***and trade receivables*** previously charged off should be ~~added to the allowance~~ ***recorded*** when received.[9] (BSI Guide, paragraph 7.30; CU Guide, paragraph 6.15; FC Guide, paragraph 2.42)

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[7] This paragraph applies only to standby commitments to purchase loans. It does not apply to other customary kinds of commitments to purchase loans, nor does it apply to commitments to originate loans. The FASB staff has issued tentative guidance in Statement 133 Implementation Issue No. C13, "When a Loan Commitment Is Included in the Scope of Statement 133," regarding the circumstances in which a loan commitment or other credit arrangement should be accounted for as a derivative under FASB Statement No. 133. Readers should be alert to any final guidance.

[8] AcSEC has a project that is addressing certain issues related to the allowance for credit losses. Readers should be alert to any final pronouncement.

[9] AcSEC recognizes that practices differ between entities as some industries typically credit recoveries directly to earnings while financial institutions typically credit the allowance for loan losses for recoveries. AcSEC reevaluated this practice as part of this project. AcSEC decided not to amend this practice because the combination of this practice and the practice of frequently reviewing the adequacy of the allowance for loan losses results in the same credit to earnings in an indirect manner.

h. ***An accrual for credit loss on a financial instrument with off-balance-sheet risk should be recorded separate from a valuation account related to a recognized financial instrument.*** ~~Actual~~ ***C***~~c~~redit losses for off-balance-sheet financial instruments should be deducted from the liability for credit losses in the period in which ~~they are deemed uncollectible~~ ***the liability is settled***.[10] (BSI Guide, paragraph 7.30; FC Guide, paragraph 2.42)

i. Once a decision has been made to sell loans ***not previously classified as held for sale***, ~~they~~ ***such loans*** should be ***transferred into the held-for-sale classification and*** carried at the lower of cost or ~~market~~ ***fair*** value.[11] ***At the time of the transfer into the held-for-sale classification, any amount by which cost exceeds fair value should be accounted for as a valuation allowance***. (BSI Guide, paragraph 8.14; CU Guide, paragraph 7.10)

j. Criteria that should be considered when evaluating whether a ***transfer*** ~~sale~~ of ~~mortgage~~ servicing rights ~~has occurred~~ ***qualifies as a sale*** ~~should include~~ ***are the guidance, as applicable, in Emerging Issue Task Force (EITF) Issue No. 95-5 "Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights",***[12] ***and the following***:

- Whether the seller has received written approval from the investor if required
- Whether the buyer is a currently approved seller/servicer and is not at risk of losing approved status
- In the event of a sale in which the seller finances a portion of the sales price, whether an adequate nonrefundable down payment has been received (necessary to demonstrate the buyer's commitment to pay the remaining sales price) and whether the note receivable from the buyer provides full recourse to the buyer. Nonrecourse notes or notes with limited recourse (such as to the servicing) do not satisfy this criterion (BSI Guide, paragraph 8.24; CU Guide, paragraph 7.18)
- Also, temporary servicing performed by the transferor for a short period of time should be compensated in accordance with a subservicing agreement that provides ***adequate compensation*** ~~a normal subservicing fee~~ (BSI Guide, paragraph 8.25)

k. Sales of servicing rights relating to loans previously sold ***should*** ~~may~~ be recognized in income subject to the considerations ~~discussed below~~ ***above***. Sales of servicing rights relating to loans that are retained ~~should not be recognized in income at the time of sale~~ ***should also be recognized in income subject to the considerations above***

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[10] *Off-balance-sheet financial instruments* refers to off-balance-sheet loan commitments, standby letters of credits, financial guarantees, and other similar instruments with off-balance-sheet credit risk except for those instruments within the scope of FASB Statement No. 133.

[11] This paragraph applies to both mortgage and nonmortgage loans.

[12] EITF Issue No. 95-5 provides guidance for determining whether a transfer of servicing rights should be accounted for as a sale.

***and at the date of sale, the carrying amount should be allocated between the servicing rights and loans retained using relative fair values in a manner consistent with paragraph 10(b) of FASB Statement No. 140,* Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities**.[13] ~~The proceeds from such sales should be accounted for in a manner similar to loan discounts and amortized using the interest method as an adjustment to the yield of the related loans~~. (BSI Guide, paragraph 8.20; CU Guide, paragraph 7.13)

l. The institution's liability for deposits originates and should be recognized at the time deposits are received rather than when the institution collects the funds. (BSI Guide, paragraph 11.30) Checks that are deposited by customers and that are in the process of collection and are currently not available for withdrawal (deposit float) should be recorded as assets and liabilities. Deposits should not be recorded based solely on collections. (BSI Guide, paragraph 11.31)

Guidance from the CU or FC Guide

B.3. Following are accounting practices unique to credit unions or finance companies that were initially established by the CU Guide or the FC Guide, and are carried forward, with conforming changes, to this SOP.

a. Amounts deposited with the NCUSIF should be accounted for and reported as assets as long as such amounts are fully refundable. The refundability of NCUSIF deposits should be ~~evaluated periodically~~ ***reviewed for impairment***. When the refundability of a deposit is evaluated, the financial condition of both the credit union and of the NCUSIF should be considered. Deposits may be returned to solvent credit unions for a number of reasons, including termination of insurance coverage, conversion to insurance coverage from another source, or transfer of operations of the insurance fund from the NCUA Board. ***However, i***~~I~~nsolvent or bankrupt credit unions are not entitled to a return of their deposits. To the extent that NCUSIF deposits are not refundable, they should be charged to expense in the period in which the deposits are made or the assets become impaired. (CU Guide, paragraph 10.20)

In years in which the equity of the NCUSIF exceeds "normal operating levels," the NCUA Board is required to make distributions to insured credit unions to reduce the equity ***of the NCUSIF*** to normal operating levels. Such distributions may be in the form of a waiver of insurance premiums, premium rebates, or cash payments. ~~Payments received~~ ***Distributions*** in connection with that reduction in the equity of the NCUSIF should be reported ~~as current-period~~ ***in the*** income ***statement*** in the period in which it is determined that a distribution will be made. (CU Guide, paragraph 10.21)

The system of savings account insurance established by the recapitalization of the NCUSIF, which provided for reserves of 1 percent of insured deposits, is based on the concept that the required deposits create a fund with an earning potential sufficient to provide for the

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[13] FASB Statement No. 140 does not address transfers of servicing rights because they are not financial assets. However, this SOP addresses transactions in which loans are transferred with servicing retained, and governs allocation of basis between loans and servicing rights for those transactions.

risk of losses in the credit union system. In years in which the earnings of the fund have been adequate to provide insurance protection and cover all expenses and losses incurred by the fund, the NCUA Board has elected to waive the insurance premiums due from insured credit unions. In those years, it has been industry practice to net imputed earnings on the insurance deposits against imputed premium expense rather than present them as gross amounts on the statement of income. In years in which the insurance premiums are not waived by the NCUA Board, the premiums should be expensed in the period to which they relate. To the extent that the NCUA Board assesses premiums to cover prior operating losses of the insurance fund or to increase the fund balance to "normal operating levels," credit unions should expense those premiums when assessed. (CU Guide, paragraph 10.22)

b. Generally accepted accounting principles (GAAP)[14] require that all member deposit accounts of credit unions, including member shares, be reported ***unequivocally*** as liabilities in the statement of financial condition.[15] ~~It must be unequivocal on the face of the statement of financial condition that deposit accounts are a liability~~. The statement of financial condition ~~must~~ either ~~(*a*)~~ (*1*) present***s*** deposit accounts as the first item in the liabilities and equity section or ~~(*b*)~~ (*2*) include***s*** deposit accounts within a captioned subtotal for total liabilities. An unclassified presentation whereby all liabilities and equity are shown together under one subheading and savings accounts are presented as the last item before retained earnings is not an acceptable presentation. The interest paid or accrued on these accounts, commonly referred to as *dividends*, should be reported as an expense on the statement of income, and the amount of interest payable to members should be included as a liability in the statement of financial condition. This is the same position that the ~~FASB's Emerging Issues Task Force (~~EITF~~) took~~ ***reached*** in EITF Issue No. 89-3, "Balance Sheet Presentation of Savings Accounts in Financial Statements of Credit Unions." (CU Guide, paragraph 8.05)

c. ***Transactions in which c***~~C~~aptive finance companies ~~that~~ offer favorable financing to increase sales of related companies ~~may present particular problems~~ ***are not exempted from the scope of Accounting Principles Board (APB) Opinion No. 21,* Interest on Receivables and Payables*, by paragraph 3(d) of that Opinion***. APB Opinion 21 provides accounting guidance to use if the face amount of the note does not reasonably represent the present value of the consideration given or received in an exchange. (FC Guide, paragraph 2.14)

Guidance from the FC Guide

B.4. Following are recognition and measurement principles initially established by the FC Guide, and carried forward, with conforming changes, to this SOP:

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[14] The Credit Union Membership Access Act (CUMAA) (H.R. 1151) was passed into law in August 1998. This legislation requires all federally insured credit unions with assets of $10 million and over to follow generally accepted accounting principles (GAAP).

[15] In October 2000, the FASB issued an exposure draft of a proposed Statement, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*, and an exposure draft of a proposed amendment to FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, entitled *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities*. Readers should be alert to any final pronouncements.

a. Delinquency fees ~~conceptually~~ should be recognized in income when chargeable, assuming collectibility is reasonably assured. ~~In practice, delinquency fees generally are recognized in income when collected, because that approach simplifies efforts to account for such relatively minor receipts~~. (FC Guide, paragraph 2.21)

b. Prepayment penalties should not be recognized in income until loans ***(or trade receivables, if applicable)*** are prepaid, ***except that the existence of prepayment penalties may affect the accounting resulting from the application of paragraph 18(a) of FASB Statement No. 91.*** (FC Guide, paragraph 2.22)

c. Rebates ***represent refunds*** ~~are cancellations~~ of portions of the precomputed finance charges on ***installment*** ~~discount~~ loans ***(or trade receivables, if applicable)*** that occur when ~~loan~~ payments are made ahead of schedule. Rebate calculations generally are governed by state laws and may differ from unamortized finance charges on ***installment*** ~~discount~~ loans ***or trade receivables*** because many states require rebate calculations to be based on the Rule of 78s or other methods instead of the interest method. Accrual of interest income on ***installment*** ~~discount~~ loans ***or trade receivables*** should not be affected by the possibility that rebates may be calculated on a method different from the interest method, ***except that the possibility of rebates affects the accounting resulting from the application of paragraph 18(a) of FASB Statement No. 91.*** Differences between rebate calculations and accrual of interest income merely adjust original estimates of interest income and should be recognized in income when loans ***or trade receivables*** are prepaid or renewed. (FC Guide, paragraph 2.23)

d. ~~Finance companies should recognize factoring commissions over the periods in which services are rendered. Those periods begin when finance companies approve customers' credit and end when the customers' accounts are settled. In practice, finance companies generally recognize factoring commissions are bought, not over the longer period of providing services, because the differences between the effects of such allocations and the effects of immediate recognition generally would be immaterial. If the differences between the effects of such allocations and the effects of immediate recognition are material, recognized over the longer period of providing services.~~ ***Transfers of receivables under factoring arrangements meeting the sale criteria of paragraph 9 of FASB Statement No. 140 are accounted for by the factor as purchases of receivables. The acquisition of receivables and accounting for purchase discounts such as factoring commissions should be recognized in accordance with FASB Statement No. 91 or AICPA Practice Bulletin No. 6,*** **Amortization of Discounts on Certain Acquired Loans,** ***as applicable.***[16] ***Transfers not meeting the sale criteria in FASB Statement No. 140 are accounted for as secured loans (that is, loans collateralized by customer accounts or receivables). Paragraph 15 of FASB Statement No. 140 provides additional guidance in those situations. Factoring commissions under these arrangements should be recognized***

[16] See footnote 5.

over the period of the loan contract in accordance with FASB Statement No. 91. That period begins when the finance company (or an entity with financing activities (including trade receivables)) funds a customer's credit and ends when the customer's account is settled. (FC Guide, paragraph 2.25)

e. Income from experience-rated or retrospective commission arrangements should be ~~accrued~~ ***recognized*** over the applicable insurance risk period. (FC Guide, paragraph 5.22)

Presentation and Disclosure

Guidance from the BSI Guide

B.5. Presentation and disclosure principles established by and carried forward from the BSI Guide to the combined Guide follow. Conforming changes are specifically noted by bold italicized or strike-through text. Certain of these disclosure principles were also established separately for credit unions or finance companies or both. Reference to specific paragraphs within the respective Guides is noted parenthetically.

a. Restrictions on the use or availability of certain cash balances, such as deposits with a F~~ederal~~ Reserve Bank, ~~or~~ FHLB, ***or correspondent financial institutions*** to meet reserve requirements or deposits under formal compensating balance agreements, should be disclosed in the ***notes to the*** financial statements. (BSI Guide, paragraph, 4.06; and the CU Guide, paragraph 3.06)

b. ***A financial institution that accepts deposits may have balances due from the same financial institution from which it has accepted a deposit***. ~~Balances due to and due from a single depository institution~~ ***Those account balances***, also called reciprocal balances, should ~~also~~ be offset if ***they will be offset in the process of collection or payment*** ~~right of setoff exists~~. Overdrafts ***of such accounts*** ~~of correspondents or other demand deposit accounts that represent borrowings rather than outstanding drafts~~ should be reclassified as liabilities, unless the ~~depositors have~~ ***financial institution has*** other accounts at the same ~~depository~~ ***financial institution against which overdrafts can be offset.*** ~~institution for which there is the right of setoff~~. (BSI Guide, paragraph 4.07)

c. ~~Management's disclosure in t~~***T***he summary of significant accounting policies should include ***the following***:

(1) The basis for accounting for loans***, trade receivables*** and lease financings, ~~both held in a portfolio and~~ ***including those classified as*** held for sale

(2) The method ~~for~~ ***used in*** determining the ~~carrying amounts~~ ***lower of cost or fair value*** of ***nonmortgage*** loans held for sale ***(that is, aggregate or individual asset basis)***[17]

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[17] A similar requirement exists for mortgage loans held for sale. See paragraph 29 of FASB Statement No. 65.

(3) ***The classification and method of accounting for interest-only strips, loans, other receivables, or retained interests in securitizations that can be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment***[18, 19, 20]

(4) The method for recognizing interest income on loans ***and trade receivables***, including a statement about the ~~institution's~~ ***entity's*** policy for treatment of ~~loan~~ ***related*** fees and costs, including the method of amortizing net deferred fees or costs. (BSI Guide, paragraph 6.74; CU Guide, paragraph 5.48)

d. The carrying amount of investment assets ~~pledged~~ ***that serve as collateral*** to secure public funds, securities sold under repurchase agreements, and ~~for~~ other borrowings***, that are not otherwise disclosed under FASB Statement No. 140***, should also be disclosed in the notes to the financial statements. (BSI Guide, paragraph 5.105; CU Guide, paragraph 4.34)

e. Loans ***or trade receivables*** ~~are typically~~ ***may be*** presented on the balance sheet as ~~an~~ aggregate amount***s***. However, ~~loans~~ ***such receivables*** held for sale should be a separate balance-sheet category. Major categories of loans ***or trade receivables*** should be presented separately either in the balance sheet or in the notes to the financial statements. The allowance for credit losses, ***the allowance for doubtful accounts and, as applicable, any*** unearned income, ***any*** unamortized premiums and discounts,[21] and ***any*** net unamortized deferred fees and costs, should be disclosed in the financial statements. ~~Also, the undisbursed portion of loans receivable (loans in process) should be disclosed~~. (BSI Guide, paragraphs 6.75 and 8.30; CU Guide, paragraphs 5.38, 5.39, 6.19, and 7.22; FC Guide, paragraph 2.44)

f. The carrying amount of loans***, trade receivables, securities and financial instruments that serve*** ~~pledged~~ as collateral for borrowings should be disclosed ***pursuant to paragraphs 18 and 19 of FASB Statement No. 5,* Accounting for Contingencies**. (BSI Guide, paragraph 6.76; CU Guide, paragraph 5.43)

g. ***For financial instruments with off-balance-sheet credit risk,***[22] ***except for those instruments within the scope of FASB***

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[18] This disclosure requirement applies to instruments within the scope of paragraph 14 of FASB Statement No. 140. The FASB plans to provide guidance on (*a*) which types of instruments qualify for the exception in paragraph 14 of FASB Statement No. 133 and (*b*) whether beneficial interests in securitized financial assets that are subordinated to other interests meet FASB Statement No. 133's definition of derivative instrument. Statement 133 Implementation Issue No. D1, "Recognition and Measurement of Derivatives: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets" provides interim guidance. Readers should be alert to any final guidance.

[19] See footnote 5.

[20] Footnote 17 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, states that "The *recorded investment in the receivable* is the face amount increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges, or acquisition costs and may also reflect a previous write-down of the investment."

[21] See footnote 5.

[22] *Off-balance-sheet credit risk* refers to credit risk on off-balance-sheet loan commitments, standby letters of credit, financial guarantees, and other similar instruments, except those instruments within the scope of FASB Statement No. 133.

Statement No. 133, **Accounting forDerivative Instruments and Hedging Activities*, an entity should disclose the following information:***

(1) The face or contract amount

(2) The nature and terms, including, at a minimum, a discussion of the:

(a) **Credit and market risk of those instruments**

(b) **Cash requirements of those instruments**

(c) Related accounting policy pursuant to APB Opinion No. 22, **Disclosure of Accounting Policies**

(3) The entity's policy for requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

~~FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrationsof Credit Risk*, as amended by FASB Statement No. 119, requires disclosure of (*a*) the extent, nature, and terms of financial instruments with off-balance-sheet risk (paragraph 17); (*b*) credit risk of financial instruments with off-balance-sheet credit risk (paragraph 18); and (*c*) concentrations of credit risk of all financial instruments (paragraph 20). The disclosure requirements set forth in paragraph 17 of FASB Statement No. 105 similarly are required for financial instruments without off-balance-sheet risk by paragraph 8 of FASB Statement No. 119.~~ Examples of ***activities and*** financial instruments with off-balance-sheet ***credit*** risk include ***obligations for*** loans sold with recourse (with or without a floating-interest-rate provision), fixed-rate and variable-rate loan commitments, financial guarantees,[23] note issuance facilities at floating rates, and letters of credit. (BSI Guide, paragraph 6.78)

h. In addition to disclosures required by FASB Statement***s*** No~~s~~. 5; 114, *Accounting by Creditors for Impairment of a Loan;* [24] and 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures,* a description of the accounting policies and methodology the ~~institution~~***entity*** used to estimate its allowance ***for loan losses, allowance for doubtful accounts,*** [25] and ***any*** liability ***for off-balance-sheet credit losses***[26] and related ~~provisions~~***charges*** for loan***, trade receivable*** or other credit losses should be included in the notes to the financial statements. Such a description should identify the factors that influenced management's judgment (for example,

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[23] A guarantor is required to disclose and account for a financial guarantee under EITF Issue 85-20, "Recognition of Fees for Guaranteeing a Loan."

[24] FASB Statement No. 114 states in paragraph 4 "For purposes of this Statement, a loan is a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. Examples include but are not limited to accounts receivable (with terms exceeding one year) and notes receivable."

[25] See footnote 8.

[26] *Off-balance-sheet credit losses* refers to losses on off-balance-sheet loan commitments, standby letters of credit, financial guarantees, and other similar instruments, except for instruments within the scope of FASB Statement No. 133.

historical losses and existing economic conditions) and may also include discussion of risk elements relevant to particular categories of financial instruments. (BSI Guide, paragraph 7.33; CU Guide, paragraph 5.48; FC Guide, paragraph 2.43)

i. The ***aggregate*** amount of ~~aggregate~~ gains or losses on sales of loans ***or trade receivables*** (including adjustments to record loans held for sale at the lower of cost or ~~market~~***fair*** value) should be presented separately ~~on the face of the income~~***in the financial*** statement***s or disclosed in the notes to the financial statements***.[27] (BSI Guide, paragraph 8.30; CU Guide, paragraph 7.22)

j. Foreclosed ***and repossessed*** assets ***should*** be classified as a separate balance-sheet amount or included in other assets on the balance sheet with separate disclosures in the notes to the financial statements. ***Certain returned or repossessed assets, such as inventory, should not be classified separately if the assets subsequently are to be utilized by the entity in operations.*** (BSI Guide, paragraph 9.11; CU Guide, paragraph 10.16; FC Guide, paragraph 2.33)

k. ***For premises and equipment,***~~N~~***n***et gains or net losses on dispositions should be ~~reflected~~ ***included*** in noninterest income or noninterest expense. (BSI Guide, paragraph 10.11)

l. Disclosures about deposit ***liabilities*** should include the following:

(1) The aggregate amount of time deposit accounts (including certificates of deposit) ~~exceeding~~***in denominations of*** $100,000 ***or more*** at the balance-sheet date (BSI Guide, paragraph 11.32*a*; CU Guide, paragraph 8.04)

(2) Securities, mortgage loans, or other financial instruments ~~pledged~~***that serve*** as collateral for deposits, ***that are otherwise not disclosed under FASB Statement No. 140*** (BSI Guide, paragraph 11.32*c*; CU Guide, paragraph 8.04)

(3) The aggregate amount of any demand deposits that have been reclassified as loan balances, ***such as overdrafts,*** at the balance-sheet date (BSI Guide, paragraph 11.32*d*; CU Guide, paragraph 8.04)

(4) Deposits that are received on terms other than those available in the normal course of business. (BSI Guide, paragraph 11.32*f*)

m. Significant categories of borrowings should be presented as separate line items in the liability section of the balance sheet, ***or as a single line item with appropriate note disclosure of components. Institutions may, alternatively, present debt based on the debt's priority (that is, senior or subordinated) if they also provide separate disclosure of significant categories of borrowings***. (BSI Guide, paragraph 13.27; CU Guide, paragraph 9.09; FC Guide, paragraphs 3.24 and 3.25)

[27] AcSEC acknowledges that many financial institutions currently present such gains or losses separately on the face of the income statement. By requiring financial statement disclosure, AcSEC is not suggesting that this industry practice should be discontinued.

n. ***For debt, t***~~T~~he notes to the financial statements should describe the principal terms of the respective agreements including; but not limited to~~,~~ the title or nature of the agreement, or both~~,~~ the interest rate (and whether it is fixed or float~~s~~***ing***); the payment terms and maturity date(s); collateral; conversion or redemption features; whether it is senior or subordinated; and restrictive covenants (such as dividend restrictions), if any. (BSI Guide, paragraph 13.27; CU Guide, paragraph 9.09)

o. Accounting ***and reporting requirements*** for long-term obligations ~~is~~ ***are*** the same for ***financial*** ~~banks and savings~~ institutions as for other ***entities*** ~~enterprises~~. ***If the*** ~~However, because~~ financial institution has an unclassified balance sheet, there is no need to separate balances into current and long-term portions.[28] (BSI Guide, paragraph 13.28; FC Guide, paragraph 3.25)

p. For redeemable preferred stock of a subsidiary accounted for as ~~liabilities~~ ***a liability in a parent's consolidated financial statements***, dividends should be included in the determination of income ***as interest expense***. ***For redeemable preferred stock of a subsidiary accounted for as a minority interest in a subsidiary in a parent's consolidated financial statements, the dividends should be presented as minority interest in income of a subsidiary.*** For redeemable preferred stock ***of a parent*** treated as capital, but displayed in the balance sheet as mezzanine capital, dividends should be included in the statement of changes in shareholders' equity.[29] (BSI Guide, paragraph 13.28)

q. ***Transfers of mortgages accounted for under FASB Statement No. 140 as secured borrowings*** ~~Mortgage backed bonds are debt obligations~~ of the issuing institution ~~and~~ should be classified as debt on the institution's balance sheet. ~~They~~ ***Such mortgage-backed bonds*** should be classified separately from advances, other notes payable, and subordinated debt. (BSI Guide, paragraph 13.30)

Guidance from the FC and CU Guide

B.6. The following are presentation and disclosure principles initially established by the CU Guide and the FC Guide or both, and carried forward, with conforming changes, to the combined Guide and applicable to all entities within its scope.

a. ~~Management's disclosure in t~~***The*** summary of significant accounting policies should include the following:

(1) ~~The method for recognizing interest income on loans, including the policy for discontinuing accrual of interest on nonperforming loans.~~ ***The policy for placing loans (and trade receivables if applicable) on nonaccrual status (or discontinuing accrual of interest) and recording payments received on nonaccrual loans (and trade receivables if applicable), and the policy for resuming accrual of interest*** (CU Guide, paragraph 5.48; FC Guide, paragraph 2.47)

[28] FASB Statement No. 47, *Disclosure of Long-Term Obligations*, requires disclosure of future payments on long-term borrowings.

[29] See footnote 15.

(2) The policy for charging off uncollectible loans ***and trade receivables*** (FC Guide, paragraph 2.47)

(3) ***The policy for determining past due or delinquency status (that is, whether past due status is based on how recently payments have been received or contractual terms).***

b. The ~~amount~~ ***recorded investment***[30] ~~of~~ ***in*** loans ***(and trade receivables if applicable)*** on ~~a~~ nonaccrual ~~basis~~ ***status as of each balance-sheet date*** should be disclosed ***in the notes to the financial statements. The recorded investment in loans (and trade receivables if applicable) past due ninety days or more and still accruing should also be disclosed. For trade receivables that do not accrue interest until a specified period has elapsed, nonaccrual status would be the point when accrual is suspended after the receivable becomes past due***. (CU Guide, paragraph 5.39; FC Guide, paragraph 2.44)

c. Insurance subsidiaries ***may be*** ~~are~~ required to deposit ~~some~~ securities~~, usually not a significant amount~~, with state regulatory authorities. ~~However, if significant~~, ***If so,*** the ***carrying*** amount ***of securities*** deposited should be disclosed. (FC Guide, paragraph 5.19)

d. Unearned premiums and unpaid claims on certain insurance ~~policies~~ ***coverage*** issued to finance customers by a subsidiary may represent intercompany items because premiums are added to the consumer loan account, which is in turn classified as a receivable until paid, and most or all of the payments on claims are applied to reduce the related finance receivables. Therefore, unearned premiums and unpaid claims on certain credit life and credit accident and health insurance policies issued to finance customers should be deducted from finance receivables in the consolidated balance sheet. ~~That will cause the receivables to be stated at net realizable value~~. Alternatively, the balance sheet may present only the net finance receivables if the notes to the financial statements contain sufficient disclosure of unearned premiums and unpaid claims and the allowance for losses. ***Unearned premiums and unpaid claims for credit life and accident and health coverage should not be applied in consolidation against related finance receivables for which the related receivables are assets of unrelated entities. In those circumstances, such amounts should be presented as liabilities***. (FC Guide, paragraph 5.26)

e. ***In the consolidated financial statements, u***~~U~~npaid claims for property insurance and ~~a portion of~~ level term life insurance, however, ***should*** ~~generally may~~ not be ***offset*** ~~applied in consolidation~~ against related finance receivables because finance companies generally do not receive substantially all proceeds of such claims. That prohibition also applies to credit life and accident and health coverage written on policies for which the related receivables are assets of unrelated ~~enterprises~~ ***entities***. In those circumstances, such amounts should be presented as liabilities. (FC Guide, paragraph 5.27)

Guidance Eliminated from the BSI Guide

B.7. The requirements from the May 1, 2000 BSI Guide eliminated for banks and savings institutions are as follows:

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[30] See footnote 20.

- Specific guidance about balance-sheet presentation of cash and cash equivalents, interest-bearing deposits with other institutions, and federal funds purchased and repurchase agreements. (BSI Guide, paragraphs 4.06 and 12.31.)
- Disclosure of long-term debt for regulatory capital purposes. (BSI Guide, paragraph 13.32)

Guidance Eliminated from the CU Guide

B.8. The requirements from the May 1, 2000, CU Guide eliminated for credit unions are as follows:

- Disclosure of significant factors affecting the carrying amount of mortgage-related derivative securities, such as prepayments and interest rates, and separate disclosure of carrying amount and fair value of mortgage-related derivative securities (CU Guide, paragraph 4.44.)
- Disclosure of additional information about repurchase and reverse repurchase agreements, apart from disclosures already required by FASB Statements No. 107, *Disclosures About Fair Value of Financial Instruments*; and No. 140, such as a description of securities underlying the agreements, cost of the agreements and accrued interest, market value of securities underlying the agreements, and so forth (CU Guide, paragraphs 4.47 and 9.14.)
- Disclosure of additional information about servicing activities, apart from disclosures required by FASB Statement No. 140, such as the amount of the credit union's servicing portfolio, a roll-forward of deferred loan sale premium or discount activity, the nature and extent of any recourse provisions, and the nature and extent of off-balance-sheet escrow accounts (CU Guide, paragraph 7.22.)
- Disclosure of additional information about credit union deposits, including major kinds of interest-bearing and non-interest-bearing deposits by interest rate ranges, weighted average interest rates paid on deposits and related balances by kind of deposit at year end, and dividend (interest) expense by kind of account (CU Guide, paragraph 8.04.)

Guidance Eliminated from the FC Guide

B.9. The requirements from the May 1, 2000, FC Guide eliminated for finance companies are as follows:

- Specific guidance for suspending income recognition on nonperforming loans to be consistent with other Guides (FC Guide, paragraphs 2.15 to 2.17.)
- Specific guidance on accounting for repossessed assets to be consistent with the other Guides (FC Guide, paragraphs 2.33 to 2.35.)
- Specific guidance on disclosure of other income (FC Guide, paragraph 2.47)
- Income statement classification guidance of interest on overnight investments (FC Guide, paragraph 3.23)
- Specific guidance on accounting for premium revenue recognition for different kinds of policies to be consistent with the other Guides (FC Guide, paragraph 5.15.)

Accounting Standards Executive Committee (2000–2001)

Guides Combination Task Force (1997–2001)

AICPA Staff

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[The next page is 81,021.]

Section 10,860

Statement of Position 02-2 Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator

December 27, 2002

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) amends the AICPA Audit and Accounting Guide *Health Care Organizations* (Guide) to address how nongovernmental not-for-profit health care organizations should report gains or losses on hedging and nonhedging derivative instruments under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended. This SOP requires the following:

- Not-for-profit health care organizations should apply the provisions of FASB Statement No. 133 (including the provisions pertaining to cash flow hedge accounting) in the same manner as for-profit enterprises.
- Not-for-profit health care organizations should provide all the disclosures required by paragraph 45 of FASB Statement No. 133, including disclosures related to reclassifications into earnings of gains and losses that are reported in accumulated other comprehensive income. Although those organizations are not otherwise required to report changes in the components of comprehensive income pursuant to paragraph 26 of FASB Statement No. 130, *Reporting Comprehensive*

Income, such organizations should separately disclose the beginning and ending accumulated derivative gain or loss that has been excluded from the performance indicator (earnings measure), the related net change associated with current period hedging transactions, and the net amount of any reclassifications into the performance indicator in a manner similar to that described in paragraph 47 of FASB Statement No. 133.

The SOP also amends the Guide to clarify that the performance indicator (earnings measure) reported by not-for-profit health care organizations is analogous to income from continuing operations of a for-profit enterprise.

The provisions of the SOP are effective for fiscal years beginning after June 15, 2003. Earlier application of this SOP is encouraged but is permitted only as of the beginning of any fiscal quarter that begins after issuance of this SOP. The provisions of the SOP should be applied prospectively. Not-for-profit health care organizations that reported derivative gains or losses in a manner inconsistent with the conclusions of the SOP in financial statements issued prior to adoption of the SOP are not permitted to reclassify those gains or losses upon adoption.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least 10 of AcSEC's 15 members, and (3) a final document that has been approved by at least 10 of AcSEC's 15 members. The document is cleared if at least four of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the document.

Introduction

.01 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, establishes accounting and reporting standards for derivative instruments and hedging activities. If certain conditions are met, a derivative may be specifically designated as a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment (fair value hedge), a hedge of the exposure to variable cash flows of an existing recognized asset or liability or a forecasted transaction (cash flow hedge), or a hedge of foreign currency exposure.[1]

.02 The accounting for derivative gains and losses depends on the intended use of the derivative and the resulting designation.

- For a fair value hedge, the gain or loss on the derivative is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged.
- For a cash flow hedge, the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings when the forecasted transaction affects earnings. Any ineffective portion of the gain or loss is reported in earnings immediately.
- For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.

.03 The application of FASB Statement No. 133 to entities that do not report earnings as a separate caption in a statement of financial performance (for example, a not-for-profit organization) is described in paragraph 43 of that Statement. Paragraph 43 indicates that such organizations shall recognize the gain or loss on hedging and nonhedging derivative instruments, and changes in the carrying amount of the hedged item in a fair value hedge, as a change in net assets in the period of change. Paragraph 43 also indicates that cash flow hedge accounting is not available to a not-for-profit or other entity that does not report earnings as a separate caption in a statement of financial performance. Consistent with the provisions of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, FASB Statement No. 133 does not prescribe how a not-for-profit organization should determine the components of an operating measure, if one is presented.

.04 Many health care entities are organized as not-for-profit organizations, and thus would appear to be subject to the provisions of paragraph 43 of FASB Statement No. 133. The thrust of the guidance in paragraph 43 appears to be directed at the fact that FASB Statement No. 117 does not require not-for-profit entities to report earnings. However, not-for-profit health care organizations must report a defined measure of earnings (performance indicator) as a separate caption in the statement of operations, based on requirements contained in paragraph 10.17 and 10.18 of the AICPA Audit and Accounting Guide *Health Care Organizations* (the Guide). Consequently, some not-for-profit health care organizations believed that paragraph 43 of FASB Statement No. 133 (including its provisions related to cash flow hedge accounting) did not affect them. Those entities applied the provisions of FASB Statement No. 133 in the same manner as for-profit enterprises. Other not-for-profit health care organizations believed they were subject to the guidance in paragraph 43, but interpreted that guidance in different ways. As a result, diversity in practice arose among not-for-profit health care organizations with respect to their accounting for derivatives.

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[1] Not-for-profit health care organizations do not frequently enter into foreign currency hedges. Therefore, this SOP focuses on matters pertaining to fair value and cash flow hedges.

.05 This SOP addresses how not-for-profit health care organizations should report gains or losses on hedging and nonhedging derivative instruments under FASB Statement No. 133 and clarifies certain matters with respect to the performance indicator (earnings measure) reported by such organizations.

Scope

.06 This SOP applies to not-for-profit health care organizations that are within the scope of the Guide. It does not apply to governmental entities that are within the scope of the Guide.

Conclusions

Application of FASB Statement No. 133

.07 Except as provided in paragraph .08 of this SOP, not-for-profit health care organizations should apply the provisions of FASB Statement No. 133 (including the provisions pertaining to cash flow hedge accounting) in the same manner as for-profit enterprises. That is, the gain or loss items that affect a for-profit enterprise's income from continuing operations similarly should affect the not-for-profit health care organization's performance indicator, and the gain or loss items that are excluded from a for-profit enterprise's income from continuing operations (such as items reported in other comprehensive income) similarly should be excluded from the performance indicator by the not-for-profit health care organization.

.08 Paragraph 47 of FASB Statement No. 133 discusses requirements to report changes in the components of comprehensive income pursuant to paragraph 26 of FASB Statement No. 130, *Reporting Comprehensive Income*. Although not-for-profit health care organizations are not subject to the requirements of FASB Statement No. 130, this SOP requires those organizations to separately disclose the beginning and ending accumulated derivative gain or loss that has been excluded from the performance indicator (also see paragraph .10 of this SOP), the related net change associated with current period hedging transactions, and the net amount of any reclassifications into the performance indicator in a manner similar to that described in paragraph 47 of FASB Statement No. 133. Similarly, this SOP requires not-for-profit health care organizations to provide disclosures that are analogous to those required by paragraph 45 of FASB Statement No. 133 for for-profit enterprises, including the disclosure of anticipated reclassifications into the performance indicator of gains and losses that have been excluded from that measure and reported in accumulated derivative gain or loss as of the reporting date.

Performance Indicator

.09 Paragraph 10.17 and 10.18 of the Guide are amended as follows. The following text is added after the first sentence of paragraph 10.17:

> This performance indicator and the income from continuing operations reported by for-profit health care enterprises generally are consistent, except for transactions that clearly are not applicable to one kind of entity (for example, for-profit health care enterprises typically would not receive contributions, and not-for-profit health care organizations would not award stock compensation). That is, the performance indicator is analogous to income from continuing operations of a for-profit enterprise.

In paragraph 10.18, item *e* is eliminated, item *f* is renumbered *e*, and item *g* is deleted and replaced with the following two subpoints:

f. Items that are required to be reported in or reclassified from other comprehensive income, such as gains or losses, prior service costs or credits, and transition assets or obligations associated with postretirement benefits; foreign currency translation adjustments; and the effective portion of the gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments.

g. Items that are required to be reported separately under specialized not-for-profit standards. These include extraordinary items, the effect of discontinued operations, and the cumulative effect of accounting changes pursuant to the provisions of FASB Statement No. 117; and unrealized gains and losses on investments not restricted by donors or by law (except for those investments classified as trading securities) and investment returns restricted by donors or by law, as required by paragraphs 4.07 through 4.10 of this Guide.

[Revised, September 2006, to reflect conforming changes necessary due to the issuance of FASB Statement No. 158.]

Effective Date and Transition

.10 The provisions of this SOP are effective for fiscal years beginning after June 15, 2003. Earlier application of this SOP is encouraged but is permitted only as of the beginning of any fiscal quarter that begins after issuance of this SOP. This SOP should be applied prospectively for all contracts existing on the initial date of application of this SOP and for transactions after that date. Derivative gains or losses reported in a manner inconsistent with the provisions of this SOP in financial statements for periods prior to the initial date of application of this SOP should not be reclassified upon adoption. Any derivative gains and losses excluded from the performance indicator in the financial statements issued for periods ended before the initial date of application of this SOP that did not meet the cash flow hedging criteria of FASB Statement No. 133 should not be reclassified and included as a component of the performance indicator in any period subsequent to the initial date of application of this SOP. In addition, the derivative gains and losses referred to in the preceding sentence should not be included in the disclosure of the accumulated derivative gain or loss (as described in paragraph .08 of this SOP). However, to the extent that derivative gains or losses on cash flow hedges qualifying under FASB Statement No. 133 had been reported in a manner consistent with the provisions of this SOP in financial statements for periods prior to the initial date of application of this SOP, such amounts should be included in that disclosure and should be reclassified and included in the performance indicator when the hedged transaction affects the performance indicator. When the financial statements of the year of adoption are presented separately or included in comparative financial statements, the notes to the financial statements should disclose (*a*) the fact that this SOP has been adopted and the effective date of adoption, and (*b*) the nature of any differences in accounting principles or financial statement presentation applicable to the financial statements presented that resulted from adoption of the SOP. Disclosure of pro forma amounts is not required.

.11 Entities initially applying hedge accounting upon adoption of this SOP are reminded that all the hedge accounting criteria in FASB Statement No. 133 must be met for the entire period to which hedge accounting is being applied. Derivative instruments should not be retroactively designated as hedges if appropriate contemporaneous documentation of the election and periodic assessment of effectiveness[2] did not occur in conformity with FASB Statement No. 133.

The provisions of this SOP need not be applied to immaterial items.

Background

.12 Issues surrounding the reporting of derivatives by not-for-profit health care organizations and the resulting diversity in practice were brought to the attention of the planning subcommittee of the AICPA's Accounting Standards Executive Committee (AcSEC) in December 2000. Specifically, questions had been raised about whether the guidance in paragraph 43 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, applied to not-for-profit health care organizations that are required under industry-specific generally accepted accounting principles (GAAP) to report a performance indicator.

.13 The planning subcommittee discussed the paragraph 43 issue and concluded that, because not-for-profit health care organizations are required to report a standardized performance indicator that is considered analogous to income from continuing operations reported by for-profit enterprises, they should apply the provisions of FASB Statement No. 133 in the same manner as do for-profit enterprises. Because that conclusion was not considered controversial, the planning subcommittee directed the AICPA staff to draft clarifying guidance in the form of a proposed AICPA Technical Practice Aid (TPA).

.14 The planning subcommittee also discussed a footnote that had been added as a conforming change to paragraph 10.18 of the Guide in May 2000. That footnote contained the following statement:

> Not-for-profit health care organizations that have early-adopted FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, should also report unrealized gains and losses on derivatives that do not qualify as a fair value hedge under FASB Statement No. 133, except for the effect of changes in interest accruals, separate from the performance indicator.

In light of the planning subcommittee's conclusion that the provisions of FASB Statement No. 133 should be applied to not-for-profit health care organizations in the same manner as for-profit enterprises, it was decided that the May 2000 conforming change should be deleted from future editions of the Guide.

.15 In January 2001, the planning subcommittee discussed a letter received by AcSEC's Chair from The Bond Market Association (TBMA). The letter indicated TBMA's awareness of the planning subcommittee's discussions and expressed concern that the proposed guidance would be issued in the form of a nonauthoritative TPA. TBMA was concerned that not-for-profit health care organizations and their independent auditors would not be aware of such

[2] FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, establishes the general requirement that, to use hedge accounting, an entity should assess a hedge's effectiveness at the time it enters into a hedge and at least every three months thereafter, unless the hedge qualifies for use of the short-cut method. The requirement to assess hedge effectiveness at least every three months applies to entities that issue financial statements only on an annual basis as well as to entities that issue quarterly financial statements.

guidance, resulting in the inconsistent application of derivative accounting among organizations in the sector. TBMA also wanted to ensure that all affected parties would have an opportunity to review and comment on the proposed guidance, because it could represent a significant change in reporting for some not-for-profit health care organizations.

.16 In March 2001, after further discussing the draft TPA and considering input received from various sources, the planning subcommittee and AcSEC decided that an SOP should be issued to amend the Guide to address these issues. Although the planning subcommittee and AcSEC did not disagree with the conclusions in the draft TPA, it was concluded that an SOP subject to due process would be the most appropriate vehicle for communicating the guidance. AcSEC issued an exposure draft of a proposed SOP on June 14, 2002 and received four comment letters.

Views on the Issue

.17 Some believed that because not-for-profit health care organizations are required by the AICPA Audit and Accounting Guide *Health Care Organizations* to report a performance indicator that is analogous to income from continuing operations of a for-profit enterprise, they should apply the provisions of FASB Statement No. 133 (including the cash flow hedge accounting provisions) in the same manner as for-profit enterprises. That is, the gain or loss items that under FASB Statement No. 133 would affect a for-profit enterprise's earnings similarly should affect the not-for-profit health care organization's performance indicator, and the gain or loss items that under FASB Statement No. 133 are reported in other comprehensive income by the for-profit enterprise similarly should be excluded from the performance indicator by the not-for-profit health care organization. They interpreted paragraph 43 of FASB Statement No. 133 as applying only to organizations that are not required to report an earnings measure.

.18 Others believed that paragraph 43 precludes the use of cash flow hedge accounting by not-for-profit health care organizations because the FASB has not defined the performance indicator to be used by those organizations. They cited the following sentence in paragraph 501 of FASB Statement No. 133 as support for their position:

> For this Statement to permit a not-for-profit entity, for example, to apply cash flow hedge accounting, the Board would first have to define a subcomponent of the total change in net assets during a period that would be analogous to earnings for a business enterprise.

They believed that the definition of *performance indicator* used by not-for-profit health care organizations does not qualify as earnings for FASB Statement No. 133 purposes because it was promulgated by AcSEC, rather than the FASB. Opponents of that view pointed to paragraph 49 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, which allows AICPA industry Audit and Accounting Guides to provide implementing guidance with respect to that Statement that, if cleared by the FASB, should be adopted by users of those guides. The FASB did not object to the definition of *performance indicator* promulgated in the Guide.

.19 Others acknowledged that not-for-profit health care organizations report a performance indicator that is analogous to income from continuing operations of a for-profit enterprise, but believed that the cash flow hedge accounting prohibitions in paragraph 43 should apply because the concept of other comprehensive income is limited to for-profit enterprises that are subject to FASB Statement No. 130, *Reporting Comprehensive Income*. Opponents of that view responded that not-for-profit health care organizations employ other comprehensive income reporting concepts in their statement of operations and their definition of a performance indicator. They pointed to the fact that among the exclusions from the performance indicator listed in paragraph 10.18 of the Guide are the items that for-profit organizations are required to include in other comprehensive income under FASB Statement No. 130 (foreign currency items, gains or losses, prior service costs or credits, and transition assets or obligations associated with postretirement benefits, and unrealized gains and losses on certain investments in debt and equity securities). Further, they pointed to paragraphs 500 and 501 of FASB Statement No. 133, which indicate that the total change in net assets of a not-for-profit organization is analogous to the total comprehensive income of a for-profit enterprise. [Revised, September 2006, to reflect conforming changes necessary due to the issuance of FASB Statement No. 158.]

.20 Still others believed that, although not-for-profit health care organizations conceptually are capable of applying the mechanics of cash flow hedge accounting in their financial statements, they are precluded from doing so because the list in paragraph 10.18 of the Guide of items to be excluded from the performance indicator does not explicitly include "the effective portion of the gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments." They believed that all transactions except those explicitly listed in paragraph 10.18 should be included in the performance indicator.

.21 Among those who believed that paragraph 43 prohibits not-for-profit health care organizations from applying cash flow hedge accounting, some believed that all hedging and nonhedging derivative gains and losses should be included in the performance indicator. Others interpreted paragraph 43 as requiring all hedging and nonhedging derivative gains and losses to be excluded from the performance indicator and reported in "other changes in net assets." Still others employed a hybrid approach to reporting derivative gains and losses based on guidance provided in a conforming change (that subsequently was rescinded)[3] contained in a footnote to paragraph 10.18 of the May 2000 edition of the Guide.

Basis for Conclusions

Scope

Other Not-for-Profit Organizations

.22 AcSEC discussed whether the scope of the SOP should extend to other types of not-for-profit organizations (that is, not-for-profit organizations other than health care organizations) in situations in which those organizations voluntarily choose to provide a performance indicator. Those organizations are subject to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, rather than the Audit and Accounting Guide *Health Care Organizations*. AcSEC chose not to address similar issues for those organizations in the context of this SOP because, unlike health care organizations, other types of not-for-profit organizations are not subject to a standardized or prescribed performance measure.

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[3] See paragraph .14 of this SOP.

Governmental Health Care Enterprises

.23 Because the concept of reporting "other comprehensive income" conflicts with the reporting requirements of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, cash flow hedge accounting is not available to governmental health care enterprises that are within the scope of the Guide. Therefore, governmental health care enterprises are excluded from the scope of the SOP. FASB Statement No. 133 applies to governmental enterprises only to the extent that provisions in that Statement do not conflict with the provisions of GASB pronouncements (see paragraph 94 of GASB Statement No. 34).

Reporting a Separate Component of Equity

.24 Pursuant to paragraph 26 of FASB Statement No. 130, for-profit entities report *accumulated other comprehensive income* as a component of equity that is displayed separately from retained earnings and additional paid-in capital in a statement of financial position. When FASB Statement No. 130 was issued, the FASB considered whether not-for-profit organizations should also be included within the scope of that Statement. The FASB decided to exclude those organizations, noting that not-for-profit organizations' financial statements already were displaying the equivalent of comprehensive income as a result of the requirements of FASB Statement No. 117. Thus, not-for-profit organizations are not required to report accumulated other comprehensive income as a separate component of equity.

.25 AcSEC discussed whether the absence of a requirement to report accumulated other comprehensive income as a separate component of equity was a significant enough difference to preclude not-for-profit health care organizations from being able to use cash flow hedge accounting under FASB Statement No. 133. AcSEC determined that the concept of reporting accumulated other comprehensive income as a separate component of equity is unique to for-profit enterprises that report retained earnings and additional paid-in capital and that, further, the concept primarily appears to be a carryforward of the reporting practices followed by such entities before the issuance of FASB Statement No. 130. Moreover, AcSEC was concerned that such reporting may conflict with the provisions of FASB Statement No. 117 requiring not-for-profit organizations to report three classes of net assets (unrestricted, temporarily restricted, and permanently restricted). Therefore, AcSEC concluded that the absence of a requirement to report a separate component of equity in the balance sheet of not-for-profit health care organizations should not preclude those organizations from using comprehensive income reporting for qualifying gains and losses on cash flow hedges. Although accumulated other comprehensive income will inherently be carried forward in a not-for-profit health care organization's net assets, there is no compelling need for it to be reported separately in the balance sheet.

Income Statement Classification of Derivative Gains and Losses

.26 Although FASB Statement No. 133 provides comprehensive disclosure guidance for derivatives, it does not explicitly address or prescribe the income statement classification for derivative gains and losses that are included in earnings.

.27 Paragraph 45 of FASB Statement No. 133 requires an entity to disclose where in the income statement it has chosen to report the net gain or loss on fair value and cash flow hedges (and the related hedged transaction or item), but the paragraph does not specify where or in what captions such gains and losses should be displayed. That allows for flexibility in reporting based on an entity's economic rationale for entering into the hedge. For derivatives that are not designated as hedges, FASB Statement No. 133 does not require disclosure of where gains and losses are reported in the income statement, nor does it specify where within the income statement those gains and losses should be reported. AcSEC decided not to provide more specific guidance regarding income statement classification in this SOP because it did not want to prescribe more restrictive guidance for not-for-profit health care organizations than that applicable to other organizations subject to FASB Statement No. 133.

Definition of Performance Indicator

.28 The term *performance indicator* was introduced in 1996 when the AICPA issued the Audit and Accounting Guide *Health Care Organizations*.[4] The 1996 revision of the industry Guide was necessitated largely by the issuance of FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made*, and No. 117, which (among other things) changed the financial statement display requirements for not-for-profit organizations. The 1995 exposure draft of the Guide had referred to the earnings measure using terms such as *net income* and *operating income*. The FASB subsequently objected to that terminology, deeming it inappropriate for describing an earnings measure of a not-for-profit organization. Accordingly, the final Guide used the generic term *performance indicator* to denote the earnings measure.

.29 Paragraph 1.04 of the Guide states, in part:

> The financial reporting for not-for-profit, business-oriented organizations and investor-owned health care enterprises generally is consistent except for transactions that clearly are not applicable. For example, not-for-profit business organizations would have nothing to report for shareholders' equity. On the other hand, investor-owned health care enterprises typically would not have anything to report for contributions.

Consequently, in developing the definition of *performance indicator* (paragraph 10.17 and 10.18 of the Guide), AcSEC intended that the linkage between the new performance indicator measure and the earnings measure previously reported by not-for-profit health care organizations be preserved to the greatest extent possible, due to its importance to users of health care organizations' financial statements. The phrase "other items that are required by GAAP to be reported separately" was included in paragraph 10.18*g* of the Guide to enable the performance indicator to remain "evergreen," that is, to permit it to be updated by conforming changes to incorporate the issuance of future accounting standards.

.30 Subsequent to issuance of the Guide, AcSEC determined that the provisions of paragraph 10.17 and 10.18 were not being interpreted by some readers of the Guide in the manner intended by AcSEC. In addition, when new accounting standards have been issued, some readers of the Guide have been uncertain how to apply them with respect to the performance indicator. Consequently, paragraph .09 of this SOP revises the definition of *performance indicator* to state explicitly that the performance indicator should be regarded as the functional equivalent of income from continuing operations of a for-profit enterprise. Additionally, this SOP amends paragraph 10.18 of the Guide

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[4] *Health Care Organizations* replaced the AICPA Industry Audit Guide *Audits of Providers of Health Care Services*.

to clarify that the reference to "other items that are required by GAAP to be reported separately" refers to GAAP applicable to for-profit enterprises (for example, items that are required under existing accounting standards to be reported in other comprehensive[5] income as well as GAAP specific to not-for-profit organizations, and that additional items may result from issuance of future accounting standards.

Transition

.31 Paragraph 515 of FASB Statement No. 133 states, in part:

> Because hedge accounting is based on an entity's intent at the time a hedging relationship is established, the Board decided that retroactive application of the provisions of this Statement was not appropriate.

Similarly, Derivatives Implementation Group (DIG) Issue No. K5, *Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues*, indicates that when an entity has applied "the recognition and measurement of derivatives differently than required by subsequently issued cleared implementation guidance, [the entity] should account for the effects of initially complying with that implementation guidance prospectively for all existing contracts and future transactions, as of the effective date for that guidance." Consequently, AcSEC determined that the effects of initially complying with the guidance in this SOP should also be accounted for prospectively.

.32 AcSEC also considered whether to allow an alternative for retroactive application of this SOP. Although this SOP does not change the "recognition and measurement of derivatives," it may change an entity's accounting policy and thus may affect certain actions taken by an entity. For example, based on their interpretation of authoritative literature, certain health care entities may have had economic hedges that they did not designate as cash flow hedges because they did not believe that cash flow hedging derivatives were accounted for differently from non-hedging derivatives. AcSEC recognized that the historical actions undertaken to document, designate, or assess effectiveness by entities that, in prior periods, had adopted accounting policies inconsistent with those set forth in this SOP may have differed had this SOP been effective during those prior periods. In recognition of this fact, and because hedging relationships cannot be documented retroactively under FASB Statement No. 133, AcSEC decided that retroactive application of the provisions of this SOP was not appropriate.

.33 Because the effect of an entity's hedging activities on its financial statements in the initial year of adoption of this SOP may not be comparable to the preceding year, AcSEC discussed whether pro forma disclosures in the year of adoption would address concerns related to consistency and comparability of financial information. Disclosure of the pro forma effects of retroactive application of hedge accounting for prior periods (in a manner similar to the requirements of paragraph 19(d) of Accounting Principles Board Opinion No. 20, *Accounting Changes*) was considered and rejected for the same reasons that AcSEC rejected retroactive restatement as a transition option, as described in paragraph .32. The exposure draft solicited comments on an alternative pro forma measure that would require entities to disclose the effect on their performance indicator for the year of adoption of continuing to apply their prior

[5] [Footnote deleted, September 2006, to reflect conforming changes necessary due to the issuance of FASB Statement No. 158.]

year's reporting practices, if such practices differed from those required by the SOP. One commenter stated that such a requirement was inappropriate and would not provide users of the financial statements with meaningful comparative information. For example, for an entity that prior to adoption of the SOP believed that paragraph 43 of Statement No. 133 prohibited cash flow hedge accounting but that upon adoption of the SOP adopted cash flow hedge accounting, the information derived from disclosing what the performance indicator would have been had the entity continued to not take advantage of hedge accounting has little (if any) meaning for users of financial statements. Similarly, for an entity that prior to adoption of the SOP was excluding gains and losses from the performance indicator in a manner other than that allowed by this SOP, disclosing what the performance indicator would have been had the entity continued to exclude those derivative gains/losses from the performance indicator subsequent to its adoption of the SOP does not provide meaningful information and, further, results in comparing a performance indicator derived in accordance with GAAP with a measure that is no longer considered to be in accordance with GAAP. Therefore, although acknowledging that the usefulness of financial information about an entity increases if that information can be compared with similar information in prior periods, AcSEC concluded that the potential usefulness of that information is diminished or eliminated if the information has no comparative value. Additionally, AcSEC considered this SOP's guidance as similar in nature to the guidance provided in Statement No. 133 and DIG Issue No. K5. Neither Statement No. 133 nor Issue No. K5 requires disclosure of any pro forma information. Consequently, AcSEC concluded that pro forma disclosures of any type would not be appropriate for the year of adoption of this SOP. However, when the financial statements of the year of adoption are presented separately or included in comparative financial statements, the entity should disclose in the notes to the financial statements (*a*) the fact that the SOP has been adopted and the effective date of adoption (for example, beginning of a year or beginning of a quarter), and (*b*) the nature of any differences in accounting principles or financial statement presentation applicable to the financial statements presented that resulted from adoption of the SOP (for example, "The effective portion of unrealized gains and losses on cash flow hedges, which prior to adoption of SOP 02-2 were included in the performance indicator, are now reported below the performance indicator").

.34 The exposure draft would have required entities to adopt the SOP as of the beginning of a fiscal year. Several respondents to the exposure draft objected to precluding entities from early adopting this SOP, based on their understanding that a number of entities had already been applying the provisions of FASB Statement No. 133 pertaining to cash flow hedge accounting prior to issuance of the exposure draft. They also were concerned about allowing diversity in practice to continue over the extended period that would result from requiring adoption as of the beginning of a fiscal year. AcSEC concluded that in the interest of remedying diversity in practice as quickly as possible, entities should be allowed to early adopt the SOP.

.35 AcSEC observed that some not-for-profit health care organizations may have employed a methodology that excluded derivative gains and losses from the performance indicator until those gains or losses were realized. Upon realization, those organizations would have recognized the derivative's gain or loss in the performance indicator. Consistent with its decision to require prospective application of this SOP, AcSEC decided that upon initial application of this SOP, any prior gains or losses on derivative instruments recognized by those not-for-profit health care organizations that had been excluded from the performance indicator in years before adoption and that did not meet the hedging criteria of FASB Statement No. 133 (including the requirements of contemporaneous documentation and testing of effectiveness) should not subsequently be reclassified and included as a component of the performance indicator. Rather, any such derivative gains and losses should be permanently excluded from the performance indicator.

.36 AcSEC did agree, however, that to the extent that a not-for-profit health care organization had reported derivative gains or losses in a manner consistent with the provisions of this SOP (including compliance with the documentation and designation requirements of FASB Statement No. 133) in financial statements for periods prior to the initial application of this SOP, such amounts should be reclassified and included in the performance indicator when the hedged item affects the performance indicator.

.37 For entities that initially apply hedge accounting upon adoption of this SOP or thereafter, paragraph .11 states that all the hedge accounting criteria in FASB Statement No. 133 must be met for the entire period to which hedge accounting is being applied in order for hedge accounting to be used. AcSEC noted that when an organization designates an existing derivative as a hedging instrument upon adoption of the SOP or thereafter, the fair value of the derivative instrument typically will not be zero at the inception of the hedging relationship. Because paragraph 68(b) of FASB Statement No. 133 requires that the fair value of the hedging instrument at the inception of the hedging relationship be zero in order for the short-cut method to be used, application of the short-cut method will not be possible and hedge ineffectiveness for cash flow hedges must be measured under either the hypothetical derivative method or the change in fair value method as described in DIG Issue No. G7, *Cash Flow Hedges: Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method is Not Applied*. For cash flow hedging relationships that were designated and accounted for pursuant to the hedge accounting criteria in FASB Statement No. 133 prior to the adoption of this SOP, the adoption of this SOP will not affect how hedge effectiveness is assessed or hedge ineffectiveness is measured for such relationships.

Accounting Standards Executive Committee (2001–2002)

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Section 10,870

Statement of Position 03-1 Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts

July 7, 2003

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) provides guidance on accounting and reporting by insurance enterprises for certain nontraditional long-duration contracts and for separate accounts. This SOP requires, among other things, the following:

- *Separate account presentation*. The portion of separate account assets representing contract holder funds should be measured at fair value and reported in the insurance enterprise's financial statements as a summary total, with an equivalent summary total for related liabilities, if the separate account arrangement meets all the criteria specified in paragraph .11 of this SOP. If a separate account arrangement does not meet the criteria, assets representing contract holder funds under the arrangement should be accounted for and recognized as general account assets. Any related liability should be accounted for as a general account liability.

- *Interest in separate accounts*. Assets underlying an insurance enterprise's proportionate interest in a separate account do not represent contract holder funds, and thus do not qualify for separate account reporting and valuation. If a separate account arrangement meets the

criteria of paragraph .11 of this SOP and (*a*) the terms of the contract allow the contract holder to invest in additional units in the separate account or (*b*) the insurance enterprise is marketing contracts that permit funds to be invested in the separate account, the assets underlying the insurance enterprise's proportionate interest in the separate account should be accounted for in a manner consistent with similar assets held by the general account that the insurance enterprise may be required to sell.

If the insurance enterprise's proportionate interest in the separate account is less than 20 percent of the separate account and all of the underlying investments of the separate account meet the definition of securities under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, or paragraph 46 of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended by FASB Statement No. 115, or cash and cash equivalents, the insurance enterprise may report its portion of the separate account value as an investment in equity securities classified as trading under FASB Statement No. 115.

- *Gains and losses on the transfer of assets from the general account to a separate account*. Assets transferred from the general account to a separate account should be recognized at fair value to the extent of third-party contract holders' proportionate interest in the separate account if the separate account arrangement meets the criteria in paragraph .11 of this SOP. Any resulting gain related to the third-party contract holder's proportionate interest should be recognized immediately in earnings of the general account of the insurance enterprise, provided that the risks and rewards of ownership have been transferred to contract holders using the fair value of the asset at the date of the contract holders assumption of risks and rewards. A guarantee of the asset's value or minimum rate of return or a commitment to repurchase the asset would not transfer the risks of ownership, and no gain should be recognized. If the separate account arrangement does not meet the criteria in paragraph .11 of this SOP, the transfer generally should have no financial reporting effect (that is, general account classification and carrying amounts should be retained). However, in certain situations, loss recognition may be appropriate.
- *Liability valuation*. The basis for determining the balance that accrues to the contract holder for a long-duration insurance or investment contract that is subject to 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* (paragraphs 15 and 17(a)), is the accrued account balance. The accrued account balance equals:
  1. Deposit(s) net of withdrawals;
  2. Plus amounts credited pursuant to the contract;
  3. Less fees and charges assessed;
  4. Plus additional interest (for example, persistency bonus); and
  5. Other adjustments (for example, appreciation or depreciation recognized in accordance with paragraph .21 of this SOP to the extent not already credited and included in item 2).

For contracts that have features that may result in more than one potential account balance, the accrued account balance should be based on the highest contractually determinable balance that will be available in cash or its equivalent at contractual maturity or the reset date, without reduction for future fees and charges. The accrued account balance should not reflect any surrender adjustments (for example, market value annuity adjustments, surrender charges, or credits). For contracts in which amounts credited as interest to the contract holder are reset periodically, the accrued balance should be based on the highest crediting rate guaranteed or declared through the reset date.

- *Return based on a contractually referenced pool of assets or index*. For a contract not accounted for under the provisions of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, that provides a return based on the total return of a contractually referenced pool of assets either through crediting rates or termination adjustments, the accrued account balance should be based on the fair value of the referenced pool of assets (or applicable index value) at the balance sheet date even if the related assets are not recognized at fair value.
- *Determining the significance of mortality and morbidity risk and classification of contracts that contain death or other insurance benefit features*. To determine the accounting under FASB Statement No. 97 for a contract that contains death or other insurance benefit features, the insurance enterprise should first determine whether the contract is an investment or universal life-type contract. If the mortality or morbidity risks are other than nominal and the fees assessed or insurance benefits are not fixed and guaranteed, the contract should be classified as a FASB Statement No. 97 universal-life type contract. There is a rebuttable presumption that a contract has significant mortality risk where the additional insurance benefit would vary significantly in response to capital markets volatility. The determination of significance should be made at contract inception, other than at transition, and should be based on a comparison of the present value of expected excess payments (that is, insurance benefit amounts and related incremental claim adjustment expenses in excess of the account balance) to be made under insurance benefit features with the present value of all amounts expected to be assessed against the contract holder (revenue).
- *Accounting for contracts that contain death or other insurance benefit features*. For contracts classified as insurance contracts that have amounts assessed against contract holders each period for the insurance benefit feature that are assessed in a manner that is expected to result in profits in earlier years and subsequent losses from that insurance benefit function, a liability should be established in addition to the account balance to recognize the portion of such assessments that compensates the insurance enterprise for benefits to be provided in future periods in accordance with the guidance in paragraphs .26 through .28 of this SOP.
- *Accounting for reinsurance and other similar contracts*. If a reinsurer assumes the insurance benefit feature, the reinsurer should assess the significance of mortality and morbidity risk within the reinsurance contract according to the guidance in paragraphs .24 and .25 of this SOP,

regardless of whether there is an account balance. The reinsurer should determine the classification of the reinsurance contract as an investment contract or as an insurance contract at the inception of the reinsurance contract. For reinsurance contracts, the mortality or morbidity risk could be deemed other than nominal even if the original issuer did not determine mortality or morbidity to be other than nominal. Similarly, the issuer of a contract that provides only an insurance benefit feature that wraps a noninsurance contract, for example, a guaranteed minimum death benefit related to a mutual fund balance, should evaluate its contract in the same manner. A reinsurer or issuer of the insurance benefit features of a contract should calculate a liability for the portion of premiums collected each period that represents compensation to the insurance enterprise for benefits that are assessed in a manner that is expected to result in current profits and future losses from the insurance benefit function. That liability should be calculated using the methodology described in paragraphs .26 through .28 of this SOP.

- *Accounting for annuitization benefits*. Contracts may provide for potential benefits in addition to the account balance that are payable only upon annuitization, such as annuity purchase guarantees, guaranteed minimum income benefit (GMIBs), and two-tier annuities. Insurance enterprises should determine whether such contract features should be accounted for under the provisions of FASB Statement No. 133. If the contract feature is not accounted for under the provisions of FASB Statement No. 133, an additional liability for the contract feature should be established if the present value of expected annuitization payments at the expected annuitization date exceeds the expected account balance at the expected annuitization date in accordance with the guidance in paragraphs .31 through .35 of this SOP.

- *Sales inducements to contract holders*. Sales inducements provided to the contract holder, whether for investment or universal life-type contracts, should be recognized as part of the liability for policy benefits over the period for which the contract must remain in force for the contract holder to qualify for the inducement or at the crediting date, if earlier, in accordance with paragraph .20 of this SOP. No adjustments should be made to reduce the liability related to the sales inducements for anticipated surrender charges, persistency, or early withdrawal contractual features.

  Sales inducements that are recognized as part of the liability under paragraph .36 of this SOP, that are explicitly identified in the contract at inception, and that meet the criteria specified in paragraph .37 of this SOP should be deferred and amortized using the same methodology and assumptions used to amortize capitalized acquisition costs.

- *Disclosures*. The financial statements of an insurance enterprise should disclose information related to the following:
  1. Separate account assets and liabilities; the nature, extent, and timing of minimum guarantees related to variable contracts; and the amount of gains and losses recognized on assets transferred to separate accounts.
  2. An insurance enterprise's accounting policy for sales inducements, including the nature of the costs capitalized and the method

of amortizing those costs; the amount of costs capitalized and amortized for each of the periods presented; and the unamortized balance as of each balance sheet date presented.

3. The nature of the liabilities and methods and assumptions used in estimating any contract benefits recognized in excess of the account balance pursuant to paragraphs .20 and .36 of this SOP.

This SOP is effective for financial statements for fiscal years beginning after December 15, 2003, with earlier adoption encouraged. This SOP should not be applied retroactively to prior years' financial statements. Initial application of this SOP should be as of the beginning of an entity's fiscal year.

At the date of initial application of this SOP, an insurance enterprise will have to make various determinations, such as qualification for separate account treatment, FASB Statement No. 115 classification of securities in separate account arrangements not meeting the criteria in paragraph .11 of this SOP, significance of mortality and morbidity risk, adjustments to contract holder liabilities, and adjustments to estimated gross profits or margins,[1] to determine the cumulative effect of a change in accounting principle from adopting this SOP. Refer to paragraphs .41 through .43 of this SOP for specific transition guidance.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least 10 of AcSEC's 15 members, and (3) a proposed final document that has been approved by at least 10 of AcSEC's 15 members. The document is cleared if at least four of the seven FASB members do not object to AcSEC undertaking the project,[2] issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

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[1] The term *estimated gross profits or margins* relates to estimated gross profits as defined in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards 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*, and estimated gross margins as defined in AICPA Statement of Position 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, and will hereinafter be referred to as estimated gross profits.

[2] At the time the Accounting Standards Executive Committee (AcSEC) undertook this project, at least five of the seven FASB members were required to not object to AcSEC undertaking this project.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the document.

Introduction and Background

Nontraditional Annuity and Life Insurance Contracts

.01 At the time that Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended, and No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, were issued, annuity and life insurance contracts were generally one of two basic designs: fixed or variable. Traditional fixed annuity and life insurance contracts, typically offered through an insurance enterprise's **general account**,[1] provide for a fixed rate of interest over some specified period, with the insurance enterprise bearing the investment risk associated with the invested assets. **Traditional variable annuity** and variable life insurance contracts, by contrast, offered through an insurance enterprise's **separate account**, provide that all investment risks associated with the separate account assets are passed through to the contract holder, with no guarantees of return of principal, minimum crediting rates or, for annuity contracts, minimum death benefits.

.02 More recently, annuity and life products with nontraditional terms have been developed. Some of those products may combine fixed and variable features and are sold as general account or separate account products. The features of nontraditional contracts are many and complex, and may be offered in different combinations, such that there are numerous variations of the same basic products being sold in the marketplace. See examples of products in Appendix D [paragraph .47] of this Statement of Position (SOP).

.03 A common feature in variable annuities is a **minimum guaranteed death benefit (MGDB)**, such as a death benefit equal to the total deposits made by the contract holder less any withdrawals, referred to as "return of premium" or "basic" MGDB. Although the return of premium MGDB has become increasingly common in variable annuities, the trend has been for insurers to offer MGDBs with more extensive benefit guarantees, such as:

a. A death benefit equal to the total of deposits made to the contract less an adjustment for partial withdrawals, accumulated at a specified interest rate, often referred to as "roll up."

b. A death benefit equal to the account balance on a specified anniversary date adjusted for deposits less partial withdrawals since the specified anniversary date, often referred to as "reset."

c. A death benefit equal to the highest account balance among prior specified anniversary dates adjusted for deposits less partial withdrawals since the specified anniversary date, often referred to as "ratchet."

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[1] Terms defined in the glossary are set in boldface type the first time they appear in this Statement of Position (SOP).

Another example of an insurance benefit feature is a no-lapse guarantee, in which the company agrees to keep the insurance policy in force even when the account balance is not sufficient to pay the cost of insurance.

.04 Some annuities may provide for potential benefits in addition to the account balance, payable only if annuitization is elected. For example, some deferred variable annuities now provide that, regardless of separate account performance, a guaranteed minimum amount is available to annuitize after a specified period, thereby providing a **guaranteed minimum income benefit (GMIB)** if the contract holder elects to annuitize. This benefit is in addition to the guaranteed minimum annuity interest rate traditionally offered. Another type of deferred annuity may provide multiple crediting rates throughout the life of the contract depending on whether the contract holder elects to terminate or annuitize the contract. An example is a contract that applies a lower rate to funds deposited if the contract holder elects to surrender the contract for cash, and a higher rate if the contract holder elects to annuitize, often referred to as a "two-tier" annuity.

.05 Contracts also exist that potentially may be viewed as providing multiple account balances, for example, a contract that provides a return based on a contractually referenced pool of real estate assets owned by the insurance enterprise but also provides for minimum investment return guarantees. Other contracts may exist that provide for the return of principal and interest if held until maturity or a specified "market adjusted value" if surrendered at an earlier date.

.06 **Sales inducements** to contract holders may be offered with fixed and variable life insurance and annuity contracts. Those inducements may be offered in many forms, including an immediate bonus, a persistency bonus credited to the contract holder's account after a specified period, or an enhanced crediting rate, or "bonus interest" rate, in the initial period(s) of the contract.

.07 FASB Statement No. 97 provides no explicit accounting guidance for the above examples of nontraditional contract features. This SOP addresses the insurance enterprise's accounting for certain contract features not covered by other authoritative accounting literature, including asset, liability, revenue, and expense recognition. Embedded derivatives contained in nontraditional contracts should be accounted for in accordance with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and its related guidance.[2]

.08 In addition, this SOP addresses the insurance enterprise's accounting for separate account assets and liabilities related to contracts for which all or a portion of the investment risk is borne by the insurer.

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[2] Refer to the FASB's publication *Accounting for Derivative Instruments and Hedging Activities*. As of the date of publication of this SOP, the following insurance-specific FASB Derivative Implementation Issues were available: B7—Variable Annuity Products and Policyholder Ownership of the Assets, B8—Identification of the Host Contract in a Nontraditional Variable Annuity Contract, B9—Clearly and Closely Related Criteria for Market Adjusted Value Prepayment Options, B10—Equity-Indexed Life Insurance Contracts, B25—Deferred Variable Annuity Contracts with Payment Alternatives at the End of the Accumulation Period, B29—Equity-Indexed Annuity Contracts with Embedded Derivatives, B30—Application of Statement 97 and Statement 133 to Equity-Indexed Annuity Contracts, B34—Period Certain Plus Life-Contingent Variable Payout Annuity Contracts with a Guaranteed Minimum Level of Periodic Payments, and B36—Modified Coinsurance Arrangements and Debt Instruments That Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor under Those Instruments.

Applicability and Scope

.09 This SOP is applicable to all entities to which FASB Statement No. 60, as amended, applies, hereinafter referred to as insurance enterprises.[3]

Conclusions

Separate Account Presentation

.10 Separate account assets and liabilities should be included in the financial statements of the insurance enterprise that owns the assets and is contractually obligated to pay the liabilities.

.11 The portion of separate account assets representing contract holder funds should be measured at fair value and reported in the insurance enterprise's financial statements as a summary total, with an equivalent summary total reported for related liabilities, if the **separate account arrangement** meets all of the following conditions:

a. The separate account is legally recognized. That is, the separate account is established, approved, and regulated under special rules such as state insurance laws, federal securities laws, or similar foreign laws.

b. The separate account assets supporting the contract liabilities are legally insulated from the general account liabilities of the insurance enterprise (that is, the contract holder is not subject to insurer default risk to the extent of the assets held in the separate account).

c. The insurer must, as a result of contractual, statutory, or regulatory requirements, invest the contract holder's funds within the separate account as directed by the contract holder in designated investment alternatives or in accordance with specific investment objectives or policies.

d. All investment performance, net of contract fees and assessments, must as a result of contractual, statutory, or regulatory requirements be passed through to the individual contract holder. Contracts may specify conditions under which there may be a minimum guarantee, but not a ceiling, as a ceiling would prohibit all investment performance from being passed through to the contract holder.

For the portion of separate account arrangements meeting these criteria, the related investment performance (including interest, dividends, realized gains and losses, and changes in unrealized gains and losses) and the corresponding amounts credited to the contract holder should be offset within the same statement of operations line item netting to zero. Contract fees and assessments should be reported in accordance with FASB Statement No. 97, paragraph 19. Any liabilities related to minimum guarantees and insurance benefit liabilities under the contracts in excess of the fair value of separate account assets representing contract holder funds should be recognized as general account liabilities.

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[3] FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended, applies to life insurance enterprises, property and liability insurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, assessment enterprises, and fraternal benefit societies.

.12 If a separate account arrangement does not meet the criteria in paragraph .11 of this SOP, assets representing contract holder funds under the arrangement should be accounted for (measured and presented) the same as other general account assets as prescribed in paragraphs 45 through 51 of FASB Statement No. 60, as amended. Any related liability should be accounted for as a general account liability. Revenue and expenses related to such arrangements should be recognized within the respective revenue and expense lines in the statement of operations. Arrangements in which contract holders' funds are maintained in separate accounts to fund fixed account options of variable contracts, market value adjusted contracts, guaranteed investment contracts, and indexed contracts are examples of separate account arrangements that would not meet the criteria in paragraph .11 because all of the investment performance on these investments is not passed through to the contract holder.

Accounting for an Insurance Enterprise's Interest in a Separate Account

.13 Assets underlying an insurance enterprise's proportionate interest in a separate account (**seed money** or other investment as described in paragraph A-12 of this SOP) do not represent contract holder funds, and thus do not qualify for separate account accounting and reporting. The insurance enterprise should "look through" the separate account[4] for purposes of accounting for its interest therein, and account for and classify the assets of the separate account underlying that interest based on their nature as if the assets of the separate account underlying the insurance enterprise's proportionate interest were held directly by the general account rather than through the separate account structure.[5]

.14 If a separate account arrangement meets the criteria in paragraph .11 of this SOP, and (*a*) the terms of the contract allow the contract holder to invest in additional units in the separate account or (*b*) the insurance enterprise is marketing contracts that permit funds to be invested in the separate account, the assets of the separate account underlying the insurance enterprise's proportionate interest in the separate account should be accounted for in a manner consistent with the accounting for similar assets held by the general account that the insurance enterprise may be required to sell. For example:

a. For a debt or equity security with an unrealized loss, the loss should be accounted for as an other than temporary impairment consistent with the guidance of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and recognized immediately in the statement of operations as a realized loss.

b. The guidance in FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, should be followed for both real estate that is held for sale and real estate that is not held for sale. For real estate that does not meet the FASB Statement No. 144 held for sale criteria, the impairment test should be performed solely using undiscounted cash flows assuming immediate disposition.

Transfers to Separate Accounts

.15 Assets transferred from the general account to a separate account should be recognized at fair value to the extent of the third-party contract holders'

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[4] For purposes of this SOP, the term *separate accounts* includes separate accounts and subaccounts or investment divisions of separate accounts.

[5] See the example in Appendix B [paragraph .45].

proportionate interests in the separate account if the separate account arrangement meets the criteria in paragraph .11 of this SOP. Any resulting gain related to the third-party contract holders' proportionate interest should be recognized immediately in earnings of the general account of the insurance enterprise provided that the risks and rewards of ownership have been transferred to contract holders using the fair value of the asset at the date of the contract holders' assumption of risks and rewards.[6] A guarantee of the asset's value or minimum rate of return or a commitment to repurchase the asset would not transfer the risks of ownership, and no gain should be recognized. If the separate account arrangement does not meet the criteria in paragraph .11 of this SOP, the transfer generally should have no financial reporting effect (that is, general account classification and carrying amounts should be retained). Consistent with the guidance in footnote 9 of this SOP, the insurance enterprise should recognize an impairment loss on an asset transferred from the general account to a separate account not meeting the criteria in paragraph .11 of this SOP if the terms of the arrangement with the contract holder are such that the insurance enterprise will not be able to recover the asset's carrying value. The insurance enterprise should recognize an impairment loss on its proportionate interest in a separate account arrangement meeting the criteria in paragraph .11, in a situation where the current fair value of the insurance enterprise's proportionate interest in the separate account assets is less than its carrying amount.

.16 If the transferred asset is subsequently sold by the separate account, any remaining unrecognized gain related to the insurance enterprise's proportionate interest should be recognized immediately in the earnings of the general account of the insurance enterprise. If third-party contract holders' proportionate interests in the separate account are subsequently increased, or the insurance enterprise otherwise reduces its proportionate interest in the separate account arrangement that meets the criteria in paragraph .11 of this SOP, the reduction in the insurance enterprise's proportionate interest may result in additional gain. If an insurance enterprise's proportionate interest subsequently increases as a result of transactions executed at fair value (for example, at net asset value), the increase is considered a purchase from the contract holder and should be recognized at fair value.

.17 For example, the general account transfers to the separate account arrangement, as seed money, a debt security with a book value of $60 and a fair value of $100. No gain is recognized on the initial transfer to the separate account arrangement. Contract holders subsequently direct $100 to the separate account arrangement, reducing the general account's proportionate interest to 50 percent. Assuming the fair value of the debt security is still $100, the general account recognizes a gain of $20, as a result of the contract holder investment into the separate account arrangement. In subsequent years, if the insurance enterprise reduces its interest in the separate account arrangement through withdrawal of cash or additional investment by contract holders, additional gains would be recognized if the fair value of the security continues to exceed the general account's basis in the security.

.18 If the insurance enterprise's proportionate interest in the separate account is less than 20 percent of the separate account and all of the underlying investments of the separate account meet the definition of securities under FASB Statement No. 115 or paragraph 46 of FASB Statement No. 60, as amended

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[6] If the asset transferred is real estate, no gain may be recognized if recognition is inconsistent with FASB Statement No. 66, *Accounting for Sales of Real Estate.*

by FASB Statement No. 115, or cash and cash equivalents, the insurance enterprise may report its portion of the separate account value as an investment in equity securities under FASB Statement No. 115. This investment should be classified as trading and accounted for under the guidance in FASB Statement No. 115. The guidance in paragraphs .13 through .17 of this SOP should be applied when an insurance enterprise's interest in the separate account represents 20 percent or greater of the separate account interest, or when the underlying investments are other than those that meet the definition of securities under FASB Statement No. 115 or paragraph 46 of FASB Statement No. 60, as amended by Statement No. 115, or cash and cash equivalents.

Valuation of Liabilities

.19 Paragraphs .20 through .23 of this SOP provide guidance for determining the balance that accrues to the benefit of contract holders under paragraphs 15 and 17(a) of FASB Statement No. 97. Paragraphs .24 through .30 of this SOP provide guidance for determining any additional liability for death or other insurance benefit features under paragraph 17(b) of FASB Statement No. 97. Paragraphs .31 through .35 of this SOP provide guidance for determining any additional liability for potential benefits available only upon annuitization. Paragraph .36 of this SOP provides guidance for determining any additional liability for sales inducements.

.20 The balance that accrues to the benefit of the contract holder for a long-duration insurance or investment contract that is subject to FASB Statement No. 97 (paragraphs 15 and 17(a)) is the accrued account balance. The accrued account balance[7] equals:

a. Deposit(s) net of withdrawals;

b. Plus amounts credited pursuant to the contract;

c. Less fees and charges assessed;

d. Plus additional interest (for example, persistency bonus); and

e. Other adjustments (for example, appreciation or depreciation recognized in accordance with paragraph .21 of this SOP to the extent not already credited and included in *b* above).

For purposes of item *d* above, additional interest is an amount that is required to be accrued under the liability valuation model that has not yet been credited to the contract holder's account. Additional interest, if any, should be accrued through the balance sheet date at the rate that would accrue to the balance available in cash, or its equivalent,[8] before reduction for future fees and charges, at the earlier of the date that the interest rate credited to the contract is reset or contractual maturity. The reset date is the date at which the existing contractually declared investment return expires.

.21 Some contracts, such as variable life and annuity and certain group pension participating and other experience-rated contracts, provide for a return through periodic crediting rates, surrender adjustments, or termination adjustments based on the total return of a contractually referenced pool of assets owned by the insurance enterprise. Insurance enterprises should determine whether such contracts will be accounted for under the provisions of FASB

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[7] The liability for the contract is the combination of amounts recorded in separate account liabilities and general account policyholder liabilities.

[8] For this purpose, an asset or contract is the equivalent of cash if it has a readily determinable fair value and can be converted to cash without incurring significant transaction costs.

Statement No. 133.[9] To the extent the contract is not accounted for under the provisions of FASB Statement No. 133, the amount of other adjustments described in paragraph .20 of this SOP should be based on the fair value of the referenced pool of assets at the balance sheet date, even if the related assets are not recognized at fair value, to the extent not already credited to the accrued account balance and included in paragraph .20*b* of this SOP. Amounts determined for other adjustments are not reduced for future fees and charges.[10]

.22 For contracts that have features that may result in more than one potential account balance (for example, a contract that provides a return based on a contractually referenced pool of real estate assets owned by the insurance enterprise but also provides for minimum investment return guarantees), the accrued account balance should be based on the highest contractually determinable balance that will be available in cash or its equivalent at contractual maturity or the reset date, before reduction for future fees and charges. For contracts in which amounts credited as interest to the contract holder are reset periodically, the accrued balance should be based on the highest crediting rate guaranteed or declared through the reset date.

.23 The accrued account balance should not reflect surrender adjustments (for example, market value annuity adjustments,[11] surrender charges, or credits). Any changes in the accrued account balance resulting from the application of the guidance in paragraphs .20 through .22 of this SOP should be reflected in net income in the period of the changes.

Contracts With Death or Other Insurance Benefit Features

Determining the Significance of Mortality and Morbidity Risk and Classification of Contracts That Contain Death or Other Insurance Benefit Features

.24 To determine the accounting under FASB Statement No. 60 or No. 97 for a contract that contains death or other insurance benefit features, the insurance enterprise should first determine whether the contract is an investment or insurance contract. Classification of a contract as an investment contract or as an insurance contract should be made at contract inception, and the classification should not be reassessed during the **accumulation phase** of the contract. If the **mortality** and **morbidity** risk associated with insurance benefit features offered in a contract is deemed to be nominal, that is, a risk of insignificant[12] amount or remote[13] probability, the contract should be classified as an investment contract; otherwise, it should be considered an insurance contract. There is a rebuttable presumption that a contract has significant mortality risk where the additional insurance benefit would vary significantly

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[9] Contracts that have been grandfathered under the provisions of paragraph 50 of FASB Statement No. 133 would need to follow the accounting guidance that is specified in paragraph .21 of this SOP.

[10] A loss should be recognized in the statement of operations to the extent an asset reported in the general account is designated as part of a contractually referenced pool of assets and on that designation date has an unrealized loss.

[11] For a description of a market value annuity and market value annuity adjustments refer to Appendix D, paragraph D1 [paragraph .47]

[12] The terms nominal and insignificant are as used in 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*, paragraph 40.

[13] The term *remote* is as defined in FASB Statement No. 5, *Accounting for Contingencies*.

in response to capital markets volatility. If the mortality or morbidity risk is other than nominal and the fees assessed or insurance benefits are not fixed and guaranteed, the contract should be classified as an FASB Statement No. 97 universal life-type contract by the insurance enterprise. If the fees assessed on a contract and insurance benefits provided by the contract are fixed and guaranteed or if the contract is short duration, the contract should be classified under FASB Statement No. 60, as amended.

.25 The determination of significance of mortality or morbidity risk should be based on a comparison of the present value of expected excess payments to be made under insurance benefit features (that is, insurance benefit amounts and related incremental claim adjustment expenses in excess of the account balance, herein referred to as the "excess payments") with the present value of all amounts expected to be assessed against the contract holder (revenue). For contracts that include investment margin[14] in their estimated gross profits,[15] the investment margin should be included with any other assessments for purposes of determining significance. In performing the analysis, an insurance enterprise should consider both frequency and severity under a full range of scenarios that considers the volatility inherent in the assumptions, rather than making a best estimate using one set of assumptions. For example, if the annuity contract is a variable annuity contract, the insurance enterprise should consider a range of fund return scenarios. When considering a range of scenarios, the insurance enterprise should consider historical investment returns, the volatility of those returns, and expected future returns, as applicable.

Accounting for a FASB Statement No. 97 Universal Life-Type Contract With Death or Other Insurance Benefit Features

.26 For a contract determined to meet the definition of an insurance contract as described in paragraphs .24 and .25, if the amounts assessed against the contract holder each period for the insurance benefit feature are assessed in a manner that is expected to result in profits in earlier years and losses in subsequent years from the insurance benefit function, a liability should be established in addition to the account balance to recognize the portion of such assessments that compensates the insurance enterprise for benefits to be provided in future periods. Insurance coverage encompasses the concepts of amounts at risk and the relative probability of mortality and morbidity events. The amount of the additional liability should be determined based on the ratio (benefit ratio) of (*a*) the present value of total expected excess payments over the life of the contract, divided by (*b*) the present value of total expected assessments over the life of the contract. The benefit ratio may exceed 100 percent, resulting in a liability that exceeds cumulative assessments. Total expected assessments are the aggregate of all charges, including those for administration, mortality, expense, and surrender, regardless of how characterized. For contracts in which the assets are reported in the general account and that include investment margin in their estimated gross profits, the investment margin should be included with any other assessments for purposes of determining total expected assessments. The insurance enterprise should calculate the present value of total expected excess payments and total assessments and investment margins, as applicable, based on expected experience. Expected experience should be based on a range of scenarios rather than a

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[14] The term *investment margin* is as defined in FASB Statement No. 97, paragraph 23(c).

[15] The term *estimated gross profit* is as defined in FASB Statement No. 97, paragraph 23.

single set of best estimate assumptions. In calculating the additional liability for the insurance benefit feature, assumptions used, such as the interest rate, discount rate, lapse rate, and mortality, should be consistent with assumptions used in estimating gross profits for purposes of amortizing capitalized acquisition costs. For contracts in which assessments are collected over a period significantly shorter than the period for which the contract is subject to mortality and morbidity risks, the assessment would be considered a front-end fee under FASB Statement No. 97 and accounted for under paragraph 20 of that Statement. The amounts recognized in income should be considered assessments for purposes of this paragraph.

.27 The insurance enterprise should regularly evaluate estimates used and adjust the additional liability balance, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised. In making such revised estimates, both the present value of total excess payments and the present value of total expected assessments and investment margins, should be calculated as of the balance sheet date using historical experience from the issue date to the balance sheet date and estimated experience thereafter.

.28 The additional liability at the balance sheet date should be equal to:

a. The current benefit ratio multiplied by the cumulative assessments[16]

b. Less the cumulative excess payments (including amounts reflected in claims payable liabilities)

c. Plus accreted interest

However, in no event should the additional liability balance be less than zero. The change in the additional liability should be recognized as a component of benefit expense in the statement of operations.

.29 The estimated gross profits used for the amortization of deferred acquisition costs should be adjusted to reflect the recognition of the liability in accordance with paragraph .28 of this SOP.

Accounting for Reinsurance and Other Similar Contracts

.30 If a reinsurer assumes the insurance benefit feature, the reinsurer should assess the significance of mortality and morbidity risk within the reinsurance contract according to the guidance in paragraphs .24 and .25 of this SOP, regardless of whether there is an account balance. The reinsurer should determine the classification of the reinsurance contract as an investment contract or as an insurance contract at the inception of the reinsurance contract. For reinsurance contracts, the mortality or morbidity risk could be deemed other than nominal even if the original issuer did not determine mortality or morbidity to be other than nominal. There is a rebuttable presumption that a contract has significant mortality risk where the additional insurance benefit would vary significantly in response to capital markets volatility. Similarly, the issuer of a contract that provides only an insurance benefit feature that wraps[17] a noninsurance contract, for example, a guaranteed minimum death benefit related to a mutual fund balance, should evaluate its contract in the same manner. A reinsurer or issuer of the insurance benefit

[16] The term *cumulative assessments* refers to actual cumulative assessments, including investment margins, if applicable, recorded from contract inception through the balance sheet date.

[17] The term *wrap* refers to the practice of adding an insurance benefit feature to a separate noninsurance contract generally from a different issuer.

features of a contract should calculate a liability for the portion of premiums collected each period that represents compensation to the insurance enterprise for benefits that are assessed in a manner that is expected to result in current profits and future losses from the insurance benefit function. That liability should be calculated using the methodology described in paragraphs .26 through .28 of this SOP. For example, a reinsurance contract that assumes only the risk related to the MGDB feature for a fee that varies with the account balance rather than with the insurance coverage provided would be a FASB Statement No. 97 universal life-type contract and the contract should be accounted for in accordance with paragraphs .26 through .28 of this SOP.

Accounting for Contracts That Provide Annuitization Benefits

.31 Contracts may provide for potential benefits in addition to the account balance that are payable only upon annuitization, such as annuity purchase guarantees, GMIBs and two-tier annuities. Insurance enterprises should determine whether such contract features should be accounted for under the provisions of FASB Statement No. 133.[18] If the contract feature is not accounted for under the provisions of FASB Statement No. 133, an additional liability for the contract feature should be established if the present value of expected annuitization payments at the expected annuitization date exceeds the expected account balance at the expected annuitization date. The amount of the additional liability should be determined based on the ratio (benefit ratio) of (*a*) the present value of expected annuitization payments to be made and related incremental claim adjustment expenses, discounted at estimated investment yields expected to be earned during the **annuitization phase** of the contract, minus the expected accrued account balance at the expected annuitization date (the "excess payments"), divided by (*b*) the present value of total expected assessments during the accumulation phase of the contract. Total expected assessments are the aggregate of all charges, including those for administration, mortality, expense, and surrender, regardless of how characterized. For contracts whose assets are reported in the general account and that include investment margin in their estimated gross profits, the investment margin should be included with any other assessments for purposes of determining total expected assessments. The insurance enterprise should calculate the present value of total expected excess payments and total assessments and investment margins, as applicable, based on expected experience. Expected experience should be based on a range of scenarios that considers the volatility inherent in the assumptions rather than a single set of best estimate assumptions. In calculating the additional liability for the additional benefit feature, assumptions used, such as the interest rate, discount rate, lapse rate, and mortality, should be consistent with assumptions used in estimating gross profits for purposes of amortizing capitalized acquisition costs. When determining expected excess payments, the expected annuitization rate is one of the assumptions that needs to be estimated.

.32 The insurance enterprise should regularly evaluate estimates used and adjust the additional liability balance, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised. In making such revised estimates, both the present value of total excess payments and the present value of total expected assessments or investment margins should be calculated as of the balance sheet

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[18] Refer to FASB Derivative Implementation Issue: B25—Deferred Variable Annuity Contracts with Payment Alternatives at the End of the Accumulation Period, Questions 1 and 2, for discussion of these products.

date using historical experience from the issue date to the balance sheet date and estimated experience thereafter.

.33 The additional liability at the balance sheet date should be equal to:

a. The current benefit ratio multiplied by the cumulative assessments

b. Plus accreted interest

c. Less, at time of annuitization, the cumulative excess payments determined at annuitization

However, in no event should the additional liability balance be less than zero. The change in the additional liability should be recognized as a component of benefit expense in the statement of operations. "Cumulative excess payments determined at annuitization" represent the amount that should be deducted at the actual date of annuitization. That amount should be calculated as the present value of expected annuity payments and related claim adjustment expenses discounted at expected investment yields minus the accrued account balance at the actual annuitization date. On the date of annuitization, the additional liability related to the cumulative excess benefits will be zero and the amount deducted will be used in the calculation of the liability for the payout annuity.

.34 The estimated gross profits used for the amortization of deferred acquisition costs should be adjusted to reflect the recognition of the liability determined in accordance with paragraph .32 of this SOP. Capitalized acquisition costs should continue to be amortized over the present value of estimated gross profits (as adjusted above) over the expected life of the book of contracts. For purposes of amortization of deferred acquisition costs, the life of the book of contracts excludes the annuitization phase.

.35 A reinsurer may agree to reinsure all or a portion of the additional benefits described in paragraph .31 of this SOP. Both the ceding company and the reinsurer should determine whether such a reinsurance contract should be accounted for under the provisions of FASB Statement No. 133. For example, unlike many of the direct contracts that contain GMIB benefits, contracts to reinsure GMIB benefits often meet the definition of a derivative under FASB Statement No. 133. If the reinsurance contract should not be accounted for under the provisions of FASB Statement No. 133, the guidance in paragraphs .31 through 34 of this SOP should be followed.

Sales Inducements to Contract Holders

.36 Sales inducements provided to the contract holder, whether for investment or universal life-type contracts, should be recognized as part of the liability for policy benefits over the period in which the contract must remain in force for the contract holder to qualify for the inducement or at the crediting date, if earlier, in accordance with paragraph .20 of this SOP. No adjustments should be made to reduce the liability related to the sales inducements for anticipated surrender charges, persistency, or early withdrawal contractual features.

.37 Sales inducements that (*a*) are recognized as part of the liability under paragraph .36 of this SOP, (*b*) are explicitly identified in the contract at inception, and (*c*) meet the criteria in the following sentence should be deferred and amortized using the same methodology and assumptions used to amortize capitalized acquisition costs. The insurance enterprise should demonstrate that such amounts are (*a*) incremental to amounts the enterprise credits on similar contracts without sales inducements and (*b*) higher than the contract's expected ongoing crediting rates for periods after the inducement, as applicable; that is, the crediting rate excluding the inducement should be consistent with assumptions used in estimated gross profits, contract illustrations, and interest-crediting strategies. Due to the nature of day-one and persistency bonuses, the criteria in the preceding sentence are generally met. The deferred amount should be recognized on the statement of financial position as an asset, and amortization should be recognized as a component of benefit expense. The annuitization phase is viewed as a separate contract under FASB Statement No. 97, and should not be combined with the accumulation phase for amortization of deferred sales inducements.

Disclosures

.38 The following information should be disclosed in the financial statements of the insurance enterprise:

a. The general nature of the contracts reported in separate accounts, including the extent and terms of minimum guarantees.

b. The basis of presentation for separate account assets and liabilities and related separate account activity.

c. A description of the liability valuation methods and assumptions used in estimating the liabilities for additional insurance benefits and minimum guarantees.

d. Disclosures should include the following amounts related to minimum guarantees:

(1) The separate account liability balances subject to various types of benefits (for example, guaranteed minimum death benefit, guaranteed minimum income benefit, guaranteed minimum accumulation benefit). Disclosures within these categories of benefits for the types of guarantees provided may also be appropriate (for example, return of net deposits, return of net deposits accrued at a stated rate, return of highest anniversary value).

(2) The amount of liability reported for additional insurance benefits, annuitization benefits and other minimum guarantees, by type of benefit, for the most recent balance sheet date and the incurred and paid amounts for all periods presented.

(3) For contracts for which an additional liability is disclosed in *d*(2) above, **net amount at risk** and weighted average attained age of contract holders.

e. The aggregate fair value of assets, by major investment asset category, supporting separate accounts with additional insurance benefits and minimum investment return guarantees as of each date for which a statement of financial position is presented.

f. The amount of gains and losses recognized on assets transferred to separate accounts for the periods presented.

.39 An insurance enterprise should disclose its accounting policy for sales inducements, including the nature of the costs deferred and the method of amortizing those costs. The amount of costs deferred and amortized for each of the periods presented and the unamortized balance as of each balance sheet date also should be disclosed.

Effective Date and Transition

.40 The provisions of this SOP are effective for financial statements for fiscal years beginning after December 15, 2003, with earlier adoption encouraged. Restatement of previously issued annual financial statements or reclassification between separate account and general account balances is not permitted. Initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date and during an interim period, all prior interim periods should be restated). Disclosure of the pro forma effects of retroactive application (discussed in paragraph 21 of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*) or the pro forma effect on the year of adoption is not required.

.41 At the date of initial application:

a. For assets that no longer qualify for separate account treatment:

(1) Debt or equity securities previously classified as separate account assets but valued in accordance with FASB Statement No. 115 should maintain their designations as held-to-maturity, available-for-sale, or trading upon reclassification to the general account.

(2) The provisions of FASB Statement No. 115 should be adopted for any debt or equity securities previously recognized at fair value in accordance with paragraph 54 of FASB Statement No. 60, as amended. Any adjustment for FASB Statement No. 115 designation resulting from initial adoption should be reported in a manner similar to the cumulative effect of a change in accounting principle in accordance with the provisions of APB Opinion No. 20 and paragraph 25 of FASB Statement No. 115:

(*a*) If designated as held-to-maturity, the adjustment should be reported through income.

(*b*) If designated as available-for-sale, the adjustment should be reported in income, with a corresponding cumulative effect adjustment for the unrealized holding gains and losses reported in other comprehensive income.

(*c*) If designated as trading, there should be no adjustment.

(3) Any revaluation adjustments related to assets that are not subject to FASB Statement No. 115 should be reported in a manner similar to the cumulative effect of a change in accounting principle in accordance with the provisions of APB Opinion No. 20.

b. The guidance in *a* above should be applied in accounting for an insurance enterprise's proportionate interest in the separate account assets regardless of whether the interest was previously reported in the separate account or the general account. If the insurance enterprise considered its portion of separate account units to be equity securities under FASB Statement No. 115, the guidance in *a*(1) or (3) above should be applied as appropriate.

c. To the extent a debt or equity security subject to FASB Statement No. 115 and previously classified as available-for-sale is part of a contractually referenced pool of assets in which total return will be accrued to the account balance (in accordance with paragraph .21 of this SOP), and a transition adjustment for the liability valuation is reported in accordance with *e* below, that security may be reclassified to trading with the revaluation adjustment recognized as a cumulative effect similar to the liability transition adjustment.

d. For contracts that are in force on the date of initial application of this SOP, the determination of significance of mortality and morbidity risk resulting from insurance benefit features, in accordance with paragraphs .24 through .25 of this SOP, should be performed as of the date of initial application of this SOP using both actual results from inception of the contract through the date of initial application and expected future results thereafter.

e. Any adjustment in contract holder liabilities from adopting this SOP should be reported in a manner similar to the cumulative effect of a change in accounting principle in accordance with the provisions of APB Opinion No. 20, through income or, for amounts previously accrued under Emerging Issues Task Force (EITF) Topic No. D-41, *Adjustments in Assets and Liabilities for Holding Gains and Losses as Related to the Implementation of FASB Statement No. 115*, accumulated other comprehensive income.

f. If the adoption of this SOP results in changes in estimated gross profits, any adjustments to unamortized deferred acquisition costs or present value of future profits[19] should be reported in a manner similar to the cumulative effect of a change in accounting principle in accordance with the provisions of APB Opinion No. 20, through income or, for amounts previously accrued under EITF Topic No. D-41, accumulated other comprehensive income.

.42 This SOP should be applied prospectively with respect to the deferral of sales inducements meeting the criteria in paragraph .37 of this SOP. Sales inducements deferred subsequent to the initial application of this SOP on policies in force at that date should be accounted for in accordance with paragraph .37 of this SOP. Costs recognized for sales inducements prior to initial application of this SOP other than for those referred to in paragraph .43 of this SOP, whether capitalized or not, should not be adjusted to the amounts that would have been deferred had this SOP been in effect when those costs were incurred. Costs capitalized for sales inducements prior to initial application of this SOP that were previously reported with unamortized deferred acquisition costs should be reported separately.

.43 Insurance enterprises that were previously amortizing sales inducements using the same methodology and assumptions used for amortizing deferred acquisition costs (the approach required by the guidance in this SOP) should continue using that approach and should consider the entire life of the contracts. Any cumulative adjustment to unamortized sales inducements resulting from changes in estimated gross profits, made as a result of the initial adoption of this SOP, should be reported in a manner similar to the cumulative effect of a change in accounting principle in accordance with the provisions of APB Opinion No. 20, through net income or, for amounts previously accrued under EITF Topic No. D-41, accumulated other comprehensive income. However, if an insurance enterprise had been amortizing sales inducements using

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[19] Adjustments are as discussed in Emerging Issues Task Force (EITF) Issue No. 92-9, *Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company.*

a methodology or assumptions other than those used for amortizing deferred acquisition costs, the amortization of deferred sales inducements after implementation of this SOP should consider only estimated gross profits or interest, as applicable, depending on the amortization methodology, from the date of initial application forward.

The provisions of this Statement need not be applied to immaterial items.

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Appendix A

Basis for Conclusions

A-1. This section discusses considerations that were deemed significant by the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position (SOP). In July 2002, AcSEC issued for public comment an exposure draft of a proposed SOP, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*. During the 90-day comment period, 20 comment letters were received by AcSEC.

Separate Account Presentation

A-2. Existing authoritative accounting guidance for separate accounts is limited to paragraphs 53 and 54 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 60, *Accounting and Reporting by Insurance Enterprises*, and was written when contracts underlying the separate accounts generally were either fixed (having guaranteed returns) or variable (wherein the performance of the assets was the sole determinant of the return to the contract holder):

> **53.** Separate accounts represent assets and liabilities that are maintained by an insurance enterprise for purposes of funding fixed-benefit or variable annuity contracts, pension plans, and similar activities. The contract holder generally assumes the investment risk, and the insurance enterprise receives a fee for investment management, certain administrative expenses, and mortality and expense risks assumed.
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> **54.** Investments in separate accounts shall be reported at market except for separate account contracts with guaranteed investment returns. For those separate accounts, the related assets shall be reported in accordance with paragraphs 45–51. Separate account assets and liabilities ordinarily shall be reported as summary totals in the financial statements of the insurance enterprise.

Paragraphs 45 through 51 of Financial Accounting Standards Board (FASB) Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, provide guidance for valuing assets of the insurance enterprise's general account (for example, FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, for securities, and FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, for mortgage loans), which for the remainder of this discussion will be referred to as "general account assets."

A-3. Paragraph 54 of FASB Statement No. 60 has not been applied consistently in practice in terms of *valuing* assets maintained in separate accounts that have been determined to require valuation as general account assets, and in classifying the assets in the insurer's statement of financial position. It is unclear whether the phrase "reported in accordance with paragraphs 45–51," as used in paragraph 54 of FASB Statement No. 60, refers only to valuation or whether it refers to statement of financial position single line presentation as well. Paragraph 54 of FASB Statement No. 60 states, "Separate account assets and liabilities ordinarily shall be reported as summary totals in the financial statements of the insurance enterprise." Because separate account liabilities are classified consistent with the related asset classification, the issue of classification also affects separate account liabilities.

A-4. Although FASB Statement No. 60, as amended, requires separate account assets and liabilities to be reported in the financial statements of the insurance enterprise, AcSEC considered whether that guidance is consistent with recent standards addressing both asset and liability recognition and derecognition, such as FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. AcSEC also considered potential analogies to similar trust fund and mutual fund products offered by the financial services industry. AcSEC noted that, unlike a financial institution trust fund account or mutual fund, the assets of the separate account are legally owned by the insurance enterprise. Additionally, a separate account is not a separate legal entity under general corporate statutes. As noted in the AICPA Audit and Accounting Guide *Life and Health Insurance Entities*, "a separate account is a legally restricted fund that is segregated from the life insurance entity. State insurance laws provide that assets in separate accounts may be invested without regard to restrictions covering general investments of life insurance entities. Separate account assets are generally not available to cover liabilities except those of the separate account."

A-5. Thus, separate account assets may be isolated from the general creditors of the insurance enterprise, but not from the insurance enterprise itself, which still legally owns the assets. In a variable annuity or similar arrangement, there is no relinquishment of ownership of assets but rather the execution of a contract pursuant to which the insurance enterprise agrees to pass through the separate account investment results to the contract holder. Furthermore, the contract executed between the contract holder and the insurance enterprise creates an obligation of the insurance enterprise that is not defeased by the segregation of funds in the separate account. Based on the above, AcSEC concluded that separate account assets and separate account liabilities should be reported in the statement of financial position of the insurance enterprise that owns the assets and is contractually obligated to settle the liabilities.

A-6. AcSEC considered whether it should ask FASB to reconsider the separate account asset and liability reporting requirements of FASB Statement No. 60, as amended, in light of AcSEC's conclusion in the SOP 00-3, *Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts*, that closed block assets, liabilities, and related statement of operations activity should be displayed with the remainder of an insurance enterprise's assets, liabilities, and statement of operations activity. AcSEC concluded that separate account structures differ in several significant respects from closed block structures: closed blocks do not legally insulate the assets supporting contract liabilities, closed block contract holders do not direct the investment of supporting assets, and individual closed block contract holders do not receive the direct pass-through of investment performance.

A-7. Collectively, the unique features of separate account arrangements warrant presentation distinct from an insurance enterprise's other assets and liabilities. AcSEC concluded that summary account totals in the statement of financial condition and the offsetting of investment performance and corresponding amounts credited to the contract holder provide the most meaningful presentation to the users of the financial statements for contracts meeting the four criteria specified in paragraph .11 of this SOP. In addition, that presentation allows financial statement users to more readily analyze investment returns of insurance enterprises by excluding amounts that are legally insulated from the general account and not available to shareholders.

A-8. Separate accounts often are used in conjunction with nontraditional products that have both fixed and variable features. For example, variable annuity and variable life contracts frequently offer fixed rate investment options (typically through the insurer's general account) and may provide contractually guaranteed benefits that are paid upon the death of the contract holder (minimum guaranteed death benefits) or at a specified date in the accumulation phase of the contract (guaranteed minimum accumulation benefits). Those products have made it difficult to determine whether the criterion in paragraph 53 of FASB Statement No. 60, that "the contract holder generally assumes the investment risk," has been met and thus whether assets and liabilities associated with such separate account arrangements should be classified as general account, separate account, or some combination of both. In addition, fixed contracts in which the insurance enterprise guarantees investment return or otherwise bears the investment risk may be offered through separate accounts, for example, as a means to provide additional credit protection to the contract holder.

A-9. AcSEC believes that the emergence of new products has created a need for criteria to be developed for evaluating separate account arrangements and applying the guidance in paragraphs 53 and 54 of FASB Statement No. 60. AcSEC concluded that a defining characteristic of separate accounts is their designation as such by appropriate regulatory bodies. AcSEC also believes that legal insulation of separate account assets, such that to the extent of contract holder liabilities, the assets would not be available to the general creditors and shareholders of the insurance enterprise in the event of insolvency, is a unique aspect of separate account assets. AcSEC also concluded that a defining characteristic of separate accounts is that the contract holder dictates the allocation of deposits among investment alternatives and receives the pass-through of investment performance (that is, the contract holder receives the investment reward). In the case of certain group contracts, this feature may take the form of the contract holder's establishment of specific investment guidelines and objectives. AcSEC also noted that an implicit ceiling could exist through the use of certain sliding-scale performance-based fees, thereby not meeting the criteria in paragraph .11*d* of this SOP.

A-10. AcSEC considered whether only the assets and liabilities associated with the pure pass-through contracts offered through separate account arrangements, such as traditional variable annuities and other variable contracts that have neither guaranteed minimum death benefits nor accumulation guarantees, should be presented as single line items in the statement of financial condition of an insurance enterprise. That treatment would require that the insurer not include in the separate account summary totals the assets and liabilities related to a contract if the insurance enterprise bore *any* investment risk related to that contract. That view was rejected because the contract holder, rather than the insurance enterprise, controls the investments and is entitled to all the rewards of owning the assets underlying variable contracts. AcSEC concluded that separate account presentation for the portion of the separate account arrangement meeting the four criteria specified in paragraph .11 of this SOP is appropriate. Guarantees on such contracts provided by the insurance enterprise are viewed as incremental contract benefits that may require recognition of any additional liability in the general account of the insurance enterprise.

A-11. Several respondents to the exposure draft expressed a view that the definition and proposed reporting of separate account arrangements in paragraph .11 of this SOP do not recognize the unique nature of certain non-U.S. products where legal insulation may not be achieved. AcSEC believes that the criteria for separate account treatment should be applied consistently to U.S. and non-U.S. products and that changes to the definition to permit classification of certain non-U.S. products as separate accounts would inappropriately expand the use of separate account presentation to certain U.S. products. AcSEC reaffirmed that legal insulation is a key criterion for summary total presentation and statement of operations separate account treatment.

Accounting for an Insurance Enterprise's Interest in a Separate Account

A-12. When a separate account is established, the insurance enterprise may transfer non-contract-holder-related funds, commonly referred to as seed money, from its general account to the separate account to support the initial or ongoing operations of the separate account. Such transfers give the insurance enterprise an ownership interest in the separate account. The insurance enterprise's interest may also include undistributed earnings on the seed money and contract charges that have not been transferred to the general account.

A-13. AcSEC recognized that there was diversity in practice regarding the classification and measurement of an insurance enterprise's proportionate interest in a separate account. Some insurance enterprises classified such amounts in the separate account caption along with separate account assets attributable to contract holders. Other insurance enterprises reclassified such amounts to general account assets. In terms of measurement, some insurance enterprises marked separate account assets to market through income, including the insurance enterprise's proportionate interest, while others accounted for the insurance enterprise's proportionate interest as general account assets. Some insurance enterprises viewed the separate account as if it were a separate legal entity, and thus considered their portion of "separate account units" to be equity securities. Other insurance enterprises looked through the separate account arrangement and viewed their investment as a proportionate interest in the underlying mutual funds, debt and equity securities, mortgage loans, real estate, or other assets in which the separate account arrangement was invested.

A-14. AcSEC concluded that an insurance enterprise's proportionate interest in the assets of a separate account does not qualify for separate account treatment, as it does not represent contract holder funds. Consequently, the assets underlying the insurance enterprise's proportionate interest should be classified and measured as general account assets in accordance with paragraphs 45 through 51 of FASB Statement No. 60, as amended.

A-15. AcSEC noted that a separate account is not a distinct legal entity under general corporate statutes, but rather an accounting entity created by and under the control of the insurance enterprise that owns 100 percent of the assets. The insurance enterprise's proportionate interest in the separate account typically would be available to general creditors in the event of the insurance enterprise's insolvency. AcSEC concluded that an insurance enterprise's proportionate interest in a separate account should not be viewed as an investment in "equity securities" of the separate account. Instead, AcSEC concluded that the insurance enterprise should "look through" to the underlying investments held in the separate account for purposes of classification and measurement as general account assets. In reaching that conclusion, AcSEC believed that assets should not be accounted for differently depending on whether an insurance enterprise has an interest in those assets through the general account or through the separate account (for example, fair value versus historical cost for real estate).

A-16. Many respondents to the exposure draft commented on the complex and burdensome task of maintaining detailed records of daily percentage ownership of bonds or stocks or other investments as required under the SOP. While AcSEC continued to believe that the guidance noted in paragraph .11 is appropriate, AcSEC considered these comments and decided to permit an insurance enterprise to account for its investment in a separate account as an investment in equity securities under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, when the insurance enterprise's proportionate interest represents less than 20 percent of the separate account and the underlying separate account investments are securities under Statement No. 115 or paragraph 46 of FASB Statement No. 60, as amended by FASB Statement No. 115, or cash and cash equivalents. AcSEC acknowledged that there should not be a difference between the aggregate fair value of the individual securities and a proportionate share of the fair value of the aggregate investments in the separate account. Therefore, in these limited situations, the cost appeared to outweigh the commensurate benefit of applying the proposed guidance.

A-17. AcSEC also acknowledged that under this alternative an insurance enterprise should perform an impairment test on the value of the interest in the separate account (or individual subaccounts, as applicable). AcSEC believes it would not be appropriate to allow this alternative for circumstances where the underlying separate account investments are other than securities under FASB Statement No. 115 or paragraph 46 of FASB Statement No. 60, as amended by FASB Statement No. 115, or cash and cash equivalents, such as mortgage loans or real estate, as the alternate method would result in different bases of accounting. AcSEC concluded that to apply the alternate method the underlying separate account investment related to the insurance company's proportionate interest should be classified as trading with changes flowing through the income statement, as classification as available for sale would defer the recognition of investment income.

A-18. Contract holders may have the right to continue to make deposits and direct transfers of their account balances, and new contract holders are permitted to invest in the various separate account arrangements. In those cases, the insurance enterprise is effectively holding for sale its proportionate interest in the separate account assets if those separate account arrangements would meet the criteria in paragraph .11 of this SOP. Consequently, the insurance enterprise should recognize an impairment loss on its proportionate interest in the assets of a separate account arrangement meeting the criteria in paragraph .11 in a situation where the current fair value of the insurance enterprise's proportionate interest in the separate account assets is less than its carrying amount.

Transfers to Separate Accounts

A-19. AcSEC concluded that transfers of assets to separate accounts should be recognized at fair value to the extent of third-party contract holders' interests in the separate account if the separate account arrangement meets the criteria in paragraph .11 of this SOP, with any resulting gains or losses recognized immediately in earnings of the insurance enterprise. Gain or loss recognition is appropriate in such cases because the contract holders are unrelated third parties to whom subsequent risks and rewards of ownership of a portion of the asset have been transferred, and the assets will subsequently be carried at fair value with changes reported in earnings (offset by changes in contract holder liabilities). Furthermore, although the insurance enterprise holds legal title to assets in separate account arrangements, the contract holders will be entitled to receive the investment performance of the assets after the transfer. This treatment is consistent with the presentation of separate account assets as summary totals in the statement of financial position, because the risks and rewards of ownership of the assets reside with the contract holders rather than the insurance enterprise that has legal ownership of the assets. If the insurance enterprise guarantees the asset's value or minimum rate of return or commits to repurchase the asset, the risks of ownership have not been transferred, and no gain should be recognized. However, loss recognition is still appropriate as noted in paragraph A-18 of this SOP. AcSEC concluded that in the limited circumstances where the alternate method, as described in paragraph .18 of this SOP, is applied, 100 percent of any gain on transfers of assets to separate accounts should be recognized as the underlying investments are designated as trading. AcSEC had already concluded that all losses were required to be recognized for transfers of assets to separate accounts.

A-20. For separate account arrangements for which the insurance enterprise is actively marketing units and hold real estate, AcSEC concluded that, in cases in which the held for sale criteria for real estate are not met, the impairment test should be performed solely using cash flows from ultimate disposition. Cash flows related to the use of the asset during the period preceding ultimate disposition should be zero because the enterprise does not have control over the dilution of its interest.

Valuation of Liabilities

A-21. *Account balance.* Paragraph 17(a) of 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*, does not explicitly define "the balance that accrues to the benefit of policyholders at the date of the financial statements," which is commonly referred to as the "account balance." FASB Statement No. 97, paragraph 18, provides that the account balance is an amount that should not be reduced for "amounts that may be assessed against policyholders in future periods, including surrender charges."

A-22. AcSEC also noted that FASB Statement No. 97 defines contract holder balance indirectly through the following:

> Premium payments are credited to the policyholder balance, against which amounts are assessed for contract services and to which amounts are credited as income. The policyholder balance provides a base upon which interest accrues to the policyholder and, when compared with the death benefit amount, fixes the insurer's net amount at risk. [*paragraph 45*]
>
> . . . the balance that accrues to the benefit of individual policyholders represents the minimum measure of an insurance enterprise's liability.... For many universal life-type contracts, this amount takes the form of an account balance that, absent future action by the policyholder, will continue to fund operation of the contract until exhausted or reduced to a contract minimum. The insurer has a present obligation, arising from past transactions, to continue to maintain the contract and provide mortality protection as long as an adequate account balance exists. Other universal life-type contracts do not have an explicit policyholder account but do have a policyholder balance to which interest is accrued at a variable rate. In either case, future events and transactions will change the amount of the enterprise's obligation as policyholders make additional premium deposits and realize contract benefits. The present obligation, however, is fixed by the amount that has accrued to the benefit of the policyholder. [*paragraph 53*]

Recent product innovation and the lack of explicit guidance has led to diversity in the application of the definition of account balance. AcSEC therefore believes that interpretive guidance is needed for determining the balance that accrues to the benefit of the policyholder at the date of the financial statements.

A-23. AcSEC concluded that all surrender charges or credits should be ignored in measuring the policyholder liability because, as noted in FASB Statement No. 97, paragraphs 18 and 53, the liability should be measured assuming no future action by the policyholder. FASB Statement No. 97 is a long-duration contract model that does not assume policyholders will surrender at the balance sheet date but rather amortizes deferred acquisition costs over the expected life of the contract. Additionally, the FASB Statement No. 60, as amended, and FASB Statement No. 97 accounting models do not require that the contract holder liability, net of unamortized acquisition costs, equal or exceed the cash surrender value of the contract. AcSEC considered whether the presence of an additional amount due on surrender but not due upon maturity, such as a market value annuity adjustment, should result in the recognition of an additional liability. AcSEC concluded that recording an additional liability for surrender adjustments prior to the contract holder's elected surrender would be inconsistent with the long-duration model.

A-24. AcSEC concluded that, in accordance with FASB Statement No. 97, it is appropriate to accrue to the amount that the contract holder could receive in cash or its equivalent, before reduction for future fees and charges, at the earlier of the date that the rate credited to the contract is reset or contractual maturity. That conclusion is consistent with the long-duration model, which does not permit the anticipation of surrenders and also with the accounting for debt instruments, under which interest is accrued to maturity using the interest method. Accrual of interest at an effective interest rate is consistent with existing accounting for debt instruments with fixed nonlevel interest payments. A delay in crediting to the contract holder account balance an amount that is to be credited in the future should not prevent the accrual of the amount ratably over the period the contract holder earns the amount.

A-25. AcSEC believes that a contract in which the amount due at maturity is based on a referenced pool of assets is similar to indexed debt, which prior to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, was accounted for in accordance with Emerging Issues Task Force (EITF) Issue No. 86-28, *Accounting Implications of Indexed Debt Instruments*. EITF Issue No. 86-28 provides the following accounting guidance:

> . . . as the applicable index increases such that the issuer would be required to pay the investor a contingent payment at maturity, the issuer should recognize a liability for the amount that the contingent payment exceeds the amount, if any, originally attributed to the contingent payment feature. The liability for the contingent payment feature should be based on the applicable index value at the balance sheet date and should not anticipate any future changes in the index value. When no proceeds are originally allocated to the contingent payment, the additional liability resulting from the fluctuating index value should be accounted for as an adjustment of the carrying amount of the debt obligation.

Therefore, AcSEC concluded that, to the extent such contracts are not accounted for under the provisions of FASB Statement No. 133, the balance that accrues to the benefit of the contract holder should be based on the fair value of the referenced pool of assets because the change in the fair value of the referenced pool of assets represents the change in the account balance. To the extent the amount credited does not equal the change in fair value of the referenced pool of assets, an adjustment as described in paragraph .20*e* of this SOP would be required. Many respondents to the exposure draft commented that this guidance would result in misleading volatility and a mismatch in the financial statements when the referenced assets are not also recorded at fair value. AcSEC reaffirmed the liability model in this SOP and noted that changing the valuation of investments was not within the scope of this project.

Contracts With Death or Other Insurance Benefit Features

A-26. *Determination of applicable accounting standard.* AcSEC decided the FASB Statement No. 97 universal life model should apply to insurance benefit features only if (*a*) the fees assessed or the benefits provided are not fixed and guaranteed, and (*b*) the mortality and morbidity risks are other than nominal. Those contracts having insurance benefit features where the fees assessed and the benefits provided are fixed and guaranteed should be accounted for under FASB Statement No. 60, as amended. Those insurance benefit features that do not pass the test of significance result in the contracts being classified as investment-type contracts under FASB Statement No. 97, and no additional liability for insurance benefits should be provided, other than a claim liability resulting from the occurrence of the insurance event.

A-27. *Determining the significance of mortality and morbidity risk.* AcSEC considered how the test of significance of mortality and morbidity risk should be applied to contracts with insurance benefit features. The significance test contained in paragraph 8 of FASB Statement No. 97 is based on the present value of the expected life contingent payments relative to the present value of all expected payments. AcSEC considered whether that test should be modified for insurance benefit features offered with annuity contracts. The test was written for payout annuities for which the entire deposit may be subject to mortality risk. For accumulation-phase annuity contracts containing insurance benefit features, the contract has a deposit element, which under all circumstances the contract holder will receive, and a mortality and morbidity element for payments in excess of the deposit element. AcSEC decided that because the timing and nature of benefit payments are different between payout annuities and an accumulation-phase annuity with an minimum guaranteed death benefit (MGDB) or other insurance benefit feature, the measurement of the significance of the mortality related payments needed to be modified. AcSEC believes a better method to determine significance for these contracts is to compare the present value of expected insurance benefit excess payments with the fee revenue or spreads the insurance enterprise will collect for accepting that and other risks.

A-28. AcSEC considered whether the test of significance should be performed only at the inception of the contract or throughout the life of the contract. It was noted that performing the test throughout the life of the contract could result in situations where contracts would switch from one accounting model to another and potentially back again as the estimate of expected benefit costs changed. AcSEC decided to require the test of significance to be performed only at the inception of the contract or reinsurance contract, noting that it is consistent with current practice for applying the test for classifying payout annuities under FASB Statement No. 97. Similarly, the comparison of the timing of expected assessments and related benefits for determining whether the amounts assessed against the contract holder each period for the insurance benefit feature are assessed in a manner that is expected to result in profits in earlier years and losses in subsequent years from the insurance benefit function would occur at inception only, as well. As discussed in the transition section of this SOP, an exception is made for contracts in force at the date of transition for which the test of significance would be performed as of transition.

A-29. For certain contracts with insurance benefit features, such as MGDBs offered with variable annuities, the expected benefit costs or the expected revenue vary with market elements such as interest rates or the performance of an underlying pool of equities. AcSEC considered whether to require expected benefit costs and expected revenue to be determined based on a single set of assumptions or a range of results. AcSEC decided that the test of significance should be based on models that use more than a single set of assumptions, because that approach would better reflect the effect of market elements on both expected benefit costs and expected revenue. This approach is consistent with FASB Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, which concludes that expected values are more useful for present value calculations, and is further supported by FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, which states that when evaluating the possibility of the reinsurer incurring a loss, reasonably possible scenarios should be considered. Because the test of significance requires consideration of a range of scenarios and the market is inherently volatile, AcSEC concluded that there is a rebuttable presumption that a contract with an insurance benefit that varies significantly in response to capital market volatility has significant mortality risk.

A-30. *Establishment of an additional liability*. AcSEC considered whether, under the universal life model of FASB Statement No. 97, a separate liability in addition to the account balance should be recognized. AcSEC noted that FASB Statement No. 97, paragraph 17, states:

> The liability for policy benefits for universal life-type contracts shall be equal to the sum of:
>
> *a*. The balance that accrues to the benefit of policyholders at the date of the financial statements
>
> *b*. Any amounts that have been assessed to compensate the insurer for services to be performed over future periods (paragraph 20)
>
> *c*. Any amounts previously assessed against policyholders that are refundable on termination of the contract
>
> *d*. Any probable loss (premium deficiency) as described in paragraphs 35–37 of Statement No. 60. [*Footnote omitted*]

A-31. AcSEC noted that the universal life model under FASB Statement No. 97 requires additional liabilities for revenue assessed for services to be performed in future periods and any probable future loss (premium deficiency). In studying the attributes of contracts with insurance benefit features, AcSEC observed that, in some contracts, periodic charges are not assessed in proportion to the risk associated with these benefit features. For example, charges may be assessed for a ratchet MGDB offered with variable annuities based on a percentage of the account balance. In such an MGDB design, as the account balance and assessments increase, the likelihood of a death benefit payment in excess of the account balance decreases. AcSEC noted that FASB Statement No. 97, paragraph 61, states, "An amount assessed might be considered unearned, for example, if it is assessed only in certain contract periods or in a manner that is expected to result in current profits and future losses from a specific contract function." AcSEC concluded that, for contracts where amounts are assessed in a manner that is expected to result in current profits and future losses from the insurance benefit function, a liability should be established in addition to the account balance. This conclusion is also appropriate when considering the reinsurer that assumes, under a long-duration contract, the MGDB risk for a level basis point charge but does not assume the account balance. Without this conclusion, the reinsurer would be recognizing revenue without the related expected benefit cost.

A-32. AcSEC also considered, but rejected, the view that an additional liability for expected losses on insurance benefit payments would only be established if all the margins of the product combined to create a premium deficiency. The premium deficiency concept would in most cases result in no additional liability being established and all amounts assessed during the period being recognized in income even for assessments that are clearly not proportionate to the risk borne by the insurance enterprise for the period. AcSEC rejected that view because such disproportionate assessments are made in part to compensate the insurance enterprise for the risk it assumes in future periods.

A-33. In calculating the liability for the insurance benefit feature, AcSEC decided it is appropriate to use assumptions, such as the interest rate, lapse rate, and mortality, consistent with those used in estimated gross profits and consequently the amortization of deferred acquisition costs. This approach is supported by paragraph 20 of FASB Statement No. 97.

A-34. Due to multiple contractual designs, some of which may include no explicit fee for the insurance benefit feature, AcSEC concluded that the liability in addition to the account balance should be based on total assessments, including investment spread, to eliminate different design features receiving different accounting treatment. This approach implicitly assumes that the assessment each period for the insurance benefit feature is a level amount of the total basis point charge. AcSEC noted that this approach is relatively easy to apply for all contracts even if there is not a separate explicit charge in the contract for the insurance benefit feature. If there is a separate explicit charge for the insurance benefit feature, AcSEC believes it is appropriate to determine the liability using total assessments because it will result in more consistent application of the methodology. In situations where expenses included in estimated gross profits are proportionate to assessments, AcSEC understands that the use of estimated gross profits instead of assessments for purposes of determining the benefit ratio may produce consistent results.

A-35. The additional liability is in substance an FASB Statement No. 60 policyholder benefit liability, but with the unlocking of assumptions each period as required under FASB Statement No. 97 to recognize the variability of the insurance benefit payments and contract assessments. That is, the FASB Statement No. 60 policy benefits liability is calculated as the present value of future expected benefits and related expenses minus the present value of future net premiums. In substance, the FASB Statement No. 60 approach is a type of unearned revenue model, although the policyholder benefit liability does not include a profit margin, in that it provides for the addition to the policyholder benefit reserve each period of a constant percentage of gross premium. AcSEC considered whether the additional liability should be reflected as unearned premium. The concept of unearned revenue includes an element of profit margin, other than in an FASB Statement No. 60 policyholder benefit liability. Allocation of profit to specific contract features such as an MGDB would require allocation of costs across all product features. Such analysis would require further actuarial modeling of costs for other product features considering a range of assumptions, which would add substantial effort to the determination of the MGDB liability. Such analysis to ascertain a profit margin for each benefit feature reconciling to the total profit margin for the contract introduces further subjectivity into the liability determination. The additional liability required in this SOP is based on the relationship of total expected benefits and related expenses to total expected revenue and thus is consistent with the FASB Statement No. 60 policyholder benefit liability with the unlocking of assumptions each period to be consistent with FASB Statement No. 97. Therefore AcSEC concluded that, because profit margin was not being considered in the calculation, the best presentation of the liability would be as a policyholder benefit liability.

A-36. *Statement of operations presentation*. AcSEC considered whether changes in the liability for insurance benefit features offered with annuity contracts should be reflected in the statement of operations as an increase or decrease in revenue or expense. AcSEC concluded for the reasons mentioned in paragraph A-35 of this SOP that the change in the liability should be reported as a benefit expense consistent with changes in policyholder benefit liabilities under FASB Statement No. 60.

A-37. *Accounting for contracts that provide only death or other insurance benefit features*. FASB Statement No. 113, paragraph 12, requires that, for long duration contracts, the reinsurance contract subjects the reinsurer to the "reasonable possibility that the reinsurer may realize significant loss from assuming insurance risk as that concept is contemplated in FASB Statement Nos. 60 and 97." Therefore, AcSEC concluded that the reinsurer should follow the same guidance as a direct writer when testing for significance of mortality and morbidity risk and when accounting for the insurance benefit feature.

Accounting for Contracts That Provide Annuitization Benefits

A-38. Certain variable annuities provide a guaranteed minimum amount available to annuitize after a specified period in addition to a guaranteed minimum annuity interest rate. Other contracts may provide a lower-tier crediting rate during the accumulation phase and a higher rate that is available only upon annuitization. There was diversity in practice with regard to the accounting for these and other annuitization options.

A-39. The conclusion in the exposure draft of the proposed SOP was that no liability should be recognized during the accumulation phase of a contract for the potential effect of annuitization options. This view was based on AcSEC's initial interpretation of FASB Statement No. 97, paragraph 7, which states in part that "a contract provision that allows the holder of a long-duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms." AcSEC had initially concluded that those words precluded accounting recognition of an annuitization option before the option is exercised. However after further discussion, AcSEC concluded that the language in paragraph 7 could be interpreted to apply only to testing for the presence of mortality risk, and not to preclude recognition of a liability. Supporters of this latter view note that FASB Statement No. 97 states in paragraph 40 that "the risk that the guaranteed price of an annuity may prove to be unfavorable to the guaranteeing enterprise when the annuity is purchased is a price risk not unlike a guaranteed price of any commodity and does not create a *mortality risk* [*emphasis added*]."

Supporters of accruing an additional liability believe that, although that guidance prohibits accounting for the contract as if the payout phase were elected and mortality risk existed, it acknowledges the existence of price risk inherent in the annuitization option, thereby allowing for the recognition of the effect of significant annuitization options in the accumulation phase.

A-40. A majority of respondents to the exposure draft of the proposed SOP noted that the exposure draft's initial conclusion to not accrue the costs related to annuitization options would, in many instances, result in an accounting treatment that does not appropriately reflect the economics of the product. Some noted that the financial statement result could be recognition of earnings during the accumulation phase followed by losses during the annuitization phase of the contract. Respondents noted that establishing a liability for these features would be consistent with fundamental generally accepted accounting principles concepts, including the definition of a liability, unearned income, and loss recognition. AcSEC redeliberated the issue and ultimately concluded that the guidance in paragraph 7 of FASB Statement No. 97 should, therefore, be interpreted to require the recognition of a liability related to any such options that are other than nominal, reversing the conclusion reached in the exposure draft of the proposed SOP. AcSEC members believe that recording a liability during the accumulation phase of a contract for expected annuitization benefits would better reflect the economics of the contract. Some amount of revenue or fees was explicitly, or in some cases implicitly, being charged for this additional contract feature; therefore, the cost of providing the potential future benefits should also be recognized in the accumulation phase. Such additional benefits can be clearly and materially favorable to the contract holder and thus represent a loss contingency that is both probable and reasonably estimable. The obligation to provide a service/benefit under an annuitization guarantee also meets the definition of a liability under FASB Concepts Statement No. 6, *Elements of Financial Statements*.

A-41. AcSEC noted that annuitization benefits are similar in many respects to MGDBs in that they provide an additional benefit beyond the account balance. For example, both the MGDB and guaranteed minimum income benefit (GMIB) features represent a minimum guaranteed amount on a variable account balance, with the principal difference being that one is promised upon death, the other upon annuitization. Based on this similarity to MGDB, AcSEC concluded that the MGDB model should be used to accrue an additional liability for GMIB if, at the expected annuitization date, the present value of expected annuitization payments exceeds the expected accrued account balance. In addition, AcSEC noted that if an insurance enterprise has reinsured the GMIB risk, in many instances the reinsurance contract results in a derivative recognized as an asset on the statement of financial condition. If the GMIB liability was not recognized, stockholders' equity would be increased, when in fact that asset is substantially offset by an unrecorded liability. However, AcSEC observed that the GMIB liability recognized under the guidance in this SOP will not be measured at fair value and therefore would not necessarily offset the reinsurance asset.

A-42. In reaching a conclusion relative to accounting for annuitization option benefits, AcSEC considered several alternative models, including the loan commitment and written option models. AcSEC's consideration of those models is discussed in the following paragraphs of this SOP.

A-43. *Consideration of the loan commitment model*. AcSEC considered an analogy between annuitization options provided to contract holders and loan commitments offered to borrowers, the accounting for which is prescribed by FASB

Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, which effectively defers revenue recognition until the economic sacrifice has occurred. FASB Statement No. 91 states in paragraph 8 that "fees received for a commitment to originate or purchase a loan or group of loans shall be deferred and, if the commitment is exercised, recognized over the life of the loan as an adjustment of yield. . . ." Under this analogy, all fees related to an annuitization option should be deferred until the contract holder selects an annuity option; the fees would then be recognized over the payout phase of the annuity or, if annuitization was not elected, recognized in income at the date the contract is surrendered.

A-44. AcSEC believes that problems would arise in applying the loan commitment model to annuity contracts. First, it would be difficult to reasonably determine which fees should be deferred within a fee-based product as the fees related to the annuitization guarantee often are not stated explicitly, or even if stated explicitly, may have been priced on an integrated basis with other revenue components within the contract rather than on a stand-alone basis. Also, it is unclear how to apply this model to products where the insurance enterprise derives its income from investment spreads and thus the contracts have no explicit fee of any kind to defer.

A-45. In addition, AcSEC noted that there are differences between annuitization options and loan commitments. Annuitization options are of a long-term nature (for example, the contract holder may have until age 65, 80, or 90 to annuitize), whereas a loan commitment is generally for a much shorter period. Also, in deciding whether or not to annuitize, there are additional economic factors that contract holders must consider, such as alternative investment options, cash flow considerations, their tax situations, and needs of beneficiaries. Those factors are not relevant to the process of taking a loan, as the commitment is entered into with the intent to borrow and the principal decision is whether the loan terms are competitive. In view of the significant practical implications and many differences between annuitization options and loan commitments, AcSEC decided to reject the FASB Statement No. 91 approach in accounting for annuitization and similar elective benefits.

A-46. *Consideration of the written option model*. AcSEC also considered whether elective benefit options should be accounted for as written options by recording the fair value of the options both at inception and throughout the accumulation phase of the contract, with changes in fair value recognized in income. Supporters of this view believe that similar to the conclusion reached by AcSEC as noted in paragraph A-37 of this SOP, the guidance in paragraph 7 of FASB Statement No. 97 should be interpreted to require the recognition of a liability related to any such options.

A-47. AcSEC also noted that under FASB Statement No. 133, reinsurance of a GMIB option typically would be accounted for as a derivative contract by both the direct writer of the deferred annuity contract with the GMIB feature (ceding company) and the reinsurer, as such reinsurance contracts are typically net settled. Also, although the FASB concluded that certain annuitization options such as GMIBs offered in direct annuity contracts typically are not net settled and therefore fall outside the scope of FASB Statement No. 133, some argue that there are other written options that fall outside the scope of FASB Statement No. 133 that nevertheless are required to be fair valued. For example, EITF Issue No. 99-2, *Accounting for Weather Derivatives*, requires fair value for certain written options even though they fall outside the scope of

FASB Statement No. 133. However, those are examples of contracts falling outside of the scope of Statement No. 133 that represent written options in their entirety and not a component embedded in a contract.

A-48. It was also noted that following the approach of valuing all elective options at fair value would be a change in practice and would require insurance enterprises to determine the fair value of every available annuitization option. Traditional annuity purchase options may have little value, but it would be necessary to continuously determine their value. AcSEC also discussed the issues of the lack of a ready market to determine the fair value of the annuity options because each contract's features are unique by product as well as by insurance enterprise, and of the difficulty involved in splitting apart an integrated fee-based contract to determine applicable fees representing the implicit option premium received, adding to the practical problems of applying this approach.

Sales Inducements to Contract Holders

A-49. Sales inducements to contract holders typically can be characterized as one of the following types: immediate, persistency, and enhanced crediting rate. The actual structure of the inducement can take many forms. Economically, recovery of the costs associated with sales inducements is predicated on a future income stream of items such as fees charged against the assets, investment margins, surrender charges, cost of insurance charges, or reduction of other cost components. In some cases, insurance enterprises may accept lower margins on the product. Sales inducements may be part of an arrangement whereby the sales agent is willing to accept lower commissions, which may offset some or all of the associated cost. In some cases, inducement programs may be initiated to prevent recognition of more dramatic losses if the insurance enterprise is unable to retain contract holders (for example, the insurance enterprise may be required to sell investments at a loss to fund contract surrenders).

A-50. *Consideration of the debt model.* Asset accumulation products accounted for under FASB Statement No. 97 as investment products or universal life-type contracts are viewed as financial instruments. The insurance enterprise has a contractual obligation to deliver cash and the customer has a contractual right to receive cash. Paragraph 15 of FASB Statement No. 97 requires that investment contracts issued by an insurance enterprise be accounted for in a manner consistent with the accounting for interest-bearing instruments.

A-51. AcSEC believes instruments issued by financial institutions should be accounted for consistently, as noted in FASB Statement No. 97, paragraph 39: "While many investment contracts are issued primarily by insurance enterprises, the Board believes that similar financial instruments should be accorded similar treatment regardless of the nature of the issuing enterprise." In connection with an immediate inducement, cash is given to the insurance company in exchange for a promise to pay back an amount in excess of the cash received. Persistency and enhanced inducements are also analogous to nonlevel interest on fixed income securities. FASB Statement No. 91 requires that fees or costs be recognized as yield adjustments over the life of the contract by the interest method of recognition for nonlevel interest. AcSEC concluded that sales inducements meeting the criteria in paragraph .37 of this SOP should result in an effective yield being recognized over the expected life of the contract, rather than expensing the persistency and enhanced interest rate inducements as amounts are credited to the contract holder. This treatment will result in recognition of the sales inducement as it is accrued or when it is credited to the account balance, whichever is earlier.

A-52. *Consideration of sales inducements as deferred acquisition costs.* AcSEC considered the arguments in favor of accounting for sales inducements as a deferred acquisition cost. Insurance companies price the products based on total cash inflows and outflows. Some argued that the form of the transaction that splits these outflows between agent and the customer should be of no consequence, and the substance of the transaction is that certain outflows are paid to induce the customer to acquire the product. AcSEC concluded that sales inducements do not meet the definition of a deferrable acquisition cost because they are benefits paid to contract holders, not payments to third parties.

A-53. *Criteria for capitalization.* AcSEC considered the criteria for determining when a sales inducement is in excess of normal crediting rates that would warrant capitalization. AcSEC believed it was necessary for an insurance enterprise to explicitly demonstrate that such amounts are (*a*) incremental to amounts the enterprise credits on similar contracts without sales inducements, and (*b*) higher than the contract's expected ongoing crediting rates for periods after the inducement; that is, the crediting rate excluding the inducement should be consistent with assumptions used in estimated gross profits, contract illustrations, and interest crediting strategies. These criteria are necessary to prevent capitalization of interest crediting amounts that are current period benefit expenses.

A-54. AcSEC believes that in determining whether an enhanced crediting rate is incremental to amounts the enterprise credits on similar contracts, an insurance enterprise should compare the enhanced crediting rate with the current rate offered on a similar product sold without a sales inducement, if available. In cases where a similar product is not actively marketed and sold without the enhanced crediting rate, AcSEC believes the enterprise should demonstrate that the enhanced crediting rate is incremental to the effective crediting rate on the enterprise's other product(s) that have common characteristics and substance. For example, variable annuities may offer a fixed return over a six-month period until the funds are transferred into equity funds (dollar cost averaging options). The fixed return is often in excess of the interest rate credited on other variable annuity general account fixed income investment alternatives of similar duration that are actively marketed and sold by the enterprise. The excess interest rate would meet the criterion in paragraph .37 of this SOP of "incremental to amounts the enterprise credits on similar contracts without sales inducements."

A-55. Normally day-one and persistency bonuses would meet the criteria in paragraph .37 of this SOP, because crediting occurs on a specific date and thus the bonus would be incremental to other similar contracts with a different anniversary.

A-56. *Consideration of expensing sales inducements in the period credited.* AcSEC also considered and rejected the view that benefits payable to contract holders should be charged to benefit expense in the period credited to the contract holder consistent with other benefit payments. Under this method, AcSEC noted that sales inducements would be recorded as a liability to the customer at the time they meet the definition of a liability, with an immediate charge to expense as a benefit cost.

A-57. AcSEC recognized the long-duration nature of the contracts as defined in FASB Statements No. 60 and No. 97 and was concerned that expensing sales inducements in the period credited could lead to different accounting for contracts that are economically similar. AcSEC noted that contract wording could easily be changed to obtain different accounting treatments. For example, contracts with identical economic benefits to the contract holder could be designed, one with an immediate bonus with a surrender charge expiring after five years and one with a persistency bonus credited at the end of five years. Expensing sales inducements in the period credited would result in very different accounting results even though the contracts were identical economically and would result in loss at inception on the contract that offered an immediate sales inducement. Another contract with a persistency bonus would give the contract holder the same cash in the future and not have a loss at inception. Based on those concerns, AcSEC rejected the concept of expensing sales inducements in the period credited and concluded to expense sales inducements over the period that the long-duration contract is in force.

A-58. *Amortization of deferred sales inducements.* For contracts accounted for under FASB Statement No. 97, the asset arising from sales inducements should be amortized using methodology and assumptions consistent with those used for deferred acquisition costs under FASB Statement No. 97, which is effectively the expected life of the accumulation phase of the contract. Because FASB Statement No. 97 requires that the annuitization phase be viewed as a separate contract, the annuitization phase should not be combined with the accumulation phase. AICPA Practice Bulletin No. 8, *Application of 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, *to Insurance Enterprises*, states:

> The amortization method described in FASB Statement No. 97 for universal life-type contracts should be used for investment contracts that include significant surrender charges or that yield significant revenue from sources other than the investment of contract holders' funds. This method matches amortization of deferred policy acquisition costs (DPAC) with the recognition of gross profits. Otherwise, DPAC on investment contracts should be amortized using an accounting method that recognizes acquisition and interest costs as expenses at a constant rate applied to net policy liabilities and that is consistent with the interest method under FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases* (interest method).

This guidance is provided for the amortization of deferred acquisition costs, which in this context is similar to debt issuance costs.

A-59. AcSEC considered, but rejected, the view that a qualifying sales inducement should be amortized over the shorter of the expected life of the contract or the period during which the sales inducement is effectively operating to incent persistency. As the recovery of sales inducements is through future income streams [such as fees charged against the assets, investment margins, cost of insurance charges, reduction of other cost components (such as commissions), or surrender charges] during the expected contract life, AcSEC concluded that qualifying sales inducements should be amortized over the expected life of the contract. In addition, amortization of deferred sales inducements will include an expected lapse assumption that is updated each period.

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A-60. AcSEC concluded that it is important to provide details of the investments of variable separate accounts with guarantees because this provides information on a significant asset for many insurance enterprises. In addition, the nature of the guarantee is affected by the nature of the investments in the separate account. Some respondents to the exposure draft recommended that gains and losses on assets transferred to a separate account also should be disclosed. AcSEC agreed that this would be useful information to readers of financial statements, and, therefore, required differentiation of gains and losses that were generated from the insurance enterprise's general account investments.

A-61. Several respondents to the exposure draft of the proposed SOP suggested that the required disclosures should also include the significant assumptions used to estimate liabilities for additional insurance benefits and minimum guarantees. AcSEC agreed that this information would help improve transparency and comparability of financial statements, and concluded that the significant assumptions should be required disclosures. AcSEC concluded that the detail and amount of the separate account liability balances subject to various types of guarantees would be useful information to readers of financial statements and promote comparability. AcSEC also concluded that it is important to disclose the net amount at risk by type of guarantee because this provides readers of financial statements with the maximum amounts the insurance enterprise is at risk for guaranteeing.

A-62. AcSEC discussed including sensitivity analysis related to significant assumptions used for liability balances related to minimum guarantees, and concluded that this information would be more appropriate in the management discussion and analysis section of an enterprise's public reporting.

Effective Date and Transition

A-63. AcSEC concluded that this SOP should be initially applied at the beginning of the fiscal year that begins after December 15, 2003, which should permit companies sufficient time to implement this SOP. AcSEC also concluded that it should allow companies the option of early adoption.

A-64. AcSEC concluded that the effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle (in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*) and that restatement of prior annual financial statements should be prohibited. AcSEC recognizes the benefits of comparable financial statements but believes that due to significant judgment and the possible use of hindsight in applying this SOP, and the significance of the efforts and costs likely to be incurred, retroactive restatement or pro forma disclosures in the year of adoption should not be required.

A-65. AcSEC considered allowing entities the choice, for certain provisions of this SOP, to reclassify previously reported financial statements provided there was no valuation basis adjustment affecting earnings, while prohibiting reclassification when the valuation provisions of this SOP would affect earnings. AcSEC concluded that the provisions of this SOP are not fundamentally different from the FASB Statement No. 97 model and that allowing entities the option of applying certain provisions and not others would result in inconsistent recognition of liabilities, revenue, and acquisition costs. AcSEC concluded that allowing restatement in certain circumstances and not allowing restatement in other circumstances is not appropriate. Therefore, AcSEC decided not to permit restatement.

A-66. AcSEC concluded that securities subject to FASB Statement No. 115 previously carried at fair value that are reclassified to the general account may be designated as held-to-maturity for debt securities, available-for-sale for debt and equity securities, or trading for debt and equity securities. AcSEC believed that prior to implementation of this SOP the assets were being accounted for under separate account valuation basis and, after reclassification to the general account per the guidance of this SOP, they are to be valued under general account guidance. Accordingly, AcSEC concluded this designation is similar to an enterprise initially adopting FASB Statement No. 115 for those securities. The guidance provided by AcSEC is consistent with that provided in FASB Statement No. 115 for its initial adoption.

A-67. AcSEC also concluded that debt or equity securities subject to FASB Statement No. 115, previously classified as part of a separate account but valued in accordance with paragraphs 45 through 51 of FASB Statement No. 60, as amended, should maintain the original designation as held-to-maturity, available-for-sale, or trading. That designation previously was made in accordance with FASB Statement No. 115 when the security was purchased and classified as a separate account asset. Although under this SOP the securities are now classified as part of the general account, the insurance enterprise has already assessed its intent under FASB Statement No. 115, which is not changed.

A-68. Any revaluation adjustment for the securities described in paragraph A-66 of this SOP should be reported in a manner similar to the cumulative effect of a change in accounting principle through net income or accumulated other comprehensive income, as appropriate. In its deliberations, AcSEC considered both the transfer and transition guidance provided in FASB Statement No. 115, paragraphs 15 and 25, related to reclassifications among categories. AcSEC believes that the transition requirements of FASB Statement No. 115 are consistent with AcSEC's decision not to permit restatement resulting from adoption of this SOP.

A-69. AcSEC concluded that, for debt or equity securities subject to FASB Statement No. 115 and classified as available-for-sale that are part of a contractually referenced pool of assets where a total return will be accrued to the account balance liability, and a transition adjustment for the liability valuation is reported in accordance with paragraph .41*e*, the related debt or equity securities may be reclassified to trading upon initial adoption of the SOP. In this case, AcSEC believes the combined effect of the asset and liability transition adjustments should be reported in a manner similar to the cumulative effect of a change in accounting principle. An enterprise may not have designated a security as available-for-sale when it purchased the security if it had known a contract holder liability designed to mimic the return would be recorded based on the referenced asset in the statement of operations. In addition AcSEC noted that FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, provides for similar transition treatment because the guidance for hedge accounting significantly changed. AcSEC also made the analogy to the transition guidance in EITF Issue No. 97-14, *Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested*.

A-70. The insurance enterprise's accounting policies with regard to assets other than those subject to FASB Statement No. 115 should be consistently applied upon reclassification of assets from separate accounts to the general account at the date of initial adoption of the SOP. AcSEC concluded that any revaluation adjustments related to assets other than those subject to FASB Statement No. 115 should be reported in a manner similar to the cumulative effect of a change in accounting principle.

A-71. AcSEC concluded that, because this SOP may change the way an insurance enterprise applies the mortality and morbidity significance test and that the results of that test may change the required liability valuation model, insurance enterprises should perform a new determination of significance of mortality and morbidity risk resulting from the insurance benefit features of the contract for purposes of contract classification at the date of initial adoption of this SOP. AcSEC considered requiring this determination to be made as of original contract issuance, but rejected that approach because it would not be practicable to obtain and document a range of reasonably possible cash flow outcomes as of those inception dates without the inappropriate use of hindsight. In addition to the burden of performing the test without original information, it would be difficult to verify the appropriateness of the outcomes. AcSEC also considered requiring the determination only for new contracts, but was concerned that would cause inconsistencies in the accounting for similar contracts of an enterprise for many years due to the long-duration nature of such contracts.

A-72. AcSEC considered whether to require restatement of contract holder liabilities as a result of adoption of this SOP, but concluded that restatement is not necessary and may not be possible to reconstruct. AcSEC concluded that any adjustment to contract holder liabilities from adoption of this SOP should be reported in a manner similar to the cumulative effect of a change in accounting principle in accordance with the provisions of APB Opinion No. 20, through net income or, for amounts previously reported under EITF Topic No. D-41, accumulated other comprehensive income.

A-73. AcSEC, in discussing sales inducements, recognized that some insurance enterprises charged those costs to expense as incurred. AcSEC believes that the costs of developing the information that would be necessary to determine the costs that would be capitalized if this SOP were applied retroactively would exceed the benefits retroactive application might offer and that such retroactive determination should not be made. AcSEC believes this treatment is consistent with transition rules of other accounting guidance, such as SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*.

A-74. AcSEC further concluded that the unamortized capitalized sales inducement balance at transition should not be adjusted, but the balance should be subject to the amortization provisions of this SOP on a prospective basis. Prospective treatment and prohibition on restating sales inducements capitalized is consistent with AcSEC's conclusions on restatement of previously expensed inducements. Identification and amortization of previously capitalized costs in accordance with the provisions of this SOP should result in an acceptable level of comparability and understandability.

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Appendix B

Illustration for Presentation of an Insurance Enterprise's Interest in a Separate Account

B-1. The following example illustrates the presentation in the financial statements of an insurance enterprise's proportionate interest in separate accounts:

An insurance enterprise has a separate account that consists of two subaccounts, Subaccount ABC and Subaccount XYZ. The insurance enterprise has a 10 percent interest in Subaccount XYZ, determined based on the fair value of Subaccount XYZ's investments. Subaccount XYZ has debt securities, mutual fund investments, mortgage loans, and real estate. Subaccount XYZ carries its investments at fair value; if the general account held these investments, they would be accounted for at amortized cost or fair value, depending on the applicable literature. Accounting for equity investments, including mutual funds, would depend on percentage ownership. If Subaccount XYZ owns more than 50 percent of the outstanding shares of a mutual fund, the accounting and classification of the items included in the column titled "Separate Account at General Account Value" would reflect consolidating the mutual fund into Subaccount XYZ. That is, if the mutual fund held debt and equity securities, those amounts would be included in the debt and equity securities lines of the table below.

The assets of Subaccount XYZ are composed of the following:

Investment	*Separate Account at Fair Value*	*Separate Account at General Account Value*[1]	*Insurer's Interest*	*Proportionate Interest*
Debt securities	400	400	10%	40
Equity securities	300	300	10%	30
Mortgage loans	250	200	10%	20
Real estate	130	100	10%	10
Total assets	$1,080	$1,000	10%	$100

Balances presented in the insurer's statement of financial condition would reflect:

Assets:	Debt securities[2]	40
	Equity securities[2, 3]	30
	Mortgage loans	20
	Real estate	10
	Total investments	100
	Separate account—Assets	$972[4]
Liabilities:	Separate account—Liabilities	$972

[1] Underlying investments valued in a manner similar to any other general account asset as prescribed in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended, paragraphs 45 through 51.

[2] Debt and equity securities need to be designated as either trading or available-for-sale.

[3] If Subaccount XYZ separate account held an investment in a mutual fund, a typical situation would be that the insurance enterprise's investment would represent less than a 20 percent ownership and the interest would be reported as an FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, equity security.

[4] Separate account assets at fair value of $1,080 x 90% (contract holders' proportionate interest).

The applicable disclosures for the insurer's proportionate interest in these specific assets would be included within the applicable disclosures for the general account invested assets.

The XYZ separate account's balances for net investment income and gains and losses:

	XYZ Separate Account Total	*Insurer's Interest*	*Appor-tioned Values*	*General Account Classification*
Net investment income (NII)	65	10%	6.5	Revenue
Realized gains and losses	20	10%	2.0	Revenue
Unrealized gains and losses:				
Debt securities	8	10%	0.8	Revenue or OCI[5]
Equity securities	25	10%	2.5	Revenue or OCI[5]
Mortgage loans	5	10%	0.5	Not recognized[6]
Real estate	2	10%	0.2	Not recognized[6]
Total NII and gains and losses	$125		12.5	

Assume in the second year:

- Insurer interest is lowered to 5 percent on the last day of the first quarter.
- At the time of dilution:
  - — Separate account at fair value was $ 1,090.
  - — Separate account at general account value was $ 1,007.
- Fair value of each investment increases 1 percent.

End of first quarter:

Investment	*Separate Account at Fair Value*	*Separate Account at General Account Value*	*Insurer's Interest*	*Proportionate Interest After Dilution*
Debt securities	404	404	5%	20
Equity securities	303	303	5%	15
Mortgage loans	252	200	5%	10
Real estate	131	100	5%	5
Total assets	$1,090	$1,007		50

[5] Unrealized gains should be included in revenue or other comprehensive income (OCI) depending on security classification as trading or available-for-sale. Unrealized losses result in other than temporary impairments, as noted in paragraph .14*a* of this SOP, and should be recognized immediately.

[6] Unrealized gains are not recognized. Cumulative unrealized losses may result in recognition of an other-than-temporary impairment.

Balances presented in the insurer's statement of financial condition would reflect:

Assets:	Debt securities	20
	Equity securities	15
	Mortgage loans	10
	Real estate	5
	Total investments	50
	Separate account—Assets	$1,036[7]

The XYZ separate account's balances for net investment income and gains and losses for the quarter:

	XYZ Separate Account Total	*Insurer's Interest*	*Apportioned Values*
Net investment income	16.3	10%	1.6
Unrealized gains and losses:			
Debt securities	4.0	10%	0.4
Equity securities	3.0	10%	0.3
Mortgage loans	2.5	10%	0.3
Real estate	1.2	10%	0.1
Total NII and gains and losses	$27		2.7

The seed money change for the quarter would be accounted for as follows:

Amount due to proportionate interest in revenue	2.3
Gain recognition on dilution of interest	4.2[8]

[7] $1,090 x 95%

[8] Fair value of separate account less general account value of separate account multiplied by dilution, ($1,090 - $1,007) x 5%. This is the gain on mortgage loans and real estate, assuming debt and equity securities have been classified as trading. If debt and equity securities had been classified as available for sale, the gain or loss on dilution would also be calculated using amortized cost of debt and equity securities.

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Appendix C

Sample Disclosures

C-1. This appendix provides an illustration of the financial statement disclosure requirements relating to paragraph .38 of this Statement of Position (SOP). Entities are not required to display the disclosure information contained herein in the specific manner illustrated. Alternative ways of disclosing the information are permissible provided that the disclosure requirements of this SOP, as described in paragraph .38, are met, such as showing account balances of contracts with guarantees by type of benefit.

> The company issues variable contracts through its separate accounts for which investment income and investment gains and losses accrue directly to, and investment risk is borne by, the contract holder (traditional variable annuities). The company also issues variable annuity and life contracts through separate accounts where the company contractually guarantees to the contract holder (variable contracts with guarantees) either (*a*) return of no less than total deposits made to the contract less any partial withdrawals, (*b*) total deposits made to the contract less any partial withdrawals plus a minimum return, or (*c*) the highest contract value on a specified anniversary date minus any withdrawals following the contract anniversary. These guarantees include benefits that are payable in the event of death, annuitization, or at specified dates during the accumulation period. During 20X1 and 20X2 there were no gains or losses on transfers of assets from the general account to the separate account.
>
> The assets supporting the variable portion of both traditional variable annuities and variable contracts with guarantees are carried at fair value and reported as summary total separate account assets with an equivalent summary total reported for liabilities. Amounts assessed against the contract holders for mortality, administrative, and other services are included in revenue and changes in liabilities for minimum guarantees are included in policyholder benefits in the Statement of Operations. Separate account net investment income, net investment gains and losses, and the related liability changes are offset within the same line item in the Statement of Operations.
>
> At December 31, 20X1 and 20X2, the company had the following variable contracts with guarantees. (Note that the company's variable contracts with guarantees may offer more than one type of guarantee in each contract; therefore, the amounts listed are not mutually exclusive.) For guarantees of amounts in the event of death, the net amount at risk is defined as the current guaranteed minimum death benefit in excess of the current account balance at the balance sheet date. For guarantees of amounts at annuitization, the net amount at risk is defined as the present value of the minimum guaranteed annuity payments available to the contract holder determined in accordance with the terms of the contract in excess of the current account balance. For guarantees of accumulation balances, the net amount at risk is defined as the guaranteed minimum accumulation balance minus the current account balance.

	December 31	
	20X1	*20X2*
Return of Net Deposits		
In the event of death		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx
Average attained age of contract holders	xx	xx
At annuitization		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx
Weighted average period remaining until expected annuitization	xx	xx
Accumulation at specified date		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx
Return of Net Deposits Plus a Minimum Return		
In the event of death		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx
Average attained age of contract holders	xx	xx
Range of guaranteed minimum return rates	x-x%	x-x%
At annuitization		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx
Weighted average period remaining until expected annuitization	xx	xx
Range of guaranteed minimum return rates	x-x%	x-x%
Accumulation at specified date		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx
Range of guaranteed minimum return rates	x-x%	x-x%
Highest Specified Anniversary Account Value Minus Withdrawals Post Anniversary		
In the event of death		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx
Average attained age of contract holders	xx	xx
At annuitization		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx
Weighted average period remaining until expected annuitization	xx	xx
Accumulation at specified date		
Account value	$xxx	$xxx
Net amount at risk	$xxx	$xxx

Account balances of contracts with guarantees were invested in variable separate accounts as follows:

Asset Type	*December 31, 20X1*	*December 31, 20X2*
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$	$
Obligations of states of the United States and political subdivisions of the states		
Corporate debt securities:		
—Investment grade		
—Noninvestment grade		
Foreign debt securities		
Mortgage-backed securities		
Equity securities (including mutual funds)[1]		
Real estate		
Mortgage loans		
Derivative financial instruments		
Cash and cash equivalents		
Total	$X,XXX,XXX	$X,XXX,XXX

The following summarizes the liabilities for guarantees on variable contracts reflected in the general account:

	Minimum Guaranteed Death Benefit (MGDB)	*Guaranteed Minimum Accumulation Benefit (GMAB)*	*Guaranteed Minimum Income Benefit (GMIB)*	*Totals*
Balance at January 1	$X,XXX,XXX	$X,XXX,XXX	$X,XXX,XXX	$X,XXX,XXX
Incurred guarantee benefits[2]	X,XXX,XXX	X,XXX,XXX	X,XXX,XXX	$X,XXX,XXX
Paid guarantee benefits	X,XXX,XXX	X,XXX,XXX	X,XXX,XXX	$X,XXX,XXX
Balance at December 31, 20X2	$X,XXX,XXX	$X,XXX,XXX	$X,XXX,XXX	$X,XXX,XXX

The MGDB liability is determined each period end by estimating the expected value of death benefits in excess of the projected account balance and recognizing the excess ratably over the accumulation period based on total expected assessments. The Company regularly evaluates estimates

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[1] The insurance enterprise may want to consider disclosing mutual funds by investment objective or other meaningful groupings that are useful in understanding the nature of the guarantee risk.

[2] For guaranteed minimum accumulation benefits, incurred guarantee benefits incorporates all changes in fair value other than amounts resulting from paid guarantee benefits.

used and adjusts the additional liability balance, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised. [*Include discussion of change in estimate if material*.]

The following assumptions and methodology were used to determine the MGDB liability at December 31, 20X2:

- Data used was 1,000 stochastically generated investment performance scenarios.
- Mean investment performance assumption was XX.
- Volatility assumption was XX.
- Mortality was assumed to be 90 percent of the Annuity 2000 table.
- Lapse rates vary by contract type and duration and range from 1 percent to 20 percent, with an average of 3 percent.
- Discount rate was XX%.

Guaranteed minimum accumulation benefits are considered to be derivatives under Financial Accounting Standards Board Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and are recognized at fair value through earnings.

The guaranteed minimum income benefit (GMIB) liability is determined each period end by estimating the expected value of the annuitization benefits in excess of the projected account balance at the date of annuitization and recognizing the excess ratably over the accumulation period based on total expected assessments. The Company regularly evaluates estimates used and adjusts the additional liability balance, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised. [*Include discussion of change in estimate if material*.] The assumptions used for calculating the GMIB liability at December 31, 20X2, are consistent with those used for calculating the MGDB liability. In addition, the calculation of the GMIB liability assumes X percent of the potential annuitizations that would be beneficial to the contract holder will be elected.

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Appendix D

Application of Statement of Position—Product and Product Feature Examples

Market Value Annuity

D-1. A market value annuity (MVA) provides for a return of principal plus a fixed rate of return if held to maturity (referred to herein as book value), or, alternatively, a "market adjusted value" if surrendered prior to maturity. The product is also sometimes referred to as a "market value adjusted annuity" or "modified guaranteed annuity." The product typically provides for a single premium that may be invested for a specified term, with typical terms of 1 to 10 years. A fixed interest rate is specified in the contract based upon the term selected. The contract contains surrender values that are based upon a market value adjustment formula if held for shorter periods. The formula typically is based on current crediting rates being offered for new MVA purchases with terms equal to the remaining term to maturity. The market value adjustment may be positive or negative, depending on crediting rates at surrender.

D-2. Because the insurance enterprise provides a fixed return for a specified period, market value adjusted annuities written through a separate account do not meet the criteria in paragraph .11*d* of this Statement of Position (SOP). Under paragraph .11*d* of this SOP, all investment performance, net of contract fees, must be required to be passed through to the contract holder to qualify for separate account treatment. Therefore, the assets and liabilities related to market value adjusted annuities should be accounted for and reported as general account assets and liabilities.

D-3. Under the model, described in paragraphs .20 through .23 of this SOP, the liability to be held for market value adjusted annuities is the accrued account balance using the contractually specified rate. The market value adjusted amount generally is available at surrender only and is not available at contract maturity; therefore, the market value adjustment is considered a surrender charge or credit.

Two-Tier Annuity

D-4. A two-tier annuity has two crediting rates applied to funds deposited into the contract. One rate is used to calculate the account balance if the contract holder elects to surrender the contract for cash, and is referred to as the "lower tier." A second rate, typically higher, is used to calculate the account balance, but only if the contract holder elects to annuitize the contract, and is referred to as the "upper tier."

D-5. This SOP requires that the accrued account balance during the accumulation phase be calculated using the lower-tier rate because the account balance accumulated at the lower tier is the amount that would be available in cash at maturity if the contract holder elects not to annuitize the contract. An additional liability determined in accordance with paragraphs .31 through .33 of this SOP should be recognized during the accumulation phase for the annuitization benefit in excess of the accrued account balance. When there is an additional liability for the annuitization benefit and a contract holder elects to annuitize, the present value of annuitization payments, including related incremental claims adjustment expenses, discounted at expected investment yields would represent the single premium used to "purchase" the annuitization benefit.

Variable Annuity With Guaranteed Minimum Accumulation Benefit

D-6. Some deferred annuities provide a minimum accumulation benefit or a guaranteed account value floor that is available to the contract holder in cash. These benefits are often referred to as guaranteed minimum accumulation benefits, or GMABs.

D-7. *Example:* Contract holder deposits $100,000 in a deferred variable annuity that provides for a GMAB that guarantees that at a specified anniversary date (for example, five years), the contract holder's account balance will be the greater of (*a*) the account value, as determined by the separate account assets, or (*b*) deposits less partial withdrawals accumulated at 3 percent interest compounded annually. At the specified anniversary date the contract holder's account balance has declined to $80,000 due to stock market declines. The guaranteed minimum value of the $100,000 deposit compounded annually at 3 percent interest is $115,930. The contract holder's account balance will be increased to the greater amount, resulting in an account balance of $115,930. Financial Accounting Standards Board (FASB) Derivative Implementation Issue B8, *Identification of the Host Contract in a Nontraditional Variable Annuity Contract,* specifies that a GMAB is an embedded derivative subject to the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The remaining part of the hybrid contract should be accounted for separately.

Variable Annuity With Guaranteed Minimum Income Benefit

D-8. Some deferred variable annuities guarantee that, regardless of separate account investment performance, the contract holder will be able to annuitize after a specified date and receive a defined minimum periodic benefit. These benefits are available only if the contract holder elects to annuitize and are often referred to as guaranteed minimum income benefits, or GMIBs.

D-9. *Example:* A contract holder deposits $100,000 in a deferred variable annuity that provides a GMIB. The GMIB contract specifies that if the contract holder elects to annuitize, the amount available to annuitize will be the higher of the then account balance or the sum of deposits less withdrawals. The contract holder directs the deposit to equity-based funds within the separate account. At the date that the contract holder chooses to annuitize, the account balance has declined to $80,000 due to stock market declines. The contract holder elects a 20-year period-certain fixed payout annuity, payable monthly in arrears. Using the $100,000 guaranteed minimum account value at the date of annuitization and a guaranteed 3 percent crediting rate, the fixed monthly periodic annuity payment is $554.

D-10. During the accumulation phase, if the GMIB feature is not accounted for under the provisions of FASB Statement No. 133, an additional liability should be established if the present value of expected annuitization payments at the annuitization date exceeds the expected account balance at the expected annuitization date. That additional liability should be determined in accordance with paragraphs .31 through .33 of this SOP. When there is an additional liability for the annuitization benefit and a contract holder elects to annuitize, the present value of annuitization payments, including related claims adjustment expenses, discounted at expected investment yields would represent the single premium used to "purchase" the annuitization benefit.

D-11. FASB Derivative Implementation Issue B25, *Deferred Variable Annuity Contracts with Payment Alternatives at the End of the Accumulation Period*, specifies that a GMIB does not meet the definition of an embedded derivative if it cannot be net settled. If the GMIB can be net settled, the guarantee is an embedded derivative in the accumulation period and should be accounted for under FASB Statement No. 133.

Variable Annuity and Life Insurance

D-12. Variable annuity and variable life insurance contracts provide the contract holder with a number of investment alternatives. Many of those investment alternatives will be separate account funds, such as equity, aggressive equity, high-grade corporate bond, mortgage loan, real estate and similar funds, that satisfy the criteria contained in paragraph .11 of this SOP. Other investment alternatives could include guaranteed investment and market value adjusted separate accounts as well as a general account fixed interest rate option.

D-13. *Example:* The contract holder deposits $100,000 in a deferred variable annuity that has no front-end load. The contract holder directs the allocation of the deposit to the following: aggressive growth equity fund, $25,000; high-yield corporate bond fund, $25,000; five-year guaranteed interest separate account, $25,000; and general account, $25,000.

D-14. Assets representing the contract holder's funds in the aggressive growth equity fund and high-yield corporate bond fund separate accounts satisfy all the criteria of paragraph .11 of this Statement of Position (SOP). The allocation to the guaranteed interest separate account does not satisfy the criterion in paragraph .11*d* of this SOP. Therefore, assets representing the contract holder's funds in the guaranteed interest separate account will be presented in the insurance enterprise's financial statements integrated with general account assets and liabilities. This reporting is appropriate even in those instances where the separate account arrangements with those contracts have been approved by regulatory authorities as separate account contracts. These contracts are often referred to as spread products, where the insurer bears the investment risk and its profits are derived primarily from the excess of investment performance over net amounts credited to the contract holder. Amounts related to this contract that are directed to the general account option will, of course, be shown within general account balances.

Group Participating Pension Contracts

D-15. Some 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,* contracts between insurance enterprises and pension plans have account balance crediting provisions that give the contract holder the total return based on a referenced pool of assets over the life of the contract either through crediting rates or termination adjustments. The ongoing crediting to the account balance may be based on statutory, cash basis, or book value returns. The contracts may not have a maturity date but specify that upon surrender any remaining return on the referenced pool of assets on the termination date not yet credited will be a termination adjustment. The referenced pool of assets may include mortgage loans, real estate, and equity and debt securities.

D-16. This SOP requires that, for contracts not accounted for under the provisions of FASB Statement No. 133, the liability for the contract holder account balance be based on the fair value of the referenced pool of assets without regard to the accounting under generally accepted accounting principles for the assets in the referenced pool of assets, with any change in the liability recognized through earnings.

Sales Inducements to Contract Holders

D-17. Sales inducements to contract holders typically can be characterized as one of the following types: immediate bonuses, persistency bonuses, and enhanced crediting rate bonuses.

D-18. In the case of the immediate bonus, the insurance company is obligated to credit to the contract holder's account the sales inducement as a result of signing the contract. The contract holder account balance is increased for the full amount of the immediate bonus on the date that the bonus is contractually granted. If the criteria in paragraph .37 of this SOP are met, an asset should be established for the same amount. Even if a company were to impose a prepayment penalty designed to recover the sales inducement, paragraph 18 of FASB Statement No. 97 specifies that amounts assessed against policyholders in future periods cannot be considered in determining the liability for policy benefits. The prepayment penalty for the sales inducement would be treated no differently than any other surrender charge.

D-19. A persistency bonus is credited to the contract holder account balance at the end of a specified period if the contract remains in force at that date. The amount that will be credited in accordance with the terms of the contract should be accrued as a component of the contract holder account balance ratably over the vesting period. If the criteria in paragraph .37 of this SOP are met, an asset should be established. While it may not become payable by the insurance company until some future vesting or crediting date, the insurance enterprise is prohibited by FASB Statement No. 97 from anticipating surrenders and must assume the contract holder will persist to earn the bonus.

D-20. In an enhanced crediting rate sales inducement, the insurance enterprise offers customers a crediting rate for a stated period in excess of that currently being offered by the company for other similar contracts. Pursuant to the contract, the enhanced crediting rate is applicable for a limited period of time, after which, the rate is "reset" under the contractual provisions, typically at the discretion of the insurance enterprise. The liability for an enhanced crediting rate sales inducement should be accrued ratably over the bonus crediting period. If the criteria in paragraph .37 of this SOP are met, an asset should be established for the same amount.

Variable Annuity With Long-Term Care Benefit

D-21. Some deferred annuities provide that if during the accumulation phase, the contract holder has an insurable event (for example, disability, loss of "activities of daily living") that meets the criteria specified in the contract, additional benefits in excess of the account balance will be available. This feature should be evaluated and accounted for in accordance with paragraphs .24 through .30 of this SOP.

Annuities With Earnings Protection Benefit

D-22. Some annuities provide that in the event of death, the beneficiary will receive a benefit in addition to the account balance equal to a percentage (for example, 40 percent) of the difference between the account balance and the deposits less withdrawals. This feature is a death benefit and should be evaluated and accounted for in accordance with paragraphs .24 through .30 of this SOP.

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Appendix E

Illustrations of the Calculation of Minimum Guaranteed Death Benefit Liability

E-1. The accompanying schedules illustrate how to calculate an additional liability for a portfolio of variable annuity contracts with a minimum guaranteed death benefit (MGDB) feature as noted in paragraphs .24 through .29 of this Statement of Position (SOP). For this illustration it is assumed that the guidance in paragraphs .24 and .25 of this SOP has been followed, with the conclusion that the mortality and morbidity risk associated with insurance benefit features is other than nominal.

E-2. The following is assumed for contracts in this illustration:

- *a.* Variable annuity contracts have no front-end loads.
- *b.* Mortality assessments include any explicit assessments for enhanced death benefit feature.
- *c.* Surrender charges are calculated based on a percentage of premiums.
- *d.* Expense assessments are a fixed annual charge.
- *e.* Discount rate of 8 percent is the same rate as used for deferred acquisition cost amortization.

E-3. Schedules 6 through 10 contain the same basic assumptions as Schedule 1, but with the impact on the adjusted gross profits of a 10 percent increase in account balances (not shown in schedules) in year 2.

E-4. The illustrations display the computations involved in:

- *a.* Gross profits
- *b.* Benefit ratio
- *c.* Additional MGDB liability
- *d.* Adjusted gross profits that should be used for the amortization of deferred acquisition costs[1]

Note: Columns in schedules do not cross foot due to rounding.

[1] The estimated gross profits used for the amortization of deferred acquisition costs should be adjusted to reflect the incidence of assessments and loss expense as a result of the recognition of the liability; refer to paragraph .29 of this SOP.

Schedule 1—Illustration of Unadjusted Gross Profits Calculation

Year	*Expense Assessments* +	*Mortality Assessments* +	*Surrender Charges* =	*Total Revenue*[1] −	*Recurring Expenses Incurred* −	*Excess Death Benefits Paid* =	*Unadjusted Gross Profits*
1	30.00	820.50	17.50	868.00	25.00	0.00	843.00
2	29.75	871.65	44.62	946.02	170.27	12.20	763.55
3	29.48	919.29	61.42	1,010.20	177.78	20.61	811.80
4	29.20	969.80	68.12	1,067.12	185.96	25.94	855.22
5	28.89	1,034.77	64.99	1,128.65	196.53	31.58	900.54
6	28.55	1,086.61	95.16	1,210.32	204.89	44.05	961.38
7	28.18	1,143.53	58.71	1,230.42	214.07	49.53	966.82
8	27.78	1,086.61	0.00	1,114.39	224.32	52.00	838.07
9	27.34	1,268.91	0.00	1,296.25	234.27	65.93	996.05
10	26.87	1,333.10	0.00	1,359.97	244.57	76.78	1,038.61
11	26.35	1,382.93	0.00	1,409.28	252.45	93.75	1,063.08
12	25.79	1,433.09	0.00	1,458.87	243.67	104.76	1,110.44
13	25.18	1,487.10	0.00	1,512.27	268.83	120.67	1,122.78
14	24.52	1,539.66	0.00	1,564.18	278.10	142.22	1,143.86
15	23.81	1,597.88	0.00	1,621.69	286.16	151.25	1,184.28
16	23.06	1,662.23	0.00	1,685.28	296.25	153.64	1,235.39
17	22.25	1,691.70	0.00	1,713.95	300.49	210.92	1,202.54
18	21.39	1,723.70	0.00	1,745.09	305.11	236.72	1,203.27
19	20.48	1,751.22	0.00	1,771.70	308.93	270.72	1,192.05
20	19.52	1,788.11	0.00	1,807.63	314.28	270.82	1,222.52
Present value				12,304.07		724.88	9,520.96

[1] If the product had investment margins, they would be included in the schedule as an additional column.

Schedule 2—Computation of Benefit Ratio

Present value of excess death benefits paid	724.88
Divided by present value of total revenue	12,304.07
Equals benefit ratio	5.8914%

Schedule 3—Computation of Year 1 Additional MGDB Liability

Cumulative revenue recognized	868.00
Multiplied by benefit ratio	5.8914%
Equals year 1 additional liability	($) 51.14

Schedule 4—Additional MGDB Liability Amortized Over Total Revenue

Year	*Beginning Additional MGDB Liability*	+ *Interest*	+ *Total Revenue X Benefit Factor*	− *Excess Death Benefits Paid*	= *Ending Additional MGDB Liability*	*Change in Additional Liability*
1	0.00	0.00	51.14	0.00	51.14	51.14
2	51.14	4.09	55.73	12.20	98.76	47.63
3	98.76	7.90	59.51	20.61	145.57	46.81
4	145.57	11.65	62.87	25.94	194.15	48.57
5	194.15	15.53	66.49	31.58	244.59	50.45
6	244.59	19.57	71.30	44.05	291.41	46.82
7	291.41	23.31	72.49	49.53	337.69	46.28
8	337.69	27.02	65.65	52.00	378.35	40.66
9	378.35	30.27	76.37	65.93	419.06	40.70
10	419.06	33.52	80.12	76.78	455.92	36.86
11	455.92	36.47	83.03	93.75	481.67	25.75
12	481.67	38.53	85.95	104.76	501.39	19.72
13	501.39	40.11	89.09	120.67	509.93	8.54
14	509.93	40.79	92.15	142.22	500.65	-9.27
15	500.65	40.05	95.54	151.25	484.99	-15.66
16	484.99	38.80	99.29	153.64	469.44	-15.55
17	469.44	37.56	100.98	210.92	397.05	-72.39
18	397.05	31.76	102.81	236.72	294.91	-102.14
19	294.91	23.59	104.38	270.72	152.16	-142.75
20	152.16	12.17	106.49	270.82	0.00	-152.16

Schedule 5—Estimated Gross Profits to Use for Amortization of Deferred Acquisition Costs

Year	Unadjusted Gross Profits	–	Change in Additional Liability	=	Estimated Gross Profits
1	843.00		51.14		791.86
2	763.55		47.63		715.92
3	811.80		46.81		765.00
4	855.22		48.57		806.64
5	900.54		50.45		850.09
6	961.38		46.82		914.56
7	966.82		46.28		920.55
8	838.07		40.66		797.40
9	996.05		40.70		955.35
10	1,038.61		36.86		1,001.75
11	1,063.08		25.75		1,037.34
12	1,110.44		19.72		1,090.72
13	1,122.78		8.54		1,114.24
14	1,143.86		-9.27		1,153.13
15	1,184.28		-15.66		1,199.94
16	1,235.39		-15.55		1,250.95
17	1,202.54		-72.39		1,274.93
18	1,203.27		-102.14		1,305.41
19	1,192.05		-142.75		1,334.80
20	1,222.52		-152.16		1,374.68

Schedule 6—Illustration of Unadjusted Gross Profits Calculation With 10 Percent Increase in Account Balances in Year 2

Year	*Expense Assess-ments* +	*Mortality Assess-ments* +	*Sur-render Charges* =	*Total Revenue* −	*Recur-ring Expenses Incurred* −	*Excess Death Benefits Paid* =	*Unad-justed Gross Profits*
1	30.00	820.50	17.50	868.00	25.00	0.00	843.00
2	29.75	952.20	44.62	1,026.58	183.70	0.00	842.88
3	29.48	1,004.82	61.42	1,095.72	192.04	14.70	888.98
4	29.20	1,060.59	68.12	1,157.91	201.10	23.32	933.50
5	28.89	1,131.90	64.99	1,225.78	212.72	30.43	982.63
6	28.55	1,189.01	95.16	1,312.72	221.96	44.65	1,046.10
7	28.18	1,251.32	58.71	1,338.21	232.04	51.02	1,055.15
8	27.78	1,189.01	0.00	1,216.79	243.33	54.23	919.23
9	27.34	1,389.04	0.00	1,416.38	254.29	68.42	1,093.67
10	26.87	1,456.89	0.00	1,483.76	265.21	82.24	1,136.32
11	26.35	1,511.61	0.00	1,537.96	273.89	101.42	1,162.64
12	25.79	1,568.05	0.00	1,593.83	264.30	112.70	1,216.83
13	25.18	1,626.63	0.00	1,651.81	292.09	131.08	1,228.64
14	24.52	1,683.48	0.00	1,708.00	302.07	154.93	1,251.00
15	23.81	1,747.40	0.00	1,771.22	311.08	163.02	1,297.12
16	23.06	1,814.73	0.00	1,837.79	321.67	167.79	1,348.33
17	22.25	1,845.71	0.00	1,867.96	326.16	232.38	1,309.42
18	21.39	1,878.58	0.00	1,899.97	330.92	261.62	1,307.43
19	20.48	1,909.07	0.00	1,929.54	335.24	296.86	1,297.44
20	19.52	1,950.07	0.00	1,969.58	341.27	296.31	1,332.00
Present value				13,326.45		759.24	10,338.27

Schedule 7—Computation of Benefit Ratio at Year 2

Present value of excess death benefits paid	759.24
Divided by present value of total revenue =	13,326.45
Equals benefit ratio	5.6972%

Schedule 8—Computation of Year 2 Additional MGDB Liability

Cumulative revenue recognized		
	Year 1	868.00
	Year 2	1,026.58
	Total	1,894.58
Multiplied by benefit ratio		5.6972%
Equals year 2 additional liability[1]		($) 107.94

[1] Excludes interest and any deduction for actual claim expenses.

Schedule 9—Additional MGDB Liability Amortized Over Total Revenue

Year	*Beginning Additional MGDB Liability*	+	*Interest*	+	*Total Revenue X Benefit Factor*	−	*Excess Death Benefits Paid*	=	*Ending Additional MGDB Liability*	*Change in Additional Liability*
1	0.00		0.00		49.45[1]		0.00		49.45[2]	51.14
2	49.45		3.96		58.49[1]		0.00		111.89[3]	60.75
3	111.89		8.95		62.43		14.70		168.57	56.68
4	168.57		13.49		65.97		23.32		224.71	56.14
5	224.71		17.98		69.84		30.43		282.09	57.38
6	282.09		22.57		74.79		44.65		334.79	52.70
7	334.79		26.78		76.24		51.02		386.80	52.01
8	386.80		30.94		69.32		54.23		432.84	46.04
9	432.84		34.63		80.69		68.42		479.74	46.90
10	479.74		38.38		84.53		82.24		520.41	40.67
11	520.41		41.63		87.62		101.42		548.24	27.83
12	548.24		43.86		90.80		112.70		570.21	21.97
13	570.21		45.62		94.11		131.08		578.86	8.65
14	578.86		46.31		97.31		154.93		567.55	-11.31
15	567.55		45.40		100.91		163.02		550.84	-16.71
16	550.84		44.07		104.70		167.79		531.82	-19.02
17	531.82		42.55		106.42		232.38		448.41	-83.41
18	448.41		35.87		108.25		261.62		330.91	-117.50
19	330.91		26.47		109.93		296.86		170.46	-160.45
20	170.46		13.64		112.21		296.31		0.00	-170.46

[1] Year 1, 49.45 + year 2, 58.49 = 107.94, as noted in Schedule 8, plus interest of 3.96 = 111.89.

[2] This represents the recomputed end-of-year liability using the new expense in year 2.

[3] The difference between the actual year 1 liability (51.14 as seen in Schedule 4) and the recomputed amount of (49.45) of 1.69 will be the true-up adjustment included in the year 2 statement of operations (111.89 – 49.45 –1.69 = 60.75).

Schedule 10—Estimated Gross Profits to Use for Amortization of Deferred Acquisition Costs

Year	*Unadjusted Gross Profits*	–	*Change in Additional Liability*	=	*Estimated Gross Profits*
1	843.00		51.14		791.86
2	842.88		60.75		782.13
3	888.98		56.68		832.30
4	933.50		56.14		877.36
5	982.63		57.38		925.25
6	1,046.10		52.70		993.40
7	1,055.15		52.01		1,003.14
8	919.23		46.04		873.19
9	1,093.67		46.90		1,046.77
10	1,136.32		40.67		1,095.65
11	1,162.64		27.83		1,134.81
12	1,216.83		21.97		1,194.86
13	1,228.64		8.65		1,219.99
14	1,251.00		-11.31		1,262.31
15	1,297.12		-16.71		1,313.83
16	1,348.33		-19.02		1,367.35
17	1,309.42		-83.41		1,392.83
18	1,307.43		-117.50		1,424.93
19	1,297.44		-160.45		1,457.89
20	1,332.00		-170.46		1,502.46

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Glossary

accumulation phase. The period during an annuity contract prior to annuitization. An insurance enterprise may refer to this type of annuity as a deferred annuity.

annuitization phase. The period during which the contract holder is receiving periodic payments from an annuity, also referred to as the payout phase.

general account. All operations of an insurance enterprise that are not reported in the separate account(s).

guaranteed investment option. Component of a variable contract that guarantees a specific rate of performance.

guaranteed minimum income benefit (GMIB). Benefit normally offered with deferred variable annuities to provide a guaranteed minimum amount available for annuitization after a specified period in addition to a guaranteed minimum annuity rate. That is, the fixed periodic annuity payments would be determined using the higher of the current accumulated account value that exists at the date of annuitization or the guaranteed amount.

long-term care (LTC) benefit. Benefit offered in an annuity product with a rider providing amounts in excess of the account balance to provide for LTC benefits if contract holder meets the criteria for restrictions on activities of daily living.

minimum guaranteed death benefit (MGDB). A feature in an annuity, life insurance, or similar contract that provides that in the event of an insured's death, the beneficiary (or insurer in the case of a reinsurance contract) will receive the higher of the current account balance of the contract or another amount defined in the contract.

morbidity. The relative incidence of disability due to disease or physical impairment.

mortality. The relative incidence of death in a given time or place.

net amount at risk. The guaranteed benefit in excess of the current account balance. For guarantees in the event of death, the net amount at risk is the minimum guaranteed amount available to the contract holder upon death in excess of the contract holder's account balance at the balance sheet date. For guarantees of amounts at annuitization, the net amount at risk is defined as the present value of the minimum guaranteed annuity payments available to the contract holder determined in accordance with the terms of the contract in excess of the current account balance.

sales inducements. Sales inducements are product features that enhance the investment yield to the contract holder on the contract. The three main types of sales inducements are (1) day-one bonus, which increases the account value at inception, also called immediate bonus; (2) persistency bonus, which increases the account value at the end of a specified period; and (3) enhanced yield, which credits interest for a specified period in excess of rates currently being offered for other similar contracts.

seed money. An investment of non-contract holder funds by an insurer in a separate account when it is established, to support the initial or ongoing operations of the separate account.

separate account. A separate investment account established and maintained by an insurance enterprise under relevant state insurance law to which funds have been allocated for certain contracts of the insurance enterprise or similar accounts used for foreign originated products. Often for administrative purposes, separate account subaccounts with differing investment objectives are created within a single separate account.

separate account arrangement. An arrangement under which all or a portion of a contract holder's funds is allocated to a specific separate account maintained by the insurance enterprise. Examples include a variable life insurance contract offered through an insurance enterprise's high return separate account and a contract holder's allocation of a portion of his or her deposit in a deferred variable annuity to a growth equity fund.

traditional variable annuity. An insurance product in which all the contract holder's payments are used to purchase units of a separate account. The contract holder directs the allocation of the account value among various investment alternatives and bears the investment risk. The units may be surrendered for their current value in cash (usually less a surrender change) or applied to purchase annuity income. The insurance enterprise periodically deducts mortality and expense charges from the account.

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[The next page is 81,131.]

Section 10,880

Statement of Position 03-3 Accounting for Certain Loans or Debt Securities Acquired in a Transfer

December 12, 2003

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, as amended, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities (loans) acquired in a transfer if those differences are attributable, at least in part, to credit quality. It includes such loans acquired in purchase business combinations and applies to all nongovernmental entities, including not-for-profit organizations. This SOP does not apply to loans originated by the entity. This SOP limits the yield that may be accreted (accretable yield) to the excess of the investor's estimate of undiscounted expected principal, interest, and other cash flows (cash flows expected at acquisition to be collected) over the investor's initial investment in the loan. This SOP requires that the excess of contractual cash flows over cash flows expected to be collected (nonaccretable difference) not be recognized as an adjustment of yield, loss accrual, or valuation allowance. This SOP prohibits investors from displaying accretable yield and nonaccretable difference in the balance sheet. Subsequent increases in cash flows expected to be collected generally should be recognized prospectively through adjustment of the loan's yield over its remaining life. Decreases in cash flows expected to be collected should be recognized as impairment.

This SOP prohibits "carrying over" or creation of valuation allowances in the initial accounting of all loans acquired in a transfer that are within the scope of this SOP. The prohibition of the valuation allowance carryover applies to the purchase of an individual loan, a pool of loans, a group of loans, and loans acquired in a purchase business combination.

This SOP is effective for loans acquired in fiscal years beginning after December 15, 2004. Early adoption is encouraged. For loans acquired in fiscal years beginning on or before December 15, 2004, and within the scope of Practice Bulletin 6 [section 12,060], paragraphs .07 and .08 of this SOP, as they apply to decreases in cash flows expected to be collected, should be applied prospectively for fiscal years beginning after December 15, 2004.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least 10 of AcSEC's 15 members, and (3) a proposed final document that has been approved by at least 10 of AcSEC's 15 members. The document is cleared if at least four[*] of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, before clearance, the FASB will propose suggestions, many of which are included in the documents.

Introduction and Background

.01 A loan or group of loans (**loan**[1]) is always transferred at a price less than its contractually **required payments receivable**. The difference between the price and the contractually required payments receivable is attributable to the time value of money and may also be attributable to (*a*) changes in interest rates between the loan's origination and transfer dates, (*b*) changes in credit quality of the borrower between the loan's origination and transfer dates, (*c*) other factors, or (*d*) some combination of all three reasons.

.02 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases*, and related FASB Emerging Issues Task Force (EITF) consensuses

[*] At the time the Accounting Standards Executive Committee developed the prospectus and exposure draft for this project, at least five of the seven Financial Accounting Standards Board members were required to not object.

[1] Terms defined in the Glossary [paragraph .23] are set in **boldface type** the first time they appear.

address accounting for differences in prepayments and interest rates that are not attributable to credit quality. Some accounting issues involving differences attributable to credit quality were addressed in Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans* [section 12,060]. However, as outlined in paragraph B-3 [paragraph .21] of this Statement of Position (SOP), the accounting for loss contingencies attributable to credit quality has subsequently changed. Accordingly, the Accounting Standards Executive Committee (AcSEC) undertook this project to (*a*) identify those objectives of Practice Bulletin 6 [section 12,060] that continue to be relevant and (*b*) update and elevate the authority of related guidance. This SOP supersedes Practice Bulletin 6 [section 12,060] for transactions entered into after this SOP's initial application. For loans acquired in fiscal years prior to the effective date of this SOP and within the scope of Practice Bulletin 6 [section 12,060], this SOP amends the application of Practice Bulletin 6 [section 12,060] with regard to accounting for decreases in cash flows expected to be collected.

Scope

.03 This SOP applies to all nongovernmental entities, including not-for-profit organizations, that acquire loans (investors). It applies to a loan[2] with evidence of deterioration of credit quality since origination acquired by **completion of a transfer** for which it is **probable**, at acquisition, that the investor will be unable to collect all contractually required payments receivable,[3] except:

a. Loans that are measured at **fair value** if all changes in fair value are included in earnings or, for a not-for-profit organization, loans that are measured at fair value if all changes in fair value are included in the statement of activities and included in the performance indicator if a performance indicator is presented. Examples include those loans classified as trading securities under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*,[4] and FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise.* [5]

b. Mortgage loans classified as held for sale under paragraph 4 of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*

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[2] For an acquisition of a pool of loans, each loan first should be determined individually to meet the scope criteria of paragraph .03 of this Statement of Position (SOP). In other words, the pool may not be evaluated as a pool to determine the applicability of the scope criteria of paragraph .03.

[3] Investors should consider the significance of delays and shortfalls for a loan so the SOP is not applied when such delays and shortfalls are insignificant with regard to the contractually required payments.

[4] Certain loans that do not meet the definition of a debt security may be accounted for as trading securities. Paragraph 14 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, states:

> Interest-only strips, retained interests in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, except for instruments that are within the scope of [FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*], shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under [FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*], as amended (paragraph 362).

[5] Paragraph 6 of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, requires that a mortgage banking enterprise must classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitization process.

c. Leases as defined in FASB Statement No. 13, *Accounting for Leases*[6]

d. Loans acquired in a business combination accounted for at historical cost[7]

e. Loans held by liquidating banks[8]

f. Revolving credit agreements, such as credit cards and home equity loans, if at the acquisition date the borrower has **revolving privileges**

g. Loans that are retained interests[9]

This SOP does not apply to loans that are derivative instruments subject to the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. If a loan would otherwise be in the scope of this paragraph of this SOP and has within it an embedded derivative that is subject to FASB Statement No. 133, the host instrument (as described in FASB Statement No. 133) remains within the scope of this paragraph of this SOP if it satisfies the conditions in this paragraph.

Conclusions

Recognition, Measurement, and Display

.04 *Loss accruals or valuation allowance.* Valuation allowances should reflect only those losses incurred by the investor after acquisition—that is, the present value of all **cash flows expected at acquisition**[10] that ultimately are not to be received. For loans that are acquired by completion of a transfer, it is not appropriate, at acquisition, to establish a loss allowance. For loans acquired in a purchase business combination,[†] the initial recognition of those loans should be the present value of amounts to be received.

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[6] Only contracts that are classified by the purchaser as leases under FASB Statement No. 13, *Accounting for Leases*, meet this exclusion. The distinction between purchasing a lease and purchasing a stream of cash flows must be drawn to determine applicability of this SOP.

[7] In June 2001, the FASB issued FASB Statement No. 141, *Business Combinations*, which supersedes Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*. FASB Statement No. 141, which applies to all business combinations except to combinations of two or more not-for-profit organizations, the acquisition of a for-profit business entity by a not-for-profit organization, and combinations of two or more mutual enterprises, requires that all business combinations initiated after June 30, 2001, be accounted for using the purchase method. The provisions of FASB Statement No. 141 are applicable to business combinations accounted for by the purchase method completed after June 30, 2001. In December 2007, the FASB issued FASB Statement No. 141 (revised 2007), *Business Combinations*, which requires that all business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, be accounted for using the acquisition method, except for those between two or more not-for-profit organizations, and the acquisition of a for-profit business entity by a not-for-profit organization. [Footnote revised, May 2008, due to the issuance of FASB Statement No. 141(R).]

[8] The Emerging Issues Task Force (EITF) discussed financial reporting by liquidating banks in EITF Issue No. 88-25, *Ongoing Accounting and Reporting for a Newly Created Liquidating Bank*.

[9] The EITF discussed accounting for loans that are retained interests in EITF Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets.*

[10] See footnote 3.

[†] Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141(R) should be applied and accounted for under the acquisition method. [Footnote added, May 2008, due to the issuance of FASB Statement No. 141(R).]

.05 Upon completion of a transfer of a loan, this SOP requires that the investor (transferee) should recognize the excess of all cash flows expected at acquisition over the investor's **initial investment** in the loan as interest income on a level-yield basis over the life of the loan (**accretable yield**).[11] The amount of accretable yield should not be displayed in the balance sheet. The loan's contractually required payments receivable in excess of the amount of its cash flows expected at acquisition (**nonaccretable difference**) should not be displayed in the balance sheet or recognized as an adjustment of yield, a loss accrual, or a valuation allowance for credit risk.

.06 *Income recognition.* Recognition of income under this SOP is dependent on having a reasonable expectation about the timing and amount of cash flows expected to be collected. Subsequent to acquisition, this SOP does not prohibit placing loans on nonaccrual status, including use of the cost recovery method or cash basis method of income recognition, when appropriate. For example, if the timing of either a sale of the loan into the secondary market or a sale of loan collateral in essentially the same condition as received upon foreclosure is indeterminate, the investor likely does not have the information necessary to reasonably estimate cash flows expected to be collected to compute its yield and should cease recognizing income on the loan. However, the ability to place a loan on nonaccrual should not be used to circumvent the loss recognition guidance contained in paragraphs .07*a* and .08*a*. Alternatively, if the timing and amount of cash flows expected to be collected from those sales are reasonably estimable, the investor should use those cash flows to apply the interest method under this SOP. Consistent with paragraph 18 of FASB Statement No. 91, interest income should not be recognized to the extent that the net investment in the loan would increase to an amount greater than the payoff amount. If the loan is acquired primarily for the rewards of ownership of the underlying collateral, accrual of income is inappropriate. Such rewards of ownership would include use of the collateral in operations of the entity or improving the collateral for resale.

Changes in Cash Flows Expected to Be Collected

.07 *Loan accounted for as a debt security.* An investor should continue to estimate cash flows expected to be collected over the life of the loan. If, upon subsequent evaluation:

a. The fair value of the debt security has declined below its **amortized cost** basis, an entity should determine whether the decline is other than temporary. An entity should apply the impairment of securities guidance in paragraph 16 of FASB Statement No. 115. For example, if it is probable, based on current information and events, that the investor is unable to collect all cash flows expected at acquisition plus any additional cash flows expected to be collected arising from changes in estimate after acquisition (in accordance with paragraph .07*b* of this SOP), an other-than-temporary impairment should be considered to have occurred. The investor should consider both the timing and amount of cash flows expected to be collected in making a determination about whether it is probable that the investor is unable to collect

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[11] Footnote 3 of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, states:

A loan may be acquired at a discount because of a change in credit quality or rate or both. When a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the loan's future cash flows with the purchase price of the loan.

all cash flows expected at acquisition plus any additional cash flows arising from changes in estimates after acquisition.

b. Based on current information and events, it is probable that there is a significant increase in cash flows previously expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, the investor should recalculate the amount of accretable yield for the loan as the excess of the revised cash flows expected to be collected over the sum of (1) the initial investment less (2) cash collected less (3) other-than-temporary impairments plus (4) amount of yield accreted to date. The investor should adjust the amount of accretable yield by reclassification from nonaccretable difference. The adjustment should be accounted for as a change in estimate in conformity with Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, with the amount of periodic accretion adjusted over the remaining life of the loan.

.08 *Loan not accounted for as a debt security.*[12] An investor should continue to estimate cash flows expected to be collected over the life of the loan. If, upon subsequent evaluation:

a. Based on current information and events, it is probable that the investor is unable to collect all cash flows expected at acquisition plus additional cash flows expected to be collected arising from changes in estimate after acquisition (in accordance with paragraph .08*b*(2) of this SOP), the condition in paragraph 8(a) of FASB Statement No. 5, *Accounting for Contingencies*, is met.[13] The loan should be considered impaired for purposes of applying the measurement and other provisions of FASB Statement No. 5 or, if applicable, FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan.*[14]

b. Based on current information and events, it is probable that there is a significant increase in cash flows previously expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, the investor should:

(1) Reduce any remaining valuation allowance (or allowance for loan losses) for the loan established after its acquisition for the increase in the present value of cash flows expected to be collected, *and*

(2) Recalculate the amount of accretable yield for the loan as the excess of the revised cash flows expected to be collected over the sum of (*a*) the initial investment *less* (*b*) cash collected *less* (*c*) write-downs *plus* (*d*) amount of yield accreted to date. The investor should adjust the amount of accretable yield by reclassification from nonaccretable difference. The adjustment should be accounted for as a change in estimate in conformity with APB Opinion No. 20 with the amount of periodic accretion adjusted over the remaining life of the loan. The resulting yield

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[12] On June 19, 2003, AcSEC issued an exposure draft of a proposed SOP, *Allowance for Credit Losses*, that addresses certain issues related to the allowance for credit losses. Readers should be alert to any final pronouncement.

[13] For purposes of applying paragraph 23 of FASB Statement No. 5, *Accounting for Contingencies*, to a loan within the scope of this SOP, the phrase "all amounts due according to the contractual terms" should be read "all cash flows originally expected to be collected by the investor plus any additional cash flows expected to be collected arising from changes in estimate after acquisition."

[14] See footnote 11.

should be used as the effective interest rate in any subsequent application of paragraph .08*a* of this SOP.

Prepayments

.09 Expected prepayments should be treated consistently for cash flows expected to be collected and projections of contractual cash flows such that the nonaccretable difference is not affected. Similarly, the difference between actual prepayments and expected prepayments should not affect the nonaccretable difference.

Restructured or Refinanced Loan

.10 If an investor subsequently refinances or restructures the loan, other than through a troubled debt restructuring,[15] the refinanced or restructured loan should not be accounted for as a new loan, and this SOP, including paragraphs .07 and .08, continues to apply.

Variable Rate Loans

.11 If a loan's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate (for example, the prime rate, the London interbank offered rate, or the U.S. Treasury bill weekly average), that loan's contractually required payments receivable should be calculated based on the factor as it changes over the life of the loan. Projections of future changes in the factor should not be made for purposes of determining the effective interest rate or estimating cash flows expected to be collected. At the acquisition date, the amount of cash flows expected to be collected should be based on the index rate in effect at acquisition. Increases in cash flows expected to be collected should be accounted for according to paragraph .07*b* or .08*b*. Decreases in cash flows expected to be collected resulting directly from a change in the contractual interest rate should be recognized prospectively as a change in estimate in conformity with APB Opinion No. 20 by reducing, for purposes of applying paragraphs .07*a* and .08*a*, all cash flows expected to be collected at acquisition and the accretable yield. The investor should decrease the amount of accretable yield and the cash flows expected to be collected. Thus, for decreases in cash flows expected to be collected resulting directly from a change in the contractual interest rate, the effect will be to reduce prospectively the yield recognized rather than recognize a loss.

Multiple Loans Accounted for as a Single Asset

.12 For purposes of applying the recognition, measurement, and disclosure provisions of this SOP for loans that are not accounted for as debt securities, investors may aggregate loans acquired in the same fiscal quarter that have **common risk characteristics** and thereby use a composite interest rate and expectation of cash flows expected to be collected for the pool. To be eligible for aggregation, each loan first should be determined individually to meet the scope criteria of paragraph .03 of this SOP. After determining that certain acquired loans are within the scope as defined in paragraph .03 of this SOP, the investor may evaluate whether such loans have common risk characteristics, thus

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[15] FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, establishes the accounting for troubled debt restructurings (TDRs). For creditors, TDRs include certain modifications of terms of loans and receipt of assets from debtors in partial or full satisfaction of loans. Outstanding loans whose terms have been modified in TDRs are accounted for under the provisions of FASB Statement No. 114 or FASB Statement No. 115, as applicable.

permitting the aggregation of such loans into one or more pools. A portion of the total cost of acquired assets should be assigned to each individual asset acquired on the basis of its relative fair value at the date of acquisition. The excess of the contractually required payments receivable over the investor's initial investment (whether accretable yield or nonaccretable difference) for a specific loan or a pool of loans with one set of common risk characteristics should not be considered available to "offset" changes in cash flows expected to be collected from a different loan or an assembled pool of loans with another set of common risk characteristics.

.13 Once a pool is assembled, the integrity of the pool should be maintained. A loan should be removed from a 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 should be removed at its carrying amount. The difference between the loan's carrying amount and the fair value of the collateral or other assets received should not affect the percentage yield calculation used to recognize accretable yield on the pool of loans.

Disclosures

.14 The notes to financial statements should describe how prepayments are considered in the determination of contractual cash flows and cash flows expected to be collected.

.15 Information about loans meeting the scope criteria of paragraph .03 of this SOP should be included in the disclosures required by paragraphs 20(a) and 20(b) of FASB Statement No. 114, if the condition in paragraph 16 of FASB Statement No. 115 or paragraph 8(a) of FASB Statement No. 5 (as discussed in paragraphs .07*a* and .08*a* of this SOP) is met.

.16 In addition to disclosures required by other generally accepted accounting principles, for each balance sheet presented, an investor should disclose the following information about loans within the scope of this SOP:

a. Separately for both those loans that are accounted for as debt securities and those loans that are not accounted for as debt securities:

(1) The **outstanding balance** and related carrying amount at the beginning and end of the period.

(2) The amount of accretable yield at the beginning and end of the period, reconciled for additions, accretion, disposals of loans, and reclassifications to or from nonaccretable difference during the period.

(3) For loans acquired during the period, the contractually required payments receivable, cash flows expected to be collected, and fair value at the acquisition date.

(4) For those loans within the scope of this SOP for which the income recognition model in this SOP is not applied in accordance with paragraph .06, the carrying amount at the acquisition date for loans acquired during the period and the carrying amount of all loans at the end of the period.

b. Further, for those loans that are not accounted for as debt securities, an investor should disclose:

(1) The amount of (*a*) any expense recognized pursuant to paragraph .08*a* of this SOP and (*b*) any reductions of the allowance

recognized pursuant to paragraph .08*b*(1) of this SOP for each period for which an income statement is presented.

(2) The amount of the allowance for uncollectible accounts at the beginning and end of the period.

Amendments to Existing Literature

.17 Amendments to Practice Bulletin 6 [section 12,060] are contained in Appendix C [paragraph .22].

Effective Date and Transition

.18 This SOP is effective for loans acquired in fiscal years beginning after December 15, 2004. Previously issued annual financial statements should not be restated. Early application of this SOP is encouraged, but not required, for transfers of loans subsequent to the issuance of this SOP but prior to the effective date.

.19 For loans acquired in fiscal years beginning on or before December 15, 2004, and within the scope of Practice Bulletin 6 [section 12,060], paragraphs .07 and .08 of this SOP, as they apply to decreases in cash flows expected to be collected, should be applied prospectively for fiscal years beginning after December 15, 2004.

The provisions of this Statement of Position need not be applied to immaterial items.

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Appendix A

Implementation Guidance

A-1. This appendix illustrates how this Statement of Position (SOP) should be applied in certain generalized situations. The facts and circumstances of specific transactions need to be considered carefully in applying this SOP. The appendix does not illustrate other provisions of this SOP that might apply in circumstances other than those assumed in this illustration. This appendix does not illustrate all disclosures required for a fair presentation in conformity with generally accepted accounting principles (GAAP). The formats presented and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations. The illustration below was developed considering the acquisition of a pool of loans in which all loans individually met the scope criteria of paragraph .03 of this SOP. For ease of description in the illustrative example, references to this acquisition of a pool of loans are depicted as a single loan or debt security. In addition, for purposes of simplifying the illustration, additional interest that would accrue under the contractual terms of the loan or debt security for the debtor's failure to make timely payments of the contractual principal and interest is not illustrated. The illustration presents the write-off of the uncollectible investment in the loans receivable at the end of the loan's term. This SOP does not address when a loan should be written off.

Illustration—Base Case

A-2. Company A acquires a loan with a principal balance of $5,046,686 and accrued delinquent interest of $500,000 (see paragraph A-1) at a discount due to concerns about the debtor's credit quality that have occurred since the loan's origination. Company A pays $4,000,000 for the loan on December 31, 20X0. No fees were paid or received as part of the acquisition. The contractual interest rate is 12 percent per year. In addition to the delinquent interest, annual payments of $1,400,000 are due in each of the five remaining years to maturity. Company A determines it is probable that it will be unable to collect all amounts due according to the loan's contractual terms. Rather, Company A expects to collect only $1,165,134 per year for five years. In Company A's balance sheet, the loan will initially be displayed at its net carrying amount (for example, $4,000,000 at December 31, 20X0).

	A	*B*	*C*	*D*	*E*
Year Ended December 31	*Beginning Carrying Amount*	*Cash Flows Expected to Be Collected*	*Interest Income*[1]	*Reduction of Carrying Amount B – C*	*Ending Carrying Amount A – D*
20X1	$4,000,000	$1,165,134	$ 560,000	$ 605,134	$3,394,866
20X2	3,394,866	1,165,134	475,281	689,853	2,705,013
20X3	2,705,013	1,165,134	378,702	786,432	1,918,581
20X4	1,918,581	1,165,134	268,601	896,533	1,022,048
20X5	1,022,048	1,165,134	143,086	1,022,048	—
		$5,825,670	$1,825,670	$4,000,000	

Initial Calculation of Nonaccretable Difference

Contractually required payments receivable (includes delinquent interest)	$7,500,000
Less: Cash flows expected to be collected	(5,825,670)
Nonaccretable difference	$1,674,330

Initial Calculation of Accretable Yield

Cash flows expected to be collected	$5,825,670
Less: Initial investment	(4,000,000)
Accretable yield	$1,825,670

As noted in paragraph A-1, the summary of activity presented in the illustrations in paragraphs A-3, A-5, A-7(*a*), A-7(*b*), A-9(*a*)(2), A-9(*b*)(2), A-11(*a*)(2), and A-11(*b*)(2) omits additional interest that would accrue on unpaid amounts under the contractual terms of the loan or debt security. Given the assumptions in the illustrations, any additional accrued interest would increase both the contractually required payments receivable and nonaccretable difference.

[1] The effective interest rate in this example is the discount rate that, at acquisition, equates all cash flows expected to be collected with the purchase price of the loan. This SOP does not address whether the investor should or should not accrue income. However, for purposes of this illustration, it is assumed that the investor can reasonably estimate cash flows expected to be collected. The yield recognized is 14.00 percent for years 20X1 through 20X5.

Illustration—Scenario A
Actual Cash Flows Equal Cash Flows Expected for Years 20X1–X5

A-3. If company A receives all the cash that it expected to be collected, the following is a summary of the effects of that activity.

	A *Contractually Required Payments Receivable*	*B* *Cash Expected to Be Collected*	*C* *Nonaccretable Difference A – B*	*D* *Accretable Yield*	*E* *Loans Receivable B – D*
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Balance	5,169,732	3,495,402	1,674,330	790,389	2,705,013
20X3 collections	(1,165,134)	(1,165,134)		(378,702)	(786,432)
Balance	4,004,598	2,330,268	1,674,330	411,687	1,918,581
20X4 collections	(1,165,134)	(1,165,134)		(268,601)	(896,533)
Balance	2,839,464	1,165,134	1,674,330	143,086	1,022,048
20X5 collections	(1,165,134)	(1,165,134)		(143,086)	(1,022,048)
Balance	1,674,330	$ —	1,674,330	$ —	$ —
Disposition[2]	(1,674,330)		(1,674,330)		
	$ —		$ —		

	Loans Receivable	*Allowance*	*Net Loans Receivable*	*Bad Debt Expense*	*Cash*	*Interest Income*
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Balance	2,705,013		2,705,013			
20X3 collections	(786,432)		(786,432)		1,165,134	378,702
Balance	1,918,581		1,918,581			
20X4 collections	(896,533)		(896,533)		1,165,134	268,601
Balance	1,022,048		1,022,048			
20X5 collections	(1,022,048)		(1,022,048)		1,165,134	143,086
Balance	$ —		$ —		$ 1,825,670	$1,825,670

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[2] For illustrative purposes, the removal of the contractual amounts and nonaccretable difference is presented at the end of the period. In this illustration, Company A wrote off the uncollectible portion of the contractually required payments receivable at the maturity of the loan. This SOP does not address when a loan should be written off.

Illustration—Scenario B
Base Cash With Increase in Cash Flows Expected for Year 20X3

A-4. *Change in Expectations.* Assume that, at December 31, 20X2, Company A determines it is probable that cash flows expected to be collected will be $250,000 more in 20X3 than previously expected but does not change its expectations of cash flows in years 20X4 and 20X5. Following are the resulting calculations.

Year Ended December 31	*Beginning Carrying Amount*	*Cash Flows Expected to Be Collected*	*Interest Income*[3]	*Reduction of Carrying Amount*	*Ending Carrying Amount*
20X1	$4,000,000	$1,165,134	$ 560,000	$ 605,134	$3,394,866
20X2	3,394,866	1,165,134	475,281	689,853	2,705,013
Totals for years 20X1–X2		$2,330,268	$1,035,281	$1,294,987	
20X3	$2,705,013	$1,415,134	$ 512,878	$ 902,256	$1,802,757
20X4	1,802,757	1,165,134	341,808	823,326	979,431
20X5	979,431	1,165,134	185,703	979,431	—
Totals for years 20X3–X5		$3,745,402	$1,040,389	$2,705,013	
Totals for years 20X1–X5		$6,075,670	$2,075,670	$4,000,000	

Recalculation of Accretable Yield

Remaining cash flows expected to be collected, December 31, 20X2		$3,745,402
Less the sum of:		
Initial investment	$4,000,000	
Less: Cash collected to date	(2,330,268)	
Less: Write-downs and allowance	—	
Plus: Yield accreted to date	1,035,281	
		2,705,013
Remaining accretable yield as recalculated		1,040,389
Less: Unadjusted balance at December 31, 20X2		(790,389)
Adjustment needed		$ 250,000

[3] The yield recognized is 14.00 percent for years 20X1 and 20X2 and 18.9603 percent for years 20X3 through 20X5.

A-5. If Company A receives all the cash flows that it expected to be collected (including the increase of $250,000 in 20X3), the following is a summary of the effects of that activity.

	A Required Payments Receivable	*B* Contractually Cash Expected to Be Collected	*C* Nonaccretable Difference A – B	*D* Accretable Yield	*E* Loans Receivable B – D
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Balance	5,169,732	3,495,402	1,674,330	790,389	2,705,013
Increase in cash flows expected		250,000[4]	(250,000)	250,000	
20X3 collections	(1,415,134)	(1,415,134)		(512,878)	(902,256)
Balance	3,754,598	2,330,268	1,424,330	527,511	1,802,757
20X4 collections	(1,165,134)	(1,165,134)		(341,808)	(823,326)
Balance	2,589,464	1,165,134	1,424,330	185,703	979,431
20X5 collections	(1,165,134)	(1,165,134)		(185,703)	(979,431)
Balance	1,424,330	$ —	1,424,330	$ —	$ —
Disposition	(1,424,330)		(1,424,330)		
	$ —		$ —		

	Loans Receivable	Allowance	Net Loans Receivable	Bad Debt Expense	Cash	Interest Income[5]
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Balance	2,705,013		2,705,013			
20X3 collections	(902,256)		(902,256)		1,415,134	512,878
Balance	1,802,757		1,802,757			
20X4 collections	(823,326)		(823,326)		1,165,134	341,808
Balance	979,431		979,431			
20X5 collections	(979,431)		(979,431)		1,165,134	185,703
Balance	$ —		$ —		$ 2,075,670	$2,075,670

[4] The $250,000 increase in cash flows expected to be collected results in a reclassification of nonaccretable difference to accretable yield.

[5] The increase in the accretable yield is recognized as interest income on a prospective basis resulting in an increase in yield for years 20X3 through 20X5 from 14.00 percent to 18.9603 percent.

Illustration—Scenario C
Base Case With Decrease in Cash Flows Expected for Years 20X3–X5

A-6. ***Change in Expectations.*** Assume instead that, at December 31, 20X2, Company A determines it is probable that cash flows expected to be collected will be $100,000 less in each of the remaining three years than expected at acquisition. Using the effective interest rate of 14 percent, the present value of the remaining cash flows expected to be collected is calculated as $2,472,850. Following are the resulting calculations.

Year Ended December 31	*Beginning Carrying Amount*	*Cash Flows Expected to Be Collected*	*Interest Income*[6]	*Reduction of Carrying Amount*	*Ending Carrying Amount*
20X1	$4,000,000	$1,165,134	$ 560,000	$ 605,134	$3,394,866
20X2	3,394,866	1,165,134	475,281	922,016[7]	2,472,850
Totals for years 20X1–X2		$2,330,268	$1,035,281	$1,527,150	
20X3	$2,472,850	$1,065,134	$ 346,199	$ 718,935	$1,753,915
20X4	1,753,915	1,065,134	245,548	819,586	934,329
20X5	934,329	1,065,134	130,805	934,329	—
Totals for years 20X3–X5		$3,195,402	$ 722,552	$2,472,850	
Totals for years 20X1–X5		$5,525,670	$1,757,833	$4,000,000	

<u>*Measurement of Impairment*</u>

Recorded amount prior to change in estimate	$ 2,705,013
Less: Present value of cash flows expected to be collected	(2,472,850)
Measured impairment at December 31, 20X2	$ 232,163

<u>*Recalculation of Accretable Yield*</u>

Remaining cash flows expected to be collected, December 31, 20X2		$ 3,195,402
Less the sum of:		
Initial investment	$ 4,000,000	
Less: Cash collected to date	(2,330,268)	
Less: Write-downs and allowance	(232,163)	
Plus: Yield accreted to date	1,035,281	
		2,472,850
Remaining accretable yield as recalculated		722,552
Less: Unadjusted balance at December 31, 20X2		(790,389)
Adjustment needed to accretable yield		$ (67,837)

<u>*Proof:*</u>

Total decrease in cash flows expected to be collected	$ 300,000
Present value of total decrease (current period loss)	(232,163)
Future accretable yield no longer expected	$ 67,837

[6] The yield recognized is 14.00 percent for years 20X1 through 20X5.

[7] The reduction of carrying amount includes an allowance for loan losses of $232,163 for a loan not accounted for as a debt security and a write-down of $232,163 for a loan accounted for as a debt security.

Accounting for as a Debt Security

A-7(*a*). If Company A receives the cash flows as expected in years 20X1 and 20X2 but at the end of 20X2 determines cash flows will be $100,000 less in each of years 20X3 through 20X5, the following is a summary of the effects of that activity.

	A *Contractually Required Payments Receivable*	*B* *Cash Expected to Be Collected*	*C* *Nonaccretable Difference A – B*	*D* *Accretable Yield*	*E* *Debt Security B – D*
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Impairment		(300,000)[8]	300,000	(67,837)	(232,163)
Balance	5,169,732	3,195,402	1,974,330	722,552	2,472,850
20X3 collections	(1,065,134)	(1,065,134)		(346,199)	(718,935)
Balance	4,104,598	2,130,268	1,974,330	376,353	1,753,915
20X4 collections	(1,065,134)	(1,065,134)		(245,548)	(819,586)
Balance	3,039,464	1,065,134	1,974,330	130,805	934,329
20X5 collections	(1,065,134)	(1,065,134)		(130,805)	(934,329)
Balance	1,974,330	$ —	1,974,330	$ —	$ —
Disposition	(1,974,330)		(1,974,330)		
	$ —		$ —		

	Debt Security	*Allowance*	*Debt Security*	*Loss*	*Cash*	*Interest Income*[9]
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Impairment	(232,163)		(232,163)	$232,163		
Balance	2,472,850		2,472,850			
20X3 collections	(718,935)		(718,935)		1,065,134	346,199
Balance	1,753,915		1,753,915			
20X4 collections	(819,586)		(819,586)		1,065,134	245,548
Balance	934,329		934,329			
20X5 collections	(934,329)		(934,329)		1,065,134	130,805
Balance	$ —		$ —	$232,163	$ 1,525,670	$1,757,833

[8] The $300,000 decrease in cash flows expected to be collected represents $67,837 of interest income (accretable yield) foregone that had been expected at acquisition to be earned and $232,163 of carrying amount that will not be recovered. The $300,000 decrease in cash flows expected to be collected results in a loss of $232,163 (recorded as a write-off) and foregone interest income in future years of $67,837.

[9] The accretable yield recognized as interest income for years 20X3 through 20X5 remains at 14.00 percent.

Accounted for as a Loan

A-7(*b*). If Company A receives the cash flows as expected in years 20X1 and 20X2 but at the end of 20X2 determines cash flows will be $100,000 less in each of years 20X3 through 20X5, the following is a summary of the effects of that activity.

	A Contractually Required Payments Receivable	*B* Cash Expected to Be Collected	*C* Nonaccretable Difference A – B	*D* Accretable Yield	*E* Loans Receivable B – D
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Impairment		(300,000)[10]	300,000	(67,837)	(232,163)
Balance	5,169,732	3,195,402	1,974,330	722,552	2,472,850[11]
20X3 collections	(1,065,134)	(1,065,134)		(346,199)	(718,935)
Balance	4,104,598	2,130,268	1,974,330	376,353	1,753,915
20X4 collections	(1,065,134)	(1,065,134)		(245,548)	(819,586)
Balance	3,039,464	1,065,134	1,974,330	130,805	934,329
20X5 collections	(1,065,134)	(1,065,134)		(130,805)	(934,329)
Balance	1,974,330	$ —	1,974,330	$ —	$ —
Disposition	(1,974,330)		(1,974,330)		
	$ —		$ —		

	Loans Receivable	*Allowance*	*Net Loans Receivable*	*Bad Debt Expense*	*Cash*	*Interest Income*[12]
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Impairment		$(232,163)	(232,163)	$232,163		
Balance	2,705,013	(232,163)	2,472,850			
20X3 collections	(718,935)		(718,935)		1,065,134	346,199
Balance	1,986,078	(232,163)	1,753,915			
20X4 collections	(819,586)		(819,586)		1,065,134	245,548
Balance	1,166,492	(232,163)	934,329			
20X5 collections	(934,329)		(934,329)		1,065,134	130,805
Balance	232,163	(232,163)	$ —	$232,163	$ 1,525,670	$1,757,833
Disposition	(232,163)	232,163				
	$ —	$ —				

[10] The $300,000 decrease in cash flows expected to be collected represents $67,837 of interest income (accretable yield) foregone that had been expected at acquisition to be earned and $232,163 of carrying amount that will not be recovered. The $300,000 decrease in cash flows expected to be collected results in a loss of $232,163 (recorded as an allowance for loan loss) and foregone interest income in future years of $67,837.

[11] For a loan (not accounted for as a debt security) with an allowance, this amount equals the net loans receivable.

[12] The accretable yield recognized as interest income for years 20X3 through 20X5 remains at 14.00 percent.

Illustration—Scenario D
Cash Flows Expected for Years 20X4–X5 Are Greater Than the Revised Cash Flows Expected for Years 20X4–X5 But Cumulative Expected Cash Flows Are Less Than Cash Flows Originally Expected at Acquisition

A-8. ***Change in Cash Collections and Expectations.*** At December 31, 20X2, Company A determined it was probable that cash flows expected to be collected will be $100,000 less in each of the remaining three years (20X3–X5) than expected at acquisition. Actual cash flows for 20X3 collected were the revised decrease in expected cash flows to be collected. At January 1, 20X4, Company A determines it is probable that cash flows will be $50,000 more in each of 20X4 and 20X5.

Loan Accounted for as a Debt Security

A-9(*a*)(1). If the loan is accounted for as a debt security, the entire subsequent increase in cash flows expected to be collected is recorded as a yield adjustment on a prospective basis because the earlier write-down may not be reversed. Following is a summary of activity.

Year Ended December 31	*Beginning Carrying Amount*	*Cash Flows Expected to Be Collected*	*Interest Income*[13]	*Reduction of Carrying Amount*	*Ending Carrying Amount*
20X1	$4,000,000	$1,165,134	$ 560,000	$ 605,134	$3,394,866
20X2	3,394,866	1,165,134	475,281	922,016[14]	2,472,850
20X3	2,472,850	1,065,134	346,199	718,935	1,753,915
Totals for years 20X1–X3		$3,395,402	$1,381,480	$2,246,085	
20X4	$1,753,915	$1,115,134	$ 309,219	$ 805,915	$ 948,000
20X5	948,000	1,115,134	167,134	948,000	—
Totals for years 20X4–X5		$2,230,268	$ 476,353	$1,753,915	
Totals for years 20X1–X5		$5,625,670	$1,857,833	$4,000,000	

[13] The yield recognized is 14.00 percent for years 20X1 through 20X3 and 17.6302 percent for years 20X4 and 20X5.

[14] The reduction of carrying amount includes a write-down of $232,163.

A-9(*a*)(2). If company A receives the cash flows as indicated above, the following is a summary of the effects of that activity.

	A Contractually Required Payments Receivable	*B* Cash Expected to Be Collected	*C* Nonaccretable Difference A – B	*D* Accretable Yield	*E* Debt Security B – D
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Impairment		(300,000)	300,000	(67,837)	(232,163)
Balance	5,169,732	3,195,402	1,974,330	722,552	2,472,850
20X3 collections	(1,065,134)	(1,065,134)		(346,199)	(718,935)
Balance	4,104,598	2,130,268	1,974,330	376,353	1,753,915
Increase in cash flows expected		100,000[15]	(100,000)	100,000	
20X4 collections	(1,115,134)	(1,115,134)		(309,219)	(805,915)
Balance	2,989,464	1,115,134	1,874,330	167,134	948,000
20X5 collections	(1,115,134)	(1,115,134)		(167,134)	(948,000)
Balance	1,874,330	$ —	1,874,330	$ —	$ —
Disposition	(1,874,330)		(1,874,330)		
	$ —		$ —		

	Debt Security	*Allowance*	*Debt Security*	*Loss*	*Cash*	*Interest Income*[16]
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Impairment	(232,163)		(232,163)	$232,163		
Balance	2,472,850		2,472,850			
20X3 collections	(718,935)		(718,935)		1,065,134	346,199
Balance	1,753,915		1,753,915			
20X4 collections	(805,915)		(805,915)		1,115,134	309,219
Balance	948,000		948,000			
20X5 collections	(948,000)		(948,000)		1,115,134	167,134
Balance	$ —		$ —	$232,163	$ 1,625,670	$1,857,833

[15] The $100,000 increase in cash flows expected to be collected results in a reclassification of nonaccretable difference to accretable yield.

[16] Because the loan is accounted for as a debt security, the reduction in cash flows evaluated at the end of 20X2 resulted in an impairment that may not be reversed. The increase in the accretable yield is recognized as interest income on a prospective basis resulting in an increase in yield for years 20X4 and 20X5 from 14.00 percent to 17.6302 percent.

Accounted for as a Loan

A-9(*b*)(1). Alternatively, if the loan is not accounted for as a debt security, the increase in cash flows expected to be collected is first used to reverse the amount of any related allowance for loan losses before the yield is adjusted. Following are the resulting calculations.

Year Ended December 31	*Beginning Carrying Amount*	*Cash Flows Expected to Be Collected*	*Interest Income*[17]	*Reduction of Carrying Amount*	*Ending Carrying Amount*
20X1	$4,000,000	$1,165,134	$ 560,000	$ 605,134	$3,394,866
20X2	3,394,866	1,165,134	475,281	922,016[18]	2,472,850
20X3	2,472,850	1,065,134	346,199	718,935	1,753,915
Totals for years 20X1–X3		$3,395,402	$1,381,480	$2,246,085	
20X4	$1,753,915	$1,115,134	$ 257,075	$ 775,726[19]	$ 978,189
20X5	978,189	1,115,134	136,945	978,189	—
Totals for years 20X4–X5		$2,230,268	$ 394,020	$1,753,915	
Totals for years 20X1–X5		$5,625,670	$1,775,500	$4,000,000	

Reversal of Valuation Allowance		
Recorded amount, January 1, 20X4		$ 1,986,078
Allowance for loan losses		(232,163)
Carrying amount, January 1, 20X4		$ 1,753,915
Less: Present value of cash flows expected to be collected		(1,836,248)
Reversal of valuation allowance		$ (82,333)
Rollforward of Accretable Yield		
Balance, at acquisition		$ 1,825,670
20X1 accretion	(560,000)	
20X2 accretion	(475,281)	
20X3 accretion	(346,199)	
		(1,381,480)
20X2 reclassification to nonaccretable difference		(67,837)
Balance, at December 31, 20X3		$ 376,353
Recalculation of Accretable Yield		
Remaining cash flows expected to be collected, January 1, 20X4		$ 2,230,268
Less the sum of:		
Initial investment	$ 4,000,000	
Less: Cash collected to date	(3,395,402)	
Less: Write-downs and allowance	(149,830)	
Plus: Yield accreted to date	1,381,480	
		1,836,248
Remaining accretable yield as recalculated		394,020
Less: Unadjusted balance		(376,353)
Adjustment needed to accretable yield		$ 17,667
Proof:		
Total increase in cash flows expected to be collected		$ 100,000
Present value of total increase (current period reversal of allowance)		(82,333)
Additional income expected		$ 17,667

[17] The yield recognized is 14.00 percent for years 20X1 through 20X5.

[18] The reduction of carrying amount includes an allowance for loan losses of $232,163.

[19] The reduction of carrying amount includes a reversal of valuation allowance of $82,333.

A-9(*b*)(2). If Company A receives the cash flows as indicated above, the following is a summary of the effects of that activity.

	A *Contractually Required Payments Receivable*	*B* *Cash Expected to Be Collected*	*C* *Nonaccretable Difference A – B*	*D* *Accretable Yield*	*E* *Loans Receivable B – D*
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Impairment		(300,000)	300,000	(67,837)	(232,163)
Balance	5,169,732	3,195,402	1,974,330	722,552	2,472,850
20X3 collections	(1,065,134)	(1,065,134)		(346,199)	(718,935)
Balance	4,104,598	2,130,268	1,974,330	376,353	1,753,915
Increase in cash flows expected		100,000[20]	(100,000)	100,000	
Reversal of prior allowance				(82,333)	82,333
20X4 collections	(1,115,134)	(1,115,134)		(257,075)	(858,059)
Balance	2,989,464	1,115,134	1,874,330	136,945	978,189[21]
20X5 collections	(1,115,134)	(1,115,134)	—	(136,945)	(978,189)
Balance	1,874,330	$ —	1,874,330	$ —	$ —
Disposition	(1,874,330)		(1,874,330)		
	$ —		$ —		

	Loans Receivable	*Allowance*	*Net Loans Receivable*	*Bad Debt Expense*	*Cash*	*Interest Income*[22]
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Impairment		$(232,163)	(232,163)	$232,163		
Balance	2,705,013	(232,163)	2,472,850			
20X3 collections	(718,935)		(718,935)		1,065,134	346,199
Balance	1,986,078	(232,163)	1,753,915			
Reversal of prior allowance		82,333	82,333	(82,333)		
20X4 collections	(858,059)		(858,059)		1,115,134	257,075
Balance	1,128,019	(149,830)	978,189			
20X5 collections	(978,189)		(978,189)		1,115,134	136,945
Balance	149,830	(149,830)	$ —	$149,830	$ 1,625,670	$1,775,500
Disposition	(149,830)	149,830				
	$ —	$ —				

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[20] The $100,000 increase in cash flows expected to be collected results in a reclassification of nonaccretable difference to accretable yield.

[21] For a loan (not accounted for as a debt security) with an allowance, this amount equals the net loans receivable.

[22] The accretable yield recognized as interest income for years 20X4 and 20X5 remains at 14.00 percent.

Illustration—Scenario E
Cash Flows Expected for Years 20X4–X5 Are Greater Than the Revised Cash Flows Expected for Years 20X4–X5 and Cumulative Expected Cash Flows Are Greater Than Cash Flows Originally Expected at Acquisition

A-10. ***Change in Expectations.*** At December 31, 20X2, Company A determined it was probable that cash flows expected to be collected will be $100,000 less in each of the remaining three years (20X3–X5) than expected at acquisition. Actual cash flows for 20X3 collected were the revised decrease in expected cash flows to be collected. At January 1, 20X4, Company A determines it is probable that, in both 20X4 and 20X5, Company A will collect $250,000 more in cash flows than previously expected.

Accounted for as a Debt Security

A-11(*a*)(1). If the loan is accounted for a debt security, the entire subsequent increase in cash flows expected to be collected is recorded as a yield adjustment on a prospective basis because the earlier write-down may not be reversed. Following is a summary of the activity.

Year Ended December 31	*Beginning Carrying Amount*	*Cash Flows Expected to Be Collected*	*Interest Income*[23]	*Reduction of Carrying Amount*	*Ending Carrying Amount*
20X1	$4,000,000	$1,165,134	$ 560,000	$ 605,134	$3,394,866
20X2	3,394,866	1,165,134	475,281	922,016[24]	2,472,850
20X3	2,472,850	1,065,134	346,199	718,935	1,753,915
Totals for years 20X1–X3		$3,395,402	$1,381,480	$2,246,085	
20X4	$1,753,915	$1,315,134	$ 558,653	$ 756,481	$ 997,434
20X5	997,434	1,315,134	317,700	997,434	—
Totals for years 20X4–X5		$2,630,268	$ 876,353	$1,753,915	
Totals for years 20X1–X5		$6,025,670	$2,257,833	$4,000,000	

[23] The yield recognized is 14.00 percent for years 20X1 through 20X3 and 31.8518 percent for years 20X4 and 20X5. Interest income exceeds the difference in cash flows expected to be collected and the acquisition price by $232,163, which is the amount of the impairment recognized in 20X2 that may not be reversed.

[24] The reduction of carrying amount includes a write-down of $232,163.

A-11(*a*)(2). If Company A receives the cash flows as indicated above, the following is a summary of the effects of that activity.

	A Contractually Required Payments Receivable	*B* Cash Expected to Be Collected	*C* Nonaccretable Difference A – B	*D* Accretable Yield	*E* Debt Security B – D
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Impairment		(300,000)	300,000	(67,837)	(232,163)
Balance	5,169,732	3,195,402	1,974,330	722,552	2,472,850
20X3 collections	(1,065,134)	(1,065,134)		(346,199)	(718,935)
Balance	4,104,598	2,130,268	1,974,330	376,353	1,753,915
Increase in cash flows expected		500,000[25]	(500,000)	500,000	
20X4 collections	(1,315,134)	(1,315,134)		(558,653)	(756,481)
Balance	2,789,464	1,315,134	1,474,330	317,700	997,434
20X5 collections	(1,315,134)	(1,315,134)		(317,700)	(997,434)
Balance	1,474,330	$ —	1,474,330	$ —	$ —
Disposition	(1,474,330)		(1,474,330)		
	$ —		$ —		

	Debt Security	*Allowance*	*Debt Security*	*Loss*	*Cash*	*Interest Income*[26]
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Impairment	(232,163)		(232,163)	$232,163		
Balance	2,472,850		2,472,850			
20X3 collections	(718,935)		(718,935)		1,065,134	346,199
Balance	1,753,915		1,753,915			
20X4 collections	(756,481)		(756,481)		1,315,134	558,653
Balance	997,434		997,434			
20X5 collections	(997,434)		(997,434)		1,315,134	317,700
	$ —		$ —	$232,163	$ 2,025,670	$2,257,833

[25] The $500,000 increase in cash flows expected to be collected results in a reclassification of nonaccretable difference to accretable yield.

[26] Because the loan is accounted for as a debt security, the reduction in cash flows expected to be collected at the end of 20X2 resulted in an impairment that may not be reversed. The increase in the accretable yield is recognized as interest income on a prospective basis resulting in an increase in yield for years 20X4 and 20X5 from 14.00 percent to 31.8518 percent.

Accounted for as a Loan

A-11(*b*)(1). If the loan is *not* accounted for as a debt security, then following are resulting calculations. The present value of cash flows expected to be collected exceeds the recorded amount. Accordingly, the allowance for loan losses will be reversed in its entirety and the amount of yield to be accreted must be adjusted.

Year Ended December 31	*Beginning Carrying Amount*	*Cash Flows Expected to Be Collected*	*Interest Income*[27]	*Reduction of Carrying Amount*	*Ending Carrying Amount*
20X1	$4,000,000	$1,165,134	$ 560,000	$ 605,134	$3,394,866
20X2	3,394,866	1,165,134	475,281	922,016[28]	2,472,850
20X3	2,472,850	1,065,134	346,199	718,935	1,753,915
Totals for years 20X1–X3		$3,395,402	$1,381,480	$2,246,085	
20X4	$1,753,915	$1,315,134	$ 416,296	$ 666,675[29]	$1,087,240
20X5	1,087,240	1,315,134	227,894	1,087,240	—
Totals for years 20X4–X5		$2,630,268	$ 644,190	$1,753,195	
Totals for years 20X1–X5		$6,025,670	$2,025,670	$4,000,000	

Rollforward of Accretable Yield

Balance, at acquisition		$ 1,825,670
20X1 accretion	(560,000)	
20X2 accretion	(475,281)	
20X2 impairment	(67,837)	
20X3 accretion	(346,199)	
		1,449,317
Balance, at December 31, 20X3		$ 376,353

Recalculation of Accretable Yield

Remaining cash flows expected to be collected at January 1, 20X4		$ 2,630,268
Less the sum of:		
Initial investment	$ 4,000,000	
Less: Cash collected to date	(3,395,402)	
Plus: Yield accreted to date	1,381,480	
		1,986,078
Remaining accretable yield as recalculated		644,190
Less: Unadjusted balance		(376,353)
Adjustment needed to accretable yield		$ 267,837

Proof:

Total increase in cash flows expected to be collected	$ 500,000
Current period reversal of valuation allowance	(232,163)
Additional income expected	$ 267,837

[27] The yield recognized is 14.00 percent for years 20X1 through 20X3 and 20.9607 percent for years 20X4 and 20X5.

[28] The reduction of carrying amount includes an allowance for loan losses of $232,163.

[29] The reduction of carrying amount includes a reversal of valuation allowance of $232,163.

A-11(*b*)(2). If Company A receives the cash flows as indicated above, the following is a summary of the effects of that activity.

	A *Contractually Required Payments Receivable*	*B* *Cash Expected to Be Collected*	*C* *Nonaccretable Difference A – B*	*D* *Accretable Yield*	*E* *Loans Receivable B – D*
Acquisition	$ 7,500,000	$ 5,825,670	$ 1,674,330	$1,825,670	$ 4,000,000
20X1 collections	(1,165,134)	(1,165,134)		(560,000)	(605,134)
Balance	6,334,866	4,660,536	1,674,330	1,265,670	3,394,866
20X2 collections	(1,165,134)	(1,165,134)		(475,281)	(689,853)
Impairment		(300,000)	300,000	(67,837)	(232,163)
Balance	5,169,732	3,195,402	1,974,330	722,552	2,472,850
20X3 collections	(1,065,134)	(1,065,134)		(346,199)	(718,935)
Balance	4,104,598	2,130,268	1,974,330	376,353	1,753,915
Increase in cash flows expected		500,000[30]	(500,000)	500,000	
Reversal of prior allowance				(232,163)	232,163
20X4 collections	(1,315,134)	(1,315,134)		(416,296)	(898,838)
Balance	2,789,464	1,315,134	1,474,330	227,894	1,087,240[31]
20X5 collections	(1,315,134)	(1,315,134)		(227,894)	(1,087,240)
Balance	1,474,330	$ —	1,474,330	$ —	$ —
Disposition	(1,474,330)		(1,474,330)		
	$ —		$ —		

[30] The $500,000 increase in cash flows expected to be collected results in the reversal of the entire allowance previously established and a reclassification of nonaccretable difference to accretable yield.

[31] For a loan (not accounted for as a debt security) with an allowance, this amount equals the net loans receivable.

	Loans Receivable	*Allowance*	*Net Loans Receivable*	*Bad Debt Expense*	*Cash*	*Interest Income*[32]
Acquisition	$ 4,000,000		$ 4,000,000		$(4,000,000)	
20X1 collections	(605,134)		(605,134)		1,165,134	$ 560,000
Balance	3,394,866		3,394,866			
20X2 collections	(689,853)		(689,853)		1,165,134	475,281
Impairment		$(232,163)	(232,163)	$232,163		
Balance	2,705,013	(232,163)	2,472,850			
20X3 collections	(718,935)		(718,935)		1,065,134	346,199
Balance	1,986,078	(232,163)	1,753,915			
Increase in cash flows expected						
Reversal of prior allowance		232,163	232,163	(232,163)		
20X4 collections	(898,838)		(898,838)		1,315,134	416,296
Balance	1,087,240	$ —	1,087,240	$ —		
20X5 collections	(1,087,240)		(1,087,240)		1,315,134	227,894
Balance	$ —		$ —		$ 2,025,670	$2,025,670

[32] Because the loan is not accounted for as a debt security, the reduction in cash flows expected to be collected at the end of 20X2 resulted in an establishment of an allowance. The example assumes no write-downs of the loan occurred and no subsequent entries were made to the allowance. The entire allowance previously established is reversed and the accretable yield is recognized as interest income on a prospective basis resulting in an increase in yield for years 20X4 and 20X5 from 14.00 percent to 20.9607 percent.

Illustration—Disclosures

A-12. Following is an illustrative note disclosure of Company A's accounting policy.

Acquired Loans (Including Debt Securities)

Company A's valuation allowances for all acquired loans subject to SOP 03-3 reflect only those losses incurred after acquisition—that is, the present value of cash flows expected at acquisition that are not expected to be collected. Valuation allowances are established only subsequent to acquisition of the loans.

Company A acquires loans (including debt securities) individually and in groups or portfolios. For certain acquired loans that have experienced deterioration of credit quality between origination and the Company's acquisition of the loans, the amount paid for a loan reflects Company A's determination that it is probable Company A will be unable to collect all amounts due according to the loan's contractual terms. At acquisition, Company A reviews each loan to determine whether there is evidence of deterioration of credit quality since origination and if it is probable that Company A will be unable to collect all amounts due according to the loan's contractual terms. If both conditions exist, Company A determines whether each such loan is to be accounted for individually or whether such loans will be assembled into pools of loans based on common risk characteristics (credit score, loan type, and date of origination). Company A considers expected prepayments, and estimates the amount and timing of undiscounted expected principal, interest, and other cash flows (expected at acquisition) for each loan and subsequently aggregated pool of loans. Company A determines the excess of the loan's or pool's scheduled contractual principal and contractual interest payments over all cash flows expected at acquisition as an amount that should not be accreted (nonaccretable difference). The remaining amount—representing the excess of the loan's cash flows expected to be collected over the amount paid—is accreted into interest income over the remaining life of the loan or pool (*accretable yield*).

Over the life of the loan or pool, Company A continues to estimate cash flows expected to be collected. Company A evaluates at the balance sheet date whether the present value of its loans determined using the effective interest rates has decreased and if so, recognizes a loss. For loans or pools that are not accounted for as debt securities, the present value of any subsequent increase in the loan's or pool's actual cash flows or cash flows expected to be collected is used first to reverse any existing valuation allowance for that loan or pool. For any remaining increases in cash flows expected to be collected, or for loans or pools accounted for as debt securities, Company A adjusts the amount of accretable yield recognized on a prospective basis over the loan's or pool's remaining life.

A-13. Following is illustrative wording that includes the disclosures required by this SOP.

For loans accounted for as debt securities (amounts in thousands):

Company A has acquired loans accounted for as debt securities, for which there was, prior to their being acquired in a transfer, evidence of deterioration of credit quality since origination. It was probable, at acquisition, that all contractually required payments for those loans would not be collected.

The carrying amount of those loans accounted for as debt securities is included in the balance sheet amounts at December 31. The outstanding balance (representing amounts owed to the company at the balance sheet date) and carrying amounts of those loans classified as held-to-maturity securities and available-for-sale securities at December 31 are as follows:

	20X5	*20X4*	*20X3*
Held-to-maturity:			
Outstanding balance	$41,362	$42,362	$39,093
Carrying amount, net	21,921	23,299	21,892
Available-for-sale securities:			
Outstanding balance	$43,726	$43,162	$42,063
Carrying amount, net	23,612	23,523	22,503

	Held-to-Maturity Securities	*Available-for-Sale Securities*
Accretable Yield:		
Balance at December 31, 20X3	$ 9,562	$ 9,392
Additions	948	829
Accretion	(1,869)	(1,966)
Disposals	—	—
Balance at December 31, 20X4	8,641	8,255
Additions	1,447	968
Accretion	(1,594)	(1,776)
Reclassifications from nonaccretable difference	1,231	902
Disposals	—	—
Balance at December 31, 20X5	$9,725	$8,349

During the years ended December 31, 20X5 and 20X4, Company A recognized other-than-temporary impairment of $15 and $3, respectively.

Debt securities acquired each year for which it was probable at acquisition that all contractually required payments would not be collected are as follows:

	20X5	*20X4*	*20X3*
Held-to-maturity:			
Contractually required payments receivable	$4,936	$3,362	$3,093
Cash flows expected to be collected	4,134	2,708	2,475
Basis in acquired securities	2,687	1,760	1,701
Available-for-sale:			
Contractually required payments receivable	$3,726	$2,562	$2,063
Cash flows expected to be collected	2,979	2,086	1,577
Basis in acquired securities	2,011	1,257	1,062

Certain of the debt securities acquired by Company A that are within the scope of SOP 03-3 are not accounted for using the income recognition model of the SOP because Company A cannot reasonably estimate cash flows expected to be collected. The carrying amounts of such debt securities, all of which are classified as available-for-sale securities, are as follows:

	20X5	*20X4*	*20X3*
Debt securities acquired during the year	$ 422	230	145
Debt securities at end of year	659	794	810

A-14. Following is illustrative wording that includes the disclosures required by this SOP.

For loans not accounted for as debt securities (amounts in thousands):

Company A has loans that were acquired in a transfer, for which there was, at acquisition, evidence of deterioration of credit quality since origination and for which it was probable, at acquisition, that all contractually required payments would not be collected.

The carrying amount of those loans is included in the balance sheet amounts of loans receivable at December 31. The amounts of loans at December 31 are as follows:

	20X5	*20X4*	*20X3*
Commercial	$28,273	$27,894	$26,777
Consumer	8,021	7,008	6,011
Outstanding balance	36,294	34,902	32,788
Carrying amount, net of allowance of $878, $860, and $850	$23,732	$23,472	$21,918

	Accretable Yield
Balance at December 31, 20X3	$10,193
Additions	998
Accretion	(426)
Reclassifications from (to) nonaccretable difference	—
Disposals	—
Balance at December 31, 20X4	10,765
Additions	1,084
Accretion	(454)
Reclassifications from nonaccretable difference	57
Disposals	—
Balance at December 31, 20X5	$11,452

During the years ended December 31, 20X5 and 20X4, Company A increased the allowance for loan losses by a charge to the income statement by $18 and $10, respectively. No allowances for loan losses were reversed in 20X5 or 20X4.

Loans acquired during each year for which it was probable at acquisition that all contractually required payments would not be collected are as follows:

	20X5	*20X4*	*20X3*
Contractually required payments receivable at acquisition:			
Commercial	$3,273	$2,894	$2,778
Consumer	1,021	1,108	1,011
Subtotal	4,294	4,002	3,789
Cash flows expected to be collected at acquisition	3,490	3,284	3,036
Basis in acquired loans at acquisition	2,406	2,286	2,101

Certain of the loans acquired by Company A that are within the scope of SOP 03-3 are not accounted for using the income recognition model of the

SOP because Company A cannot reasonably estimate cash flows expected to be collected. The carrying amounts of such loans (which are included in the carrying amount, net of allowance, described above) are as follows:

	20X5	*20X4*	*20X3*
Loans acquired during the year	$ 320	240	158
Loans at end of year	749	902	930

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Appendix B

Basis for Conclusions

Introduction and Background

B-1. The Accounting Standards Executive Committee (AcSEC) issued an exposure draft of a proposed Statement of Position (SOP), *Accounting for Discounts Related to Credit Quality*, on December 30, 1998. AcSEC received 33 comment letters in response to the exposure draft during the exposure period ending April 29, 1999.

B-2. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases*, requires that discounts be recognized as an adjustment of yield over the instrument's life (see paragraphs 18, 19, and 53 of FASB Statement No. 91). Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans* [section 12,060], was issued in August 1989 and further addressed accretion of discounts, which involves intertwining issues of accretion of yield, measurement of credit losses, and recognition of interest income. Specifically, Practice Bulletin 6 [section 12,060]:

a. Provides guidance on when to and when not to accrete discounts on acquired loans (paragraph 13 [section 12,060.13]).

b. Limits the accretion of discount on loans within its scope to amounts expected to be collected (paragraph 13 [section 12,060.13]).

c. Addresses the effects on accretion of changes in the amounts, estimability, and probability of cash collections (paragraph 15 [section 12,060.15]). Specifically, when estimated (expected) cash flows decrease, Practice Bulletin 6 [section 12,060] permitted the yield to decrease below the initial yield and to fall ultimately to zero, spreading the effect of the change in the estimate.

d. Explains how to apply the cost-recovery method to certain loans (paragraphs 16 and 17 [section 12,060.16 and .17]).

e. Sets out factors to be considered in assessing collectibility (paragraph 18 [section 12,060.18]).

Also, appendixes to Practice Bulletin 6 [section 12,060.19 and .20] (*a*) flowchart Practice Bulletin 6's [section 12,060] provisions and (*b*) illustrate and give conclusions on specific scenarios.

B-3. The following pronouncements have been issued or amended since August 1989 to address various related issues:

a. FASB Statement No. 5, *Accounting for Contingencies*, was amended to clarify that enterprises should consider collectibility of both principal and interest for all receivables.

b. FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, was issued, which requires that an impaired loan, including a loan that has been restructured in a troubled debt restructuring involving a modification of terms, be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral-dependent. Further, footnote 3 of FASB Statement No. 114 states, "When a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the loan's future cash flows with the purchase price of the loan." FASB Statement No. 114 also eliminated "in-substance foreclosures" by amending paragraph 34 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings.*

c. FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, was issued, paragraph 16 of which requires an enterprise to determine whether a decline in the fair value of an individual available-for-sale or held-to-maturity security below its amortized cost basis is other than temporary. For example, if it is probable that an investor is unable to collect all amounts due according to the contractual terms of the security, an other-than-temporary impairment shall be considered to have occurred.

d. FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, was issued, paragraph 11 of which says FASB considered income recognition to be secondary in importance to the issue of measurement of impairment. Recognizing the importance of knowing how an enterprise recognizes interest and records cash receipts related to impaired loans, FASB required, in paragraph 20 of FASB Statement No. 114, that an enterprise disclose its accounting policies for recognizing interest income on impaired loans, including its policy for recording cash receipts.

B-4. AcSEC undertook this SOP project to identify those objectives of Practice Bulletin 6 [section 12,060] that continue to be relevant and to update and elevate the authority of related guidance.

Scope

B-5. The scope of Practice Bulletin 6 [section 12,060] includes loans, which were defined to include "loans and other debt securities." Practice Bulletin 6 [section 12,060] discusses the concept of a discount related to credit quality and further defined loans within its scope by reference to (*a*) how the loan was acquired and (*b*) the probability of cash collections. Certain collateralized loans and loans carried at fair value or the lower of cost or fair value are excluded from the scope of Practice Bulletin 6 [section 12,060]. Loans held by liquidating banks were excluded because the related accounting was discussed in the FASB's Emerging Issues Task Force (EITF) Issue No. 88-25, *Ongoing Accounting and Reporting for a Newly Created Liquidating Bank.*

B-6. *Collectibility of contractual amounts.* AcSEC believes it is appropriate to focus one element of the scope criteria of paragraph .03 of this SOP on whether it is probable, at acquisition, that the investor will be unable to collect all amounts due according to the contractual terms of the loan. AcSEC believes the concepts of contractually required payments receivable, initial investment, and cash flows expected to be collected are more understandable and workable than the face amount concept discussed in paragraph 4 of Practice Bulletin 6 [section 12,060.04] and more consistent with the guidance in FASB Statement No. 114. AcSEC intends for this element of the scope criteria of paragraph .03 to exclude loans for which it is possible, but not probable, that the investor will be unable to collect all amounts due according to the contractual terms of the loan. Further, AcSEC intends that investors should consider the significance of delays and shortfalls for a loan such that this SOP would not be applied when such delays and shortfalls are insignificant with regard to the contractually required payments.

B-7. AcSEC intends for this SOP to be applied to loans individually determined to meet the scope criteria of paragraph .03 of this SOP. AcSEC provided in paragraph .12 that loans may be aggregated for purposes of applying the guidance on initial and subsequent accounting. Individual loans are not to be aggregated for determining whether they, as a group, are within the scope defined in paragraph .03 of this SOP. Because the use of aggregation may result in a different scope applicability, AcSEC decided to allow aggregation only for recognition, measurement, and disclosure purposes.

B-8. Paragraph .03 includes as a scope criterion "for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable." AcSEC intends for investors to consider collectibility of contractual amounts due regardless of whether the acquisition price is greater than (premium) or less than (discount) the face amount of the loan. For example, a loan may be acquired at a small, net premium. The pricing of that small premium could actually be the net of a premium for an above-market contractual interest rate and a discount for credit quality. Based on this scenario, AcSEC concluded that the existence of a premium or a discount is not sufficient to determine whether the loan meets the scope criteria of paragraph .03 this SOP.

B-9. *Evidence of deterioration of credit quality since origination.* AcSEC excluded from the scope defined in paragraph .03 of this SOP acquired loans or debt securities for which there has been no evidence of deterioration of credit quality from the date of origination. Deterioration may be evidenced by such sources as Fair Isaac Company (FICO) scores (an automated rating process for credit reports), downgrading, decline in value of collateral, or past-due status. Without evidence of deterioration of credit quality since origination, AcSEC determined that the accounting prescribed by this SOP would conflict with FASB Statements No. 5 and No. 91. Further, without evidence of deterioration of credit quality since origination added to the scope criteria in paragraph .03, a difference in recognition of interest income and impairment accounting would exist when there has been no intervening change in the credit quality of the debtor for an originated loan versus a loan acquired shortly after origination or at any subsequent time. This difference could result in selective accounting practices between investors and, therefore, diminish comparability to readers of financial statements.

B-10. *Exclusion of originated loans.* The scope defined in paragraph .03 of this SOP excludes originated loans (for which related discounts are addressed by FASB Statement No. 91). The income recognition provisions of this SOP apply only to loans with evidence of deterioration of credit quality that occurred between origination and acquisition by completion of a transfer (*a*) that satisfies the conditions in paragraph 9 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, to be accounted for as a sale; (*b*) in a purchase business combination; (*c*) to a newly created subsidiary if the transferee has written the loan down to its fair value with the intent of transferring the stock of the subsidiary as a dividend to the shareholders of the parent company;[1] or (*d*) that is a contribution receivable or a transfer that satisfies a prior promise to give. The exposure draft of the proposed SOP proposed defining "completion of a transfer" to exclude transactions in which the investor acquires loans from the transferor through an agency relationship. Most respondents to the exposure draft were supportive of the FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, criteria (later replaced by FASB Statement No. 140). However, some respondents indicated the "agency relationship" concept in the glossary definition of "completion of transfer" was not operational. AcSEC agreed and removed the agency relationship concept from the definition and inserted the criterion for deterioration in credit quality as discussed in paragraph B-25.

B-11. *Fair value.* Practice Bulletin 6 [section 12,060] excludes from its scope loans and debt securities that are measured at fair value or at the lower of cost or fair value. Consistent with Practice Bulletin 6 [section 12,060] and paragraphs 3 and 34 of FASB Statement No. 91, AcSEC concluded that carrying loans within the scope criteria in paragraph .03 of this SOP at fair value with changes in fair value included in earnings obviates the need for accounting guidance on recognition of discounts associated with those loans.[2] However, AcSEC has clarified exclusions in Practice Bulletin 6 [section 12,060] to address changes in related standards.

B-12. First, AcSEC concluded that loans whose changes in value are reported in other comprehensive income should not be excluded from the scope of this SOP. Some respondents to the exposure draft suggested that all loans held for sale should be excluded. AcSEC reasoned that some loans held for sale are held for an extended time and such guidance was necessary for those situations. Accordingly, paragraph .03*a* of this SOP excludes only loans that are measured at fair value with changes in value reported in earnings, for example, mortgage-backed and other securities classified as trading securities in conformity with FASB Statement No. 115. For a not-for-profit organization, loans that are measured at fair value, if all changes in fair value are included in the statement of activities and included in the performance indicator if a performance indicator is presented, are also excluded from paragraph .03 of this SOP. (Paragraph 130(a) of FASB Statement No. 115 similarly amended

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[1] Emerging Issues Task Force (EITF) Issue No. 87-17, *Spinoffs or Other Distributions of Loans Receivable to Shareholders*, requires that such loans (received as dividends-in-kind) initially be measured at fair value. This SOP provides additional guidance on recognition, measurement (including subsequent measurement), and display of such loans.

[2] Paragraph 116 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, states:

> Amendment of [FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases*]
>
> Some respondents noted that the change from LOCOM to fair value for reporting available-for-sale securities would cause [FASB Statement No. 91] to no longer apply to those securities. Paragraph 3 of Statement 91 indicates that it does not apply to loans and securities reported at fair value. The Board noted that the intent of that provision was to exclude only the loans and securities whose changes in value were included in earnings, not those loans and securities whose changes in value are reported in [other comprehensive income]. Consequently, the Board agreed to amend Statement 91 to clarify that only loans and securities reported at fair value with changes in value reported in earnings are excluded from that Statement's scope. Thus, Statement 91 would continue to apply to available-for-sale securities that previously were reported at amortized cost or LOCOM.

the scope [paragraph 3] of FASB Statement No. 91 to clarify that only loans reported at fair value with changes in value reported in earnings are excluded from FASB Statement No. 91.) AcSEC recognizes that the AICPA Audit and Accounting Guide *Audits of Investments Companies* (the Guide) requires the amortization of discounts on loans and debt instruments carried at fair value. AcSEC considered applying the guidance in this SOP to such loans but decided, for several reasons, not to expand the scope defined in paragraph .03 of this SOP to apply to loans whose changes in fair value are reported in earnings. The applicability to such loans would expand the scope defined in paragraph .03 of this SOP, change the Guide, and for such loans, only result in income statement classification changes between interest income and unrealized gains and losses. Further, AcSEC received no comments asking that this guidance be applied to such loans. For these reasons, AcSEC decided to exclude from the scope of this SOP those loans whose changes in value are reported in earnings or the statement of activities, as applicable.

B-13. Second, AcSEC concluded that only mortgage loans held for sale (rather than any loan accounted for using the lower-of-cost-or-market-value [LOCOM] method), should be excluded from the scope set forth in paragraph .03 of this SOP. Paragraph 5 of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, prohibits the accretion of discounts on mortgage loans held for sale:

> Purchase discounts on mortgage loans shall not be amortized as interest revenue during the period the loans or securities are held for sale.

AcSEC concluded that this prohibition should not be extended to other loans within the scope defined in paragraph .03 of this SOP that are being held for sale. Further, FASB Statement No. 115 eliminated the acceptability of the LOCOM method for debt securities held for sale.

B-14. *Leases.* Consistent with FASB Statement No. 114, this SOP does not apply to leases as defined in FASB Statement No. 13, *Accounting for Leases.*

B-15. *Historical cost.* The scope defined in paragraph .03 of this SOP excludes loans acquired in a business combination accounted for at historical cost in conformity with Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*,[3] because the existing basis of accounting for such assets generally continues for the combined entity.

B-16. *Business combinations.* Several respondents to the exposure draft suggested the exclusion be extended to purchase business combinations. AcSEC found no conceptual reason to exclude such loans, while at the same time including in the scope of this SOP individual or "bulk" loan acquisitions of loans whose credit quality has deteriorated.

B-17. *Liquidating banks.* This SOP retains the Practice Bulletin 6 [section 12,060] exclusion of loans held by liquidating banks because related accounting matters are discussed in EITF Issue No. 88-25.

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[3] In June 2001, the FASB issued FASB Statement No. 141, *Business Combinations*, which supersedes Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*. FASB Statement No. 141, which applies to all business combinations except to combinations of two or more not-for-profit organizations, the acquisition of a for-profit business entity by a not-for-profit organization, and combinations of two or more mutual enterprises, requires that all business combinations initiated after June 30, 2001, be accounted for using the purchase method. The provisions of FASB Statement No. 141 are applicable to business combinations accounted for by the purchase method completed after June 30, 2001.

B-18. *Revolving privileges.* In revolving credit agreements, such as credit cards and home equity loans and other lines of credit, the borrower will typically have "revolving privileges" that allow it to pay down and then reborrow additional funds up to a maximum approved amount. The creditor in certain cases, such as borrower default, may revoke these revolving privileges. Respondents suggested excluding revolving credits when the customer has revolving privileges at the acquisition date because, from a practicality standpoint, it would be difficult to account for the acquisition balance separately from new advances and payments on revolving credit. Accordingly, AcSEC does not intend for the scope defined in paragraph .03 of this SOP to include situations in which credit is still being offered, and the entire relationship is excluded if, at the acquisition date, the borrower has revolving privileges. AcSEC believes this scope exclusion is appropriate because lenders generally will not continue to make credit available to borrowers from whom it is probable that the lender will not collect all contractually required payments receivable.

B-19. *Retained interests.* Under FASB Statement No. 140, a transferor allocates the previous carrying amount of transferred assets to interests sold and interests retained based on their relative fair values. That allocation could result in a significant difference between a retained interest's carrying amount and its contractually required payments receivable. Loans that are retained interests are not within the scope defined in paragraph .03 of this SOP. Rather, the EITF addressed the accounting for loans that are retained interests in EITF Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets.*

B-20. *Certain collateralized loans other than troubled debt restructurings.* Paragraph 3 of Practice Bulletin 6 [section 12,060.03] requires that "enterprises that acquire loans primarily for the rewards of ownership of the underlying nonmonetary collateral should record the collateral rather than the loan." This SOP omits that requirement, which paralleled the "insubstance foreclosure" accounting that effectively has been superseded by FASB Statement No. 114. Specifically, the FASB concluded that:

> Paragraph 34 [of FASB Statement No. 15] was intended to apply to a narrow set of circumstances; that is, a troubled debt restructuring or other circumstance in which a debtor surrendered property to the creditor and the creditor was in possession of the asset with or without having to go through formal foreclosure procedures. [FASB Statement No. 114, paragraph 70]

B-21. As a result of that conclusion, paragraph 22(d) of FASB Statement No. 114 amended paragraph 34 of FASB Statement No. 15 to require that:

> A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor, that is, the creditor receives physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, shall be accounted for according to paragraphs 28 and 33 and, if appropriate, 39 [of FASB Statement No. 15].

B-22. Consistent with this clarification of FASB Statement No. 15, AcSEC believes loans meeting the scope criteria of paragraph .03 of this SOP should be accounted for as loans until the creditor is in possession of the collateral, with or without having to go through formal foreclosure procedures. However, as described in paragraph B-35, if the loan is acquired primarily for the rewards of ownership of the underlying collateral, accrual of income is inappropriate. Such rewards of ownership would include use of the collateral in operations of the entity or significantly improving the collateral for resale.

B-23. *Recently originated loans.* The scope set forth in paragraph .03 of this SOP excludes originated loans (for which related discounts are addressed by FASB Statement No. 91) because this SOP applies only to loans acquired by completion of a transfer that have experienced deterioration of credit quality between origination and the acquisition date.

B-24. The exposure draft of this SOP proposed defining "completion of a transfer" to exclude transactions in which the investor acquires loans from the transferor through an "agency" relationship. The FASB and AcSEC were concerned that without the "agency concept," two entities, for example, one originating its own loans and the other purchasing loans within hours after origination, would have different accounting treatments. Respondents to the exposure draft indicated that FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, criteria (later replaced by FASB Statement No. 140) were appropriate but the agency relationship definition was not operational. AcSEC agreed and concluded that the criteria in FASB Statement No. 140 eliminated the need to establish other criteria that distinguish between loans originated and loans acquired.

B-25. Without the agency concept, the original concern of different accounting treatments still existed. AcSEC discussed this concern and added the third criterion, evidence of deterioration of credit quality between origination and acquisition of the loan, to the scope criteria of paragraph .03 of this SOP. AcSEC considered whether reexposure was needed based on the additional criterion added. AcSEC concluded that questions about scope were highlighted in the exposure draft and that the scope, although different, was not sufficiently changed from the exposure draft to warrant reexposure.

B-26. *Smaller balance homogenous loans.* Several respondents to the exposure draft suggested that the scope exclude smaller balance homogenous loans. AcSEC found no conceptual reason to exclude such loans and further noted that the exclusion of such loans would significantly reduce the applicability of this SOP.

B-27. *Acquisition, development, or construction (ADC) arrangements.* AcSEC observes that the AICPA's third Notice to Practitioners on ADC arrangements (which appears as Exhibit I in AICPA Practice Bulletin 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance* [section 12,010.09]) requires that certain ADC arrangements be accounted for as investments in real estate (in conformity with FASB Statements No. 66, *Accounting for Sales of Real Estate*, and No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*) or real estate joint ventures (in conformity with SOP 78-9, *Accounting for Investments in Real Estate Ventures* [section 10,240], and FASB Statement No. 34, *Capitalization of Interest Cost*) rather than as loans. As discussed in that Notice, whether acquired or originated, ADC arrangements accounted for as investments in real estate or real estate joint ventures should not be reported as loans in the balance sheet.

B-28. One of the objectives of this SOP is to prohibit the seller's allowances related to loan losses on loans subject to this SOP from being carried over by the investor to recognize an allowance on its books in accounting for an acquisition. In paragraphs 5 and B-31 of the exposure draft of this SOP, AcSEC took the position that "it would never be necessary, at acquisition, to establish a loss allowance." AcSEC was concerned that this guidance would not be considered for all acquisitions of loans, including those with no evidence of deterioration of credit quality. To remedy that concern, AcSEC had agreed to add an additional scope paragraph to apply this prohibition to *all* acquisitions of loans, including those in a purchase business combination. However, AcSEC and FASB ultimately concluded that the issue related to acquired loans that are not within the scope of this SOP should be addressed by FASB. Again, AcSEC considered the need for reexposure for this issue. Several respondents from the exposure draft process did comment on the inability to carry over the seller's allowance. As this issue had been considered by respondents, AcSEC concluded that reexposure was not necessary.

Conclusions

Recognition, Measurement, and Display

B-29. *Loss accrual or valuation allowance.* Paragraph .05 of this SOP prohibits the recognition of the nonaccretable difference related to a loan as an adjustment of yield, a loss accrual, or a valuation of the loan for credit risk (loss allowance). The price an investor is willing to pay for a loan-and accordingly, the resulting yield-reflects the investor's estimate of credit losses over the life of the loan. Further, the acquisition price of-and the investor's expected yield on-the loan does not reflect losses measured and recognized by the transferor in conformity with FASB Statement No. 5. Using a loss allowance to address the collectibility of cash flows the investor does not initially expect to receive (and, therefore, presumably did not pay for) would not faithfully represent the substance of the underlying event. Rather, credit valuations should reflect only those losses incurred by the investor after acquisition-that is, the present value of cash flows expected at acquisition that ultimately are not to be received. The loss accrual or valuation allowance recorded by the investor should reflect only losses incurred by the investor, rather than losses incurred by the transferor or the investor's estimate at acquisition of credit losses over the life of the loan.

B-30. AcSEC noted differences in practice for establishing or carrying over a seller's allowance upon acquisition of a loan or a pool of loans. Some interpreted paragraph 88(b) of APB Opinion No. 16 and paragraph 37(b) of FASB Statement No. 141 to suggest that acquired loans should be evaluated in a two-step process: first, measuring the effects of changes in interest rates and second, measuring the effect of changes in collectibility. Another interpretation of those paragraphs was to consider changes in interest rates and changes in collectibility to be embedded into the loan valuation. AcSEC endorses the latter interpretation such that for loans that are acquired in a purchase business combination and recorded at fair value, AcSEC believes it would never be appropriate, at acquisition, to establish a loss allowance. AcSEC believes this interpretation is supported by paragraphs 68 and 87 of APB Opinion No. 16 and paragraphs 7 and 35 of FASB Statement No. 141, which require that a portion of the total cost of a group of acquired assets be assigned to each individual asset acquired on the basis of its fair value at the date of acquisition. Paragraphs 88(b) of APB Opinion No. 16 and 37(b) of FASB Statement No. 141 limit initial recognition of such receivables to the present values of amounts to be received:

> Receivables at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary.

This interpretation applies to all loans within the scope of this SOP that are acquired by completion of a transfer and includes an individual loan, a pool of loans, a group of loans, and loans acquired in a purchase business combination.

B-31. Paragraph 15 of FASB Statement No. 91 states that the difference between the acquisition amount of the loan and the principal amount should be recognized as an adjustment of yield over the life of the loan. FASB Statement No. 91 gives guidance on accounting for loans acquired at a discount because of net origination fees and costs and differences between prevailing interest rates on the date of origination and the date of acquisition. Paragraph 13 of Practice Bulletin 6 [section 12,060.13] limits the recognition and measurement of discount (at acquisition of a loan) to amounts expected to be collected. Paragraph .06 of this SOP similarly defines the amount of accretable yield and prohibits recognition of nonaccretable difference as an adjustment of yield. This approach is consistent with the concept stated in footnote 3 to paragraph 14 of FASB Statement No. 114:

> When a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the loan's future cash flows with the acquisition price of the loan.

B-32. *Recording assets acquired in a group.* For guidance on allocation of cost for a group of assets acquired, FASB Statement No. 141 provides the following guidance for allocating the cost of a company acquired in a purchase business combination to loans acquired:

> Acquiring assets in groups requires not only ascertaining the cost of the asset group but also allocating the cost to the individual assets that make up the group. The cost of such a group is determined using the concepts described in paragraphs 5 and 6. A portion of the cost of the group is then assigned to each individual asset acquired on the basis of its fair value. [Paragraph 7]
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> . . . [A]n acquiring entity shall allocate the cost of an acquired entity to the assets acquired and liabilities assumed based on their estimated fair values at date of acquisition. Prior to that allocation, the acquiring entity shall (a) review the purchase consideration if other than cash to ensure that it has been valued in accordance with the requirements in paragraphs 20–23 and (b) identify all of the assets acquired and liabilities assumed, including intangible assets that meet the recognition criteria in paragraph 39, regardless of whether they had been recorded in the financial statements of the acquired entity. [Paragraph 35]

B-33. Loans subject to this SOP that are acquired individually and in pools in arm's-length transactions should be recorded at their acquisition price, presumed to be fair value. Loans subject to this SOP that are acquired in business combinations accounted for as purchase business combinations should be recorded, as a result of the allocation of the acquisition price pursuant to FASB Statement No. 141, at their fair value. Fair value should be estimated using reliable measures considering FASB Statements of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information,* and No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. AcSEC believes one acceptable method of making this estimate is described in paragraphs 42 through 54 of FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, which address the use of an expected cash flow approach. The face amount of the loans may be substantially different from the acquisition-date fair value of the loans due to changes in market interest rates, credit risk, and expected prepayments.

B-34. *Loan fees.* Paragraph .05 of this SOP addresses the effect of loan fees on the initial investment, consistent with paragraph 15 of FASB Statement No. 91, which states, "[T]he initial investment in a purchased loan or pool of loans shall include the amount paid to the seller plus any fees paid or less any fees received."

B-35. *Income recognition.* Recognition of income on a loan under this SOP is dependent on having a reasonable expectation about the timing and amount of cash flows to be collected. Subsequent to acquisition, this SOP does not prohibit placing loans on nonaccrual status, including use of the cost recovery method or cash basis method of income recognition, if appropriate. For example, if the timing of either a sale of the loan into the secondary market or a sale of loan collateral is indeterminate, the investor may not have the information necessary to reasonably estimate cash flows to compute its yield and should cease recognizing income on the loan. However, the ability to place a loan on nonaccrual status should not circumvent the loss recognition guidance contained in paragraphs .07*a* and .08*a* of this SOP. Alternatively, if the timing and amount of cash flows expected to be collected from such sales are reasonably estimable, the investor should be using those cash flows to apply the interest method under this SOP. For example, if the investor determines that foreclosure is probable, paragraph 13 of FASB Statement No. 114 requires that the investor measure impairment of the loan based on the fair value of the collateral. In that circumstance, the loan's cash flows expected to be collected presumably would include the fair value of the collateral less estimated selling costs rather than expected collections of interest and principal. If the loan is acquired primarily for the rewards of ownership of the underlying collateral, accrual of income is inappropriate. Rewards of ownership would include use of the collateral in operations of the entity or significantly improving the collateral for resale. AcSEC reasoned that although the asset should be accounted for as a loan (a monetary asset), there are instances in which the ultimate disposition would result in a nonmonetary asset type of transaction and that in those instances, there should be no accrual of income.

B-36. *Prohibition of offset.* AcSEC recognizes that some loans have common risk characteristics and may be aggregated for purposes of applying this SOP (see paragraphs B-50 through B-54 of this SOP). However, in either case, the application of this SOP results in a measurement of accretable yields, nonaccretable difference, and impairment identified to the particular loan or pool of loans.

B-37. AcSEC concluded that accretable yields and nonaccretable difference for a specific loan or a pool of loans with common risk characteristics should not be considered available to "offset" changes in cash flows from a different loan or a pool of loans with another set of common characteristics. In conformity with this SOP and FASB Statements No. 5, No. 114, and No. 115, measurement and recognition of accretable yields and nonaccretable difference, and any subsequent impairment of a specific loan or pool of loans, are to be made by reference to specific characteristics, cash flows expected to be collected, contractually required payments receivable, and pricing assumptions thereof.

B-38. *Display.* Paragraph .05 of this SOP prohibits the investor from displaying accretable yield or nonaccretable difference in the balance sheet. This SOP requires that an investor disclose information about accretable yield in the notes to the financial statements. It does not prohibit the investor from discussing the relationship between nonaccretable difference and contractually required payments receivable and the related effect of nonaccretable difference on the measurement of credit risk (for example, that nonaccretable difference reflects contractually required payments receivable that are not expected to be collected).

Changes in Cash Flows Expected to Be Collected

B-39. *Decreases in cash flows expected to be collected.* Paragraph 15 of Practice Bulletin 6 [section 12,060.15] addresses the effects on accretion of changes in the amounts, estimability, and probability of future cash collections. Specifically, if estimated (expected) cash flows decreased, Practice Bulletin 6 [section 12,060] permitted the yield to decrease below the initial yield and to fall ultimately to zero, thereby spreading the effect of the change in the estimate. This SOP addresses subsequent recognition and measurement based on whether the investor's initial cash flow estimate subsequently decreases (paragraphs .07*a* and .08*a*) or increases (paragraphs .07*b* and .08*b*).

B-40. Paragraph .08*a* of this SOP addresses the application of FASB Statement No. 5 to subsequent recognition and measurement of impairment of loans not accounted for as debt securities. Paragraph 8 of FASB Statement No. 5 establishes conditions that must be met for an estimated loss from a loss contingency to be accrued by a charge to income. Paragraph 23 of FASB Statement No. 5 provides an example of the application of the paragraph .08 conditions to the collectibility of receivables. The first two sentences of paragraph 23 of FASB Statement No. 5 state:

> If, based on current information and events, it is probable that the enterprise will be unable to collect all amounts due according to the contractual terms of the receivable, the condition in paragraph 08(a) is met. As used here, *all amounts due according to the contractual terms* means that both the contractual interest payments and the contractual principal payments will be collected as scheduled according to the receivable's contractual terms.

B-41. Footnote 13 of this SOP explains that, for purposes of applying paragraph 23 of FASB Statement No. 5 to a loan meeting the scope criteria in paragraph .03 of this SOP, the phrase "all amounts due according to the contractual terms" should be read "all cash flows originally expected to be collected by the investor plus any additional cash flows expected to be collected arising from changes in estimate after acquisition." If that condition is met, the subsequent recognition and measurement is governed by FASB Statement No. 5 and other authoritative pronouncements governing the application of FASB Statement No. 5 to loans.

B-42. This change from Practice Bulletin 6 [section 12,060] in accounting for decreases in cash flows expected to be collected is needed also to reflect the concept in footnote 3 to FASB Statement No. 114 that "when a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the loan's future cash flows with the purchase price of the loan."

B-43. Accordingly, a decrease in the cash flows expected to be collected from a loan meeting the scope of this SOP would result in accrual of a loss contingency rather than a prospective change in yield as previously required by Practice Bulletin 6 [section 12,060].

B-44. *Increases in cash flows expected to be collected.* Paragraph 15 of Practice Bulletin 6 [section 12,060.15] requires certain increases in cash flows expected to be collected to result in an increase in the amount of yield to be accreted. Paragraphs .07*b* and .08*b* of this SOP similarly require an increase in the amount of accretable yield, after such an adjustment first reverses any existing valuation allowance for the loan, if applicable, established after acquisition. Consistent with Practice Bulletin 6 [section 12,060], paragraphs .07*b* and .08*b*(2) of this SOP require that the amount of any increase in accretable yield be accounted for as a change in estimate in accordance with APB Opinion No. 20, *Accounting Changes*, with the amount of periodic accretion adjusted over the remaining life of the loan. AcSEC acknowledges the potential for a high effective yield prospectively if, under FASB Statement No. 115, an other-than-temporary impairment has been recognized, or a write-down has been recorded. As this SOP does not address the timing of write-downs, AcSEC acknowledges this scenario and notes that this treatment is consistent with FASB Statements No. 114 and No. 115. Consistent with paragraphs .07*a* and .08*a*, paragraphs .07*b* and .08*b* of this SOP require that an investor, when considering whether the yield should be adjusted upward or the allowance reversed, would consider the impact of current information and events on the cash flow expectation and thus would not anticipate future events that might also cause recognition of a change in the cash flow expectation. This SOP does not address or provide any guidance on when an entity should recognize a write-down on a loan (referred to in some industries as a charge-off). As indicated above, FASB Statement No. 115 provides that if an entity recognizes an other-than-temporary impairment, that recognition results in a new cost basis for the security. Any subsequent appreciation in fair value is recognized in other comprehensive income. Likewise, if a write-down of a loan occurs, AcSEC believes that recognition establishes a new cost basis for the loan. If a subsequent upward revision occurs in the loan's cash flows expected to be collected, prior write-downs should not be reversed, but rather, that increase in cash flows expected to be collected is recognized pursuant to paragraph .08*b*(2) of this SOP on a prospective basis even if that income recognition results in an unusually high effective rate for the loan. The example in paragraph A-11(*b*)(1) and footnote 32 of Appendix A [paragraph .20] of this SOP illustrate this concept for a loan.

B-45. An increase in accretable yield establishes a higher effective interest rate and a different threshold for any subsequent impairment determination. Paragraph .08*b*(2) of this SOP requires that the higher effective interest rate (established by an adjustment of accretable yield) be used in any later valuation of the loan for impairment. Further, paragraphs .07*a* and .08*a* of this SOP require that the threshold for recognizing and measuring impairment include the incremental cash flows that resulted in any previous increase in cash flows expected to be collected.

Prepayments

B-46. Prepayments were not addressed in the exposure draft. Because FASB Statement No. 91 does not require consideration of prepayments, AcSEC does not give guidance in this SOP on whether or how to consider prepayments. However, this SOP does require that prepayments be treated consistently for contractual cash flows and cash flows expected to be collected such that the nonaccretable difference is not affected.

Restructured or Refinanced Loan

B-47. *Refinancing and restructuring after acquisition*. As discussed in paragraphs .07*b* and .08*b*, this SOP requires that the amount of any increase in accretable yield be accounted for as a change in estimate that is recognized prospectively. Paragraph .10 provides that a loan meeting the scope criteria of paragraph .03 of this SOP that is refinanced or restructured, other than through a troubled debt restructuring,[4] should not be accounted for as a new loan. AcSEC believes accounting for such a loan as a new loan would impair comparability between entities. For example, assume that two investors hold similar loans that fall within the scope of this SOP. There is a significant increase in cash flows expected to be collected for each loan. Investor A revises the contractual terms of the loan to make them consistent with the revised estimate of cash flows expected to be collected. Absent the guidance in paragraph .10 of this SOP, Investor A, following paragraph 12 of FASB Statement No. 91, would recognize the income upon refinancing. Investor B, instead of refinancing the loan, revises the cash flows expected to be collected and, as required by paragraphs .07*b* and .08*b* of this SOP, recognizes an increased yield prospectively. AcSEC believes that both loans should continue to be accounted for in conformity with paragraphs .07*b* and .08*b* of this SOP. Paragraph .10 requires the income on a refinanced or restructured loan to be recognized prospectively rather than currently as a gain, as would have been Investor A's accounting absent these provisions.

Variable Rate Loans

B-48. In response to the comment letters, AcSEC addressed variable rate loans in this SOP. AcSEC considered three approaches for variable rate loans whose contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate. In the first approach, the contractually required payments receivable and cash flows expected to be collected should be calculated based on the factor as it changes over the life of the loan. The second approach required contractually required payments receivable and cash flows expected to be collected to be fixed at the rate in effect at the date the loan was acquired. The third approach allowed the investor to select and apply consistently either of those methods.

B-49. Paragraph 18(c) of FASB Statement No. 91 allows preparers the alternative of recalculating a new effective rate each time the index on a loan changes. Further, paragraph 57 of FASB Statement No. 91 notes that the effect on the amortization as a result of subsequent changes in interest rates generally would not be significant. However, in FASB Statement No. 91, a variable rate change affects only the amortization of the premium or discount, a component of income, whereas, for this SOP, variable rate changes affect all cash flows. AcSEC determined that, for purposes of this SOP, the effects of the interest rate changes could be significant. Therefore, the guidance in paragraphs .07 and .08 for increases and decreases should be followed without having to meet the significance threshold contained in those paragraphs. AcSEC decided that the only meaningful approach is to require both the loan's contractually required payments receivable and cash flows expected to be collected to be calculated based on the factor as it changes over the life of the loan.

Multiple Loans Accounted for as a Single Asset

B-50. *Aggregation of loans not accounted for as debt securities.* Aggregation may enhance an investor's confidence in the cash flow projections needed to apply the guidance in this SOP. Aggregation, if desired by the investor and if certain criteria are met, provides for a practical approach by permitting the evaluation of pools of loans and the use of statistics of pool behaviors. Paragraph 12 of FASB Statement No. 114 allows a creditor to aggregate loans that have "risk characteristics in common with other impaired loans" and to use, in part, "a

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[4] See footnote 15 of this SOP.

composite effective interest rate" as a means of measuring impairment of those loans. AcSEC applied that concept in concluding that, for purposes of applying the recognition, measurement, and disclosure provisions of this SOP, investors should be allowed to aggregate loans that are not accounted for as debt securities and to use a composite interest rate and cash flow expectation for the pool. AcSEC does not intend for this aggregation to be analogized to for purposes other than this SOP. Further, AcSEC decided not to allow aggregation for loans accounted for as debt securities because FASB Statement No. 115 does not permit aggregation.

B-51. *Aggregation criteria.* Other authoritative accounting literature permits aggregation based on common characteristics for a practical approach. For example, paragraph 63(g)(1) of FASB Statement No. 140 identifies risk characteristics such as financial asset type, interest rate, date of origination, term, and geographic location. The exposure draft of this SOP would have required aggregated loans to have common risk characteristics including financial asset type, purchase date, interest rate, date of origination, term, geographic location, and credit risk. Several respondents to the exposure draft indicated that the proposed aggregation criteria were too restrictive. AcSEC agreed and the criteria for aggregation in the final SOP were made less restrictive.

B-52. After each loan is determined individually to meet the scope criteria of paragraph .03 of this SOP and if certain criteria are met, the investor may aggregate into pools loans that are not accounted for as debt securities. The aggregation should be based on common risk characteristics that include similar credit risk or risk ratings, and one or more predominant risk characteristics. Aggregated loans must have been acquired in the same fiscal quarter.

B-53. *Unit of account.* AcSEC concluded that once a pool is assembled, the pool should be accounted for as a single asset. Therefore, the pool is deemed to be the unit of accounting and should be considered one loan for purposes of applying this SOP. A loan should be removed from a 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 should be removed at its carrying amount.

B-54. *Example.* The following illustrates a scenario in which loans are accounted for individually and a scenario in which some of the loans are accounted for in assembled pools. In both scenarios, each loan is evaluated individually, whether the loan was acquired individually or in a group.

Scenario A: Loans acquired in a group; accounted for individually

An investor acquires 1,000 loans from Seller A in a single transaction and one loan from Seller B in another transaction the same day. The investor individually evaluates each loan, making individual determinations of probability of collecting all contractual cash flows. The loans for which there is evidence of deterioration of credit quality since origination and it is probable that a more than insignificant shortfall will occur are considered to be within the scope of this SOP and the investor accounts for each loan individually. The other loans (that is, those loans not meeting the paragraph .03 scope criteria) are accounted for as acquired loans under FASB Statement No. 91.

Scenario B: Loans acquired in a group; accounted for as a pool

Alternatively, to facilitate recordkeeping and reporting, the investor decides to aggregate certain loans that individually are within the scope of this SOP and that are not accounted for as debt securities into pools that have common credit risk characteristics such as past-due status, FICO score (an automated rating process for credit reports), or risk rating and a predominant risk characteristic, such as type of loan. All loans not determined individually to be within the scope defined in paragraph .03 of this SOP are accounted for as acquired loans under FASB Statement No. 91.

How This SOP Differs From Practice Bulletin 6 [section 12,060]

B-55. The exposure draft of this SOP posed a question to respondents regarding the application of the then-proposed SOP to loans acquired prior to the SOP's adoption date. As described in paragraph B-65, respondents believed such a "fresh start" approach would be troublesome. AcSEC agreed and decided that this SOP should apply prospectively to loans acquired in a transfer. Other than the guidance in Practice Bulletin 6 [section 12,060] for decreases in cash flows expected to be collected, all provisions of Practice Bulletin 6 [section 12,060] remain in place for loans acquired in fiscal years beginning on or before December 15, 2004, and within the scope of Practice Bulletin 6 [section 12,060]. AcSEC included the following paragraphs, which AcSEC considers to be consistent with the impairment guidance in FASB Statements No. 114 and No. 115, for users of Practice Bulletin 6 [section 12,060] to better understand how this SOP differs from Practice Bulletin 6 [section 12,060]. The following discussion as it relates to this SOP is not applicable to loans acquired in fiscal years beginning on or before December 15, 2004, and within the scope of Practice Bulletin 6 [section 12,060].

B-56. *Certain collateralized loans.* Paragraph 15 of Practice Bulletin 6 [section 12,060.15] provides that if, after acquisition of a loan that is not accounted for as a debt security, it was later determined that the loan is held primarily for the rewards of ownership of the underlying nonmonetary collateral, the collateral should be accounted for in accordance with the guidance in Practice Bulletin 1 [section 12,010]. This guidance to record the collateral instead of the loan has been eliminated for the reasons discussed in paragraphs B-20 through B-22 in this appendix. Income recognition for such loans is discussed in paragraph B-35.

B-57. *Mandated use of cost-recovery method.* Paragraph 15 of Practice Bulletin 6 [section 12,060.15] provides that if, after acquisition, it is not possible for the investor to estimate the amount and timing of cash collections, accretion should cease and the cost-recovery method should be used. Paragraphs 16 and 17 of Practice Bulletin 6 [section 12,060.16 and .17] further address applying the cost-recovery method to certain loans. However, paragraph 35 in FASB Statement No. 114 states:

> Application of judgment to determine expected future cash flows may be complex, but that complexity is the unavoidable result of the need for information about the effect of impaired loans on a creditor's financial position and results of operations.

AcSEC similarly believes it should be possible in most situations for an investor to estimate cash flows expected to be collected and, accordingly, did not carry forward the guidance in paragraphs 15 through 17 of Practice Bulletin 6 [section 12,060.15–.17] to this SOP.

B-58. *Collectibility.* Paragraph 18 of Practice Bulletin 6 [section 12,060.18] identifies factors to consider in assessing the collectibility of loans within its scope. This SOP does not specify how an investor should determine that it is probable it will be unable to collect all cash flows expected at acquisition. AcSEC notes that the FASB found such requirements unnecessary when addressing the application of paragraph 23 of FASB Statement No. 5 to (*a*) loans accounted for as debt securities[5] and (*b*) loans not accounted for as debt securities.[6]

B-59. *Income recognition.* Paragraph 13 of Practice Bulletin 6 [section 12,060.13] gives guidance on when and when not to accrete discounts on acquired loans. This SOP eliminates such guidance for acquired loans because FASB Statement No. 118 eliminated such guidance for originated loans from FASB Statement No. 114. Specifically, paragraph 20(b) of FASB Statement No. 114 simply requires disclosure of the creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded. This SOP does not prohibit, however, subsequently suspending accrual of interest income (that is, placing loans on "nonaccrual status"), including use of the cost recovery method or cash basis method of income recognition.

Disclosures

B-60. Several respondents to the exposure draft indicated some of the proposed disclosures were not meaningful and would impose a significant cost burden on investors to obtain the necessary information. AcSEC reassessed the disclosures, eliminated those related to the nonaccretable difference, and modified other disclosures to amounts that would be more readily obtainable and yet would convey information regarding the credit quality of acquired loans that are within the scope of this SOP. AcSEC agreed that the outstanding balance (that is, unpaid principal, unpaid interest, penalties, and other) and the related carrying amount (including any related allowance for uncollectible amounts) should be disclosed at each balance sheet date because these disclosures provide an indication of credit quality, comparability between entities, and how

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[5] Paragraph 16 of FASB Statement No. 115 states:

Impairment of Securities

For individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred. [*Footnote omitted*.] If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair values. Subsequent increases in the fair value of available-for-sale securities shall be included in other comprehensive income pursuant to paragraph 13 [of *FASB Statement No. 115*]; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in other comprehensive income.

[6] Paragraph 8 of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, states:

Recognition of Impairment

A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. As used in [FASB Statement No. 114 and FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*,] *all amounts due according to the contractual terms* means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. For a loan that has been restructured in a troubled debt restructuring, the *contractual terms of the loan agreement* refers to the contractual terms specified by the original loan agreement, not the contractual terms specified by the restructuring agreement. [FASB Statement No. 114] does not specify how a creditor should determine that it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan. A creditor should apply its normal loan review procedures in making that judgment. An insignificant delay or insignificant shortfall in amount of payments does not require application of [FASB Statement No. 114]. A loan is not impaired during a period of delay in payment if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate for the period of delay. Thus, a demand loan or other loan with no stated maturity is not impaired if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate during the period the loan is outstanding.

the credit quality has changed from balance sheet to balance sheet. Similarly, AcSEC revised the disclosures to require certain information for loans within the scope of the SOP for which the income recognition model of the SOP is not being applied. Some identify such loans as loans on nonaccrual status. These disclosures are in addition to the disclosures of nonaccrual loans required by SOP 01-6, *Accounting by Certain Entities* (*Including Entities With Trade Receivables*) *That Lend to or Finance the Activities of Others* [section 10,850]. AcSEC does not prohibit disclosure of additional information that describes the difference between the contract balance and the carrying amount.

B-61. *Accounting policies.* Although AcSEC does not provide guidance in this SOP on whether and how to consider prepayments, AcSEC believes they should be treated consistently for projected contractually required cash flows and cash flows expected to be collected, as well as actual and expected prepayments, such that the nonaccretable difference is not affected. Accordingly, the accounting policy should describe how prepayments were considered.

B-62. *FASB Statement No. 114 disclosures.* As addressed in paragraph .15 of this SOP, AcSEC concluded that information about loans within the scope of this SOP should not be included in certain disclosures about impaired loans if the loan performs at least as well as expected at acquisition. AcSEC believes this approach is warranted given the focus of this SOP's recognition and measurement provisions on the investor's obtaining its originally expected yield on the loan. This approach is consistent with similar provisions in footnote 3 of FASB Statement No. 114, paragraphs 20 and 23 of FASB Statement No. 118, and the consensus in EITF Issue No. 96-22, *Applicability of the Disclosures Required by FASB Statement No. 114 When a Loan is Restructured in a Troubled Debt Restructuring into Two (or More) Loans.*

B-63. *Financial statement disclosures.* AcSEC believes that the accounting for acquired loans within the scope of this SOP is sufficiently different from the accounting for originated loans, particularly with respect to provisions for impairment and the potential for upside revisions in yield, such that the amount of loans accounted for in accordance with this SOP should be disclosed separately in the notes to financial statements. AcSEC believes that the disclosure for loans acquired during the period of the amounts of contractually required payments receivable, cash flows expected to be collected, and fair value for loans meeting the scope criteria of paragraph .03 of this SOP, as well as the carrying amount of those loans at acquisition date that are within the scope of this SOP for which the income recognition model in this SOP is not applied in accordance with paragraph .06, provides users of the financial statements with useful information about the credit quality of loans at acquisition, and a basis for comparison between companies that acquire such loans. AcSEC also believes that disclosure of changes in cash flows expected to be collected via the disclosure of reclassifications between nonaccretable difference and accretable yield provides the reader with valuable information about the performance of the acquired loan portfolio, including whether management has obtained or currently expects to obtain more or less than the cash flows originally expected to be collected. Further, AcSEC believes that disclosure of the balance sheet carrying amount of all loans within the scope of this SOP for which the income recognition model in this SOP is not applied provides users of financial information with a better indication of the quality of loans acquired.

Effective Date and Transition

B-64. Respondents indicated that transition requirements applying to loans acquired before the adoption date would be burdensome. Accordingly, AcSEC concluded that initial application of this SOP should be at the beginning of a fiscal year with restatement of previously issued financial statements prohibited. Because cash flows expected to be collected are based on estimates that are likely to change, AcSEC concluded that restatement would not be meaningful.

B-65. The exposure draft of this SOP proposed application to loans acquired before the adoption date, including loans acquired in a purchase business combination, and would have required transition adjustments. Specifically, benchmarks for yield and impairment measurements of such loans would have been based on the calculation of nonaccretable difference and accretable yield as of the adoption date rather than as of the date the investor acquired the loan. Several comment letters suggested the difficulty of distinguishing, as of the adoption date, loans that were originated from those that were acquired because the loans may not have been tracked separately in the accounting system. The difference in scope between this SOP and Practice Bulletin 6 [section 12,060] also posed challenges with requiring a "fresh start" approach as proposed in the exposure draft. For these reasons, AcSEC concluded that this SOP should be applied prospectively to loans acquired by completion of a transfer after the initial application of this SOP.

B-66. Loans within the scope of Practice Bulletin 6 [section 12,060] will continue to be accounted for in accordance with that guidance as amended. The issuance of FASB Statements No. 114 and No. 115 amended accounting for loan impairment, and accordingly, Practice Bulletin 6 [section 12,060], was in conflict with that guidance as the Bulletin provided for recognition of decreases in cash flows prospectively over the remaining life of the loan. This SOP, in paragraphs .07*a* and .08*a*, provides guidance for subsequent decreases in cash flows expected to be collected. To remove the conflict, AcSEC amended paragraph 15 of Practice Bulletin 6 [section 12,060.15] as described in Appendix C, *Amended Paragraphs of Practice Bulletin 6 [Section 12,060] to Show Changes Made by This Statement of Position* [paragraph .22].

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Appendix C

Amended Paragraphs of Practice Bulletin 6 [section 12,060] to Show Changes Made by This Statement of Position

C-1. Some accounting issues involving differences attributable to credit quality were addressed in Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans* [section 12,060]. However, as outlined in paragraph B-3 [paragraph .21] of this Statement of Position (SOP), the accounting for loss contingencies attributable to credit quality has subsequently changed. This SOP should be applied to loans acquired in fiscal years beginning after December 15, 2004. For loans acquired in fiscal years beginning on or before December 15, 2004, and within the scope of Practice Bulletin 6 [section 12,060], this SOP amends the application of Practice Bulletin 6 [section 12,060] for decreases in cash flows expected to be collected.

C-2. *Amended paragraph 2 of Practice Bulletin 6* [section 12,060.02]. Conforming changes are specifically noted by bold italicized or strike-through text.

> This practice bulletin addresses the accounting and reporting by purchasers of loans ***in fiscal years beginning on or before December 15, 2004*** (1) that are acquired in a purchase business combination, bought at a discount from face value in a transaction other than a business combination, or transferred to a newly created subsidiary after having been written down to fair value with the intent of transferring the stock of the subsidiary as a dividend to the shareholders of the parent company and (2) for which it is not probable that the undiscounted future cash collections will be sufficient to recover the face amount of the loan and contractual interest.

C-3. *Amended paragraph 15 of Practice Bulletin 6* [section 12,060.15]. For loans within the scope of Practice Bulletin 6 [section 12,060], investors should follow the guidance in paragraphs .07 and .08 of this SOP in accounting for decreases in cash flows expected to be collected. Conforming changes are specifically noted by bold italicized or strike-through text.

> Collectibility should continue to be evaluated throughout the life of the acquired loan. If, upon ***subsequent*** evaluation—
>
> - The estimate of the total probable collections is increased ~~or decreased but is still greater than the sum of the acquisition amount less collections plus the discount amortized to date and it is probable that collection will occur~~, the amount of the discount to be amortized should be adjusted accordingly. The adjustment should be accounted for as a change in estimate in accordance with APB Opinion 20, *Accounting Changes*, and the amount of periodic amortization adjusted over the remaining life of the loan.
> - ***For a loan not accounted for as a debt security,*** the estimate of amounts probable of collection is reduced and ~~it is less than the acquisition amount less collections plus the discount amortized to date, amortization should cease, and either~~ the loan should be ~~written down or an allowance for uncollectibility relating to that loan should be recognized~~ ***considered impaired for purposes of applying the measurement and other provisions of FASB Statement No. 5,*** **Accounting for Contingencies*, or, if applicable, FASB Statement of Accounting Standards No. 114,* Accounting by Creditors for Impairment of a Loan.**

- ***For a loan accounted for as a debt security, the fair value of the debt security has declined below its amortized cost basis, the acquirer should determine whether the decline is other than temporary. An acquirer should apply the impairment of securities guidance in paragraph 16 of FASB Statement No. 115,* Accounting for Certain Investments in Debt and Equity Securities.**

- It is not possible to estimate the amount and timing of collection, amortization should cease, and the cost-recovery method should be used as described in paragraph .17 below.

- It is determined that collection is less than probable, amortization should cease, either the loan should be written down or an allowance for uncollectibility related to that loan should be recognized, and the cost-recovery method should be used as described in paragraph .17 below.

- It is determined that the loan is held primarily for the rewards of ownership of the underlying nonmonetary collateral, the collateral should be accounted for in accordance with the guidance on ADC arrangements in AcSEC Practice Bulletin 1.

C-4. *New paragraphs for transition and effective date of Practice Bulletin 6* [section 12,060]. Additions are specifically noted by bold italicized. The following paragraphs follow paragraph 18 of Practice Bulletin 6 [section 12,060.18].

Transition and Effective Date

This Practice Bulletin is amended by SOP 03-3,* Accounting for Certain Loans or Debt Securities Acquired in a Transfer, *for decreases in estimated cash flows. The amendments should be applied prospectively for fiscal years beginning after December 15, 2004.

This Practice Bulletin is effective for loans purchased in fiscal years beginning on or before December 15, 2004. Loans acquired in fiscal years beginning after December 15, 2004, should be accounted for in accordance with SOP 03-3. For loans purchased in fiscal years beginning on or before December 15, 2004, all guidance in this practice bulletin is applicable, as amended, for fiscal years beginning after December 15, 2004.

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Glossary

This glossary defines terms and phrases used in this Statement of Position (SOP).

Accretable yield. The excess of a loan's cash flows expected to be collected over the investor's initial investment in the loan.

Amortized cost. The sum of (1) the initial investment *less* (2) cash collected *less* (3) write-downs *plus* (4) yield accreted to date.

Cash flows expected at acquisition. The investor's estimate, at acquisition, of the amount and timing of undiscounted principal, interest, and other cash flows expected to be collected.[1] This would be the investor's best estimate of cash flows, including the effect of prepayments if considered, that is used in determining the acquisition price, and, in a business combination, the investor's estimate of fair value for purposes of acquisition price allocation.[*]

Common risk characteristics. For purposes of applying this SOP, loans with similar credit risk (for example, evidenced by similar Fair Isaac Company [FICO] scores, an automated rating process for credit reports) or risk ratings, and one or more predominant risk characteristics, such as financial asset type, collateral type, size, interest rate, date of origination, term, and geographic location, should be considered to have common risk characteristics.

Completion of a transfer. Completion of a transfer (1) that satisfies the conditions in paragraph 9 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, to be accounted for as a sale; (2) in a purchase business combination;[†] or (3) to a newly created subsidiary if the transferee has written the loan down to its fair value with the intent of transferring the stock of the subsidiary as a dividend to the shareholders of the parent company; or (4) that is a contribution receivable or a transfer that satisfies a prior promise to give.

Contractually required payments receivable. The total undiscounted amount of all uncollected contractual principal and contractual interest payments both past due and scheduled for the future, adjusted for the timing of prepayments, if considered, less any reduction[2] by the investor.

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[1] One acceptable method of making this estimate is described in paragraphs 42 through 54 of FASB Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, which discusses the use of an expected cash flow approach.

[*] Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141 (revised 2007), *Business Combinations*, should be applied and accounted for under the acquisition method. In a business combination this would be the investor's estimate of fair value for purposes of assignment in accordance with FASB Statement No. 141(R). [Footnote added, May 2008, due to the issuance of FASB Statement No. 141(R).]

[†] Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141(R) should be applied and accounted for under the acquisition method. [Footnote added, May 2008, due to the issuance of FASB Statement No. 141(R).]

[2] This Statement of Position does not address when an investor should record a direct write-down of an impaired loan.

For an acquired asset-backed security (ABS) with required contractual payments of principal and interest, the "contractually required payments receivable" is represented by the contractual terms of the security. However, when contractual payments of principal and interest are not specified by the security, the investor should look to the contractual terms of the underlying loans or assets.

Fair value. Refer to paragraphs 68 through 70 of FASB Statement No. 140.

Initial investment. The amount paid to the seller plus any fees paid or less any fees received.[3] In a business combination accounted for as a purchase,[†] the allocation of fair value to loans or groups of loans should be in accordance with FASB Statement No. 141, *Business Combinations*.

Loan. As defined in paragraph 4 of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*:

> [A] contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. Examples include but are not limited to accounts receivable (with terms exceeding one year) and notes receivable.

This definition encompasses loans accounted for as *debt securities* (as defined in paragraph 137 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*).

Nonaccretable difference. A loan's contractually required payments receivable in excess of the amount of its cash flows expected to be collected.

Outstanding balance. For loans that have a net carrying amount, the undiscounted sum of all amounts, including amounts deemed principal, interest, fees, penalties, and other under the loan, owed to the investor at the reporting date, whether or not currently due and whether or not any such amounts have been written or charged off by the investor. Amounts forgiven in a debt restructuring but contingently payable to the investor should be included in the forgiven contract balance, but amounts irrevocably forgiven in a debt restructuring should not be included. Amounts payable to the investor in cash, in kind, and by any other means should be included. Amounts legally discharged should not be included. The outstanding balance does not include amounts that would be accrued under the contract as interest, fees, penalties, and other after the reporting date.

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[3] Only certain fees paid are included in the initial investment in a purchased loan. Paragraph 36 of FASB Statement on Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases*, explains that "designation of a fee or cost as an origination fee or cost for a loan that is purchased is inappropriate because a purchased loan has already been originated by another party." Also, the answer to question 39 in the FASB Special Report, *A Guide to Implementation of Statement 91 on Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases: Questions and Answers*, explains that:

> fees paid to an independent third party, or incurred internally, for portfolio management or investment consultation...are considered "other costs incurred in connection with acquiring purchased loans or committing to purchase loans" because they constitute investment advisory costs, not loan origination costs. Therefore, such costs should be charged to expense in accordance with paragraph 15 [of FASB Statement No. 91] whether the costs are paid to independent third parties or incurred internally.

[†] Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141(R) should be applied and accounted for under the acquisition method. [Footnote added, May 2008, due to the issuance of FASB Statement No. 141(R).]

Probable. As defined in paragraph 10 of FASB Statement No. 114 (*emphasis in original*):

> The term *probable* is used in this Statement consistent with its use in [FASB Statement No. 5, *Accounting for Contingencies*], which defines probable as an area within a range of the likelihood that a future event or events will occur confirming the fact of the loss. That range is from probable to remote, as follows:
>
> > *Probable.* The future event or events are likely to occur.
> >
> > *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.
> >
> > *Remote*. The chance of the future event or events occurring is slight.
>
> The term *probable* is further described in paragraph 84 [of FASB Statement No. 5], which states:
>
> > The conditions for accrual in paragraph 8 [of FASB Statement No. 5] are not inconsistent with the accounting concept of conservatism. *These conditions are not intended to be so rigid that they require virtual certainty before a loss is accrued.* [*Emphasis added*.] They require only that it be *probable* that an asset has been impaired or a liability has been incurred and that the amount of loss be *reasonably* estimable. [*Emphasis in original*.]

Revolving privileges. A feature in a loan that provides the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and to then reborrow under the same loan.

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[The next page is 81,201.]

Section 10,890

Statement of Position 03-4 Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies *and AICPA Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships

December 29, 2003

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) provides guidance on the application of certain provisions of the AICPA Audit and Accounting Guide *Audits of Investment Companies* (the Guide) and AICPA SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships* [section 10,660], that are directed to the reporting by nonregistered investment partnerships of financial highlights and the schedule of investments. It amends certain provisions of the Guide and SOP 95-2 [section 10,660] by adapting those provisions to nonregistered investment partnerships based on their differences in organizational and operational structures from registered investment companies. This SOP provides that:

- Nonregistered investment partnerships should disclose the range of expiration or maturity dates and fair values of derivative instruments in the condensed schedule of investments based on whether the fair value

of a specific type of derivative and underlying (for example, equity index of a particular stock exchange, U.S. Treasury Bond, or natural gas) exceeds 5 percent of net assets, regardless of counterparty. For open futures contracts of a particular underlying, the disclosure should be based on appreciation (depreciation) rather than fair value and include the number of contracts outstanding.

- Funds-of-funds partnerships should provide certain qualitative disclosures (the investment objective and restrictions on redemption) in addition to the name of the investment for each investment in a nonregistered investment partnership for which the fair value exceeds 5 percent of net assets.
- Nonregistered investment partnerships should calculate average net assets (ANA) by using the fund's weighted ANA (as measured at each accounting period or periodic valuation) adjusting for capital contributions or withdrawals occurring between accounting periods.
- Nonregistered investment partnerships should calculate the denominator of their expense and net investment income ratios based on ANA.
- Nonregistered investment partnerships in which the majority of the expenses are based on committed capital should provide additional disclosures in the financial statements of the total committed capital of the partnership, the year of formation of the partnership, and the ratio of the total contributed capital to committed capital.
- Funds-of-funds and master-feeder funds should calculate net investment income and expense ratios based on the net investment income and expenses reported in the statement of operations.
- Nonregistered investment partnerships, other than those that meet certain criteria as indicated in the next bullet, should calculate and disclose as a financial highlight an annual total rate of return based on a geometric linking of performance for each discrete period within a year for which invested capital is constant.
- Nonregistered investment partnerships that meet the criteria by the terms of their offering document, as indicated in the next sentence, should calculate and disclose as a financial highlight an internal rate of return since inception for the current and prior accounting period. The partnership criteria are that the partnerships (1) have limited lives, (2) do not continuously raise capital and are not required to redeem their interests upon investor request, (3) have as a predominant operating strategy the return of the proceeds from disposition of investments to investors, (4) have limited opportunities, if any, for investors to withdraw prior to termination of partnership, and (5) do not routinely acquire (directly or indirectly) market-traded securities or derivatives as part of their investment strategy.

This SOP is effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application, except for the provisions to require certain nonregistered investment partnerships to compute and disclose internal rate of return from inception (IRR). The provisions to require certain nonregistered investment partnerships to compute and disclose IRR are effective for annual financial statements issued for fiscal years beginning after December 15, 2003, with early application encouraged. Presentation of previously issued financial highlights is not required; however, if comparative financial highlights are presented, the presentation should be on a comparable basis.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least 10 of AcSEC's 15 members, and (3) a proposed final document that has been approved by at least 10 of AcSEC's 15 members. The document is cleared if at least four of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing a final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Introduction and Background

.01 Historically, the guidance in the AICPA Audit and Accounting Guide *Audits of Investment Companies* (the Guide) has been related principally to investment companies registered under the Investment Company Act of 1940 (the 1940 Act) and similar entities. The most recent comprehensive review and revision of the Guide, completed in November 2000, made substantial changes to clarify the differences in accounting and reporting by registered investment companies and nonregistered investment partnerships (for example, explicitly distinguishing the extent of financial statement disclosures required under generally accepted accounting principles (GAAP) and Securities and Exchange Commission (SEC) requirements).

.02 Nonregistered investment partnerships, nonetheless, continue to raise questions as to the application of certain provisions of the Guide, principally because of the differences between the operating structures of nonregistered investment partnerships and registered investment companies.

.03 In particular, those questions relate to paragraphs 7.65 and 7.68 of the Guide, which address the presentation of financial highlights.

.04 In January 2002, AICPA issued Technical Practice Aids (TPAs)[1] to assist practitioners on a timely basis in computing and presenting financial highlights in accordance with the Guide's requirements. The TPAs were limited

[1] TPAs No. 6910.04 through 6910.10 are rescinded upon the effective date of this SOP.

to clarifying the application of the provisions of the Guide to nonregistered investment partnerships rather than modifying the requirements of the Guide.

.05 However, implementation of the TPAs revealed issues, particularly for limited-life, nonregistered investment partnerships, regarding the relevance of the expense and total return ratios. The industry asserted that the methods required to calculate certain financial highlights were not well suited for these partnerships due to their operational structure, and that the implementation of the provisions of the Guide may have resulted in disclosing information that is either irrelevant or in a format that investors cannot easily understand. In particular, some have asserted that the geometric linking method of computing total return (as required by paragraph 7.68(*c*) of the Guide and discussed in TPA section 6910.10) at times can produce what are viewed as misleading results for those funds.

.06 Paragraph 7.12 of the Guide requires disclosure of derivative positions exceeding 5 percent of net assets based on their fair value. Questions have been raised as to whether the fair value of a derivative position is always the best determinant of whether information about that position should be presented in the schedule of investments, or whether other determinants, such as notional amounts, for certain kinds of derivative positions would result in more useful reported information. Questions also have been raised as to whether derivatives with the same underlying but different counterparties or expiration or delivery dates should be aggregated.

.07 Furthermore, AcSEC believes that disclosing only the names of other nonregistered investment partnerships in which the reporting partnership has invested provides little, if any, meaningful information to the financial statement user and thus believes that a qualitative description of the investee's principal investment objectives (including any particular specialization) should provide information that would allow for a better understanding of the nature of the investment.

.08 The purpose of this SOP is to provide guidance to clarify the application of certain provisions of the Guide to nonregistered investment partnerships.

Applicability and Scope

.09 This SOP applies only to nonregistered investment partnerships that are within the scope of the Guide. Footnote 13 to paragraph 7.12 of the Guide is amended as follows to clarify that only certain brokers and dealers in securities under the Securities Exchange Act of 1934 (the Exchange Act) are excluded from the requirement of paragraph 7.12. Inserts are shown in italics and underlined; deletions are shown with strikethrough.

> Included are **hedge funds**, limited liability companies, limited liability partnerships, limited duration companies, and offshore investment companies with similar characteristics, and commodity pools subject to regulation under the Commodity Exchange Act of 1974. Excluded are investment partnerships ~~that are~~ *regulated as* brokers and dealers in securities ~~subject to regulation~~ under the Securities Exchange Act of 1934 (registered broker-dealers) ~~and~~ that manage funds only for those who are officers, directors, or employees of the general partner.

Conclusions

.10 Paragraph 7.12 of the Guide and paragraph 11 of SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships* [section 10,660.11] (as amended by SOP 01-1, *Amendment to Scope of Statement of Position 95-2*, Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools* [section 10,820]) (refer to Appendix B [paragraph .19], "Effect on Other Pronouncements," for the changes to SOP 95-2 [section 10,660]), which provide guidance relative to the condensed schedule of investments, are amended by adding the guidance shown in italics and underlined.

Schedule of Investments

7.12 Investment partnerships[13] that are exempt from SEC registration under the Investment Company Act of 1940 (the 1940 Act) should:

a. Categorize investments by the following:

1. Type (such as common stocks, preferred stocks, convertible securities, fixed-income securities, government securities, options purchased, options written, warrants, futures, loan participations, short sales, other investment companies, and so forth).
2. Country or geographic region.
3. Industry.

Report the percent of net assets that each such category represents and the total value and cost for each category in (*a*)(1) and (*a*)(2). *Derivatives for which the underlying is not a security should be categorized by broad category of underlying (for example, grains and feeds, fibers and textiles, foreign currency, or equity indices) in place of categories (a)(2) and (a)(3).*

b. Disclose the name, shares or principal amount, value, and type of the following:

1. Each investment (including short sales), constituting more than 5 percent of net assets, *except for derivative instruments as discussed in items (d) and (e) below.*
2. All investments in any one issuer aggregating more than 5 percent of net assets, *except for derivative instruments as discussed in items (d) and (e) below.*

In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.

c. Aggregate other investments (each of which is 5 percent or less of net assets) without specifically identifying the issuers of such investments and categorize them as required by item (*a*) above.

d. Disclose the number of contracts, range of expiration dates, and cumulative appreciation (depreciation) for open futures contracts of a particular underlying (such as wheat, cotton, specified equity index, or U.S. Treasury Bonds), regardless of exchange, delivery location, or delivery date, if cumulative appreciation (depreciation) on the open contracts exceeds 5 percent of net assets.

In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.

e. Disclose the range of expiration dates and fair value for all other derivatives (such as forwards, swaps [such as interest rate and currency swaps], and options) of a particular underlying (such as foreign currency, wheat, specified equity index, or U.S. Treasury Bonds), regardless of counterparty, exchange, or delivery date, if fair value exceeds 5 percent of net assets.

In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.

f. *Provide the following additional qualitative description for each investment in another nonregistered investment partnership whose fair value constitutes more than 5 percent of net assets:*

- *The investment objective.*
- *Restrictions on redemption (that is, liquidity provisions).*

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[13] Included are hedge funds, limited liability companies, limited liability partnerships, limited duration companies, and offshore investment companies with similar characteristics, commodity pools subject to regulation under the Commodity Exchange Act of 1974. Excluded are investment partnerships ~~that are~~ *regulated as* brokers and dealers in securities ~~subject to regulation~~ under the Securities Exchange Act of 1934 (registered broker-dealers) ~~and~~ that manage funds only for those who are officers, directors, or employees of the general partner.

.11 Paragraph 7.65 of the Guide, which requires disclosure of financial highlights, is amended by adding the guidance shown in italics and underlined to clarify how nonregistered investment partnerships should interpret the terms *classes*, *units*, and *theoretical investment* when reporting financial highlights. Additionally, the paragraph is amended to indicate that nonregistered investment partnerships should disclose financial highlights of each class of common shares of nonmanaging investors in the general-purpose financial statements.

Financial Highlights

7.65 Financial highlights (see paragraph 7.01) should be presented either as a separate schedule or within the notes to the financial statements for each class of common shares outstanding. Per share amounts presented are based on a share outstanding throughout each period presented. Investment companies with multiple classes of shares may present financial highlights only for those classes of shares that are included in reports to such shareholders. In such cases, the investment company should include appropriate disclosures related to all classes so as to ensure that the financial statements are complete (for example, detail of capital share activity in the statement of changes in net assets or notes to financial statements). *Nonregistered investment partnerships should disclose per share data for all common classes in general-purpose financial statements. However, it is permissible for financial highlights to be presented only for those classes of shares that are included in reports to those classes.*

Nonregistered investment partnerships, when disclosing financial highlights, should interpret the terms classes, units, and theoretical investments as follows:

a. Classes. *Only the classes related to the nonmanaging investors (that is, classes of investors that do not consist exclusively of managing investor interests) are considered to be the common interests requiring financial highlight disclosure. Nonregistered investment funds typically have two classes of ownership interest, with one class being the management interest in the fund and the other being the investment interest. For unitized funds (that is, funds with units specifically called for in the governing underlying legal or offering documents), the management interest usually is a voting class and the investment interest is a nonvoting class. Temporary series of shares (that is, shares that are intended at the time of issuance to be consolidated at a later date with another specified series of shares that remains outstanding indefinitely) are not considered separate classes. Permanent series of a class of share should be the basis for which that share's financial highlights are determined and presented. For nonunitized funds, the management interest usually is the general partner class and the investment interest usually is the limited partner class. Generally, a class has* *certain rights as governed by underlying legal documents or offering documents and local law. Rights to certain investments that do not otherwise affect the rights available under the underlying legal documents and local law do not ordinarily represent a separate share class. For example, rights to income and gains from a specific investment attributed solely to investors at the date the investment is made (side-pocket investments) are not considered to give rise to a share class. Similarly, a temporary series of shares is not considered a share class.*

b. Units. *Only funds with units specifically called for in the governing underlying legal or offering documents should be considered unitized. Some funds may employ units for convenience in making allocations to investors for internal accounting or bookkeeping purposes, but the units are not required or specified by legal or offering documents, and for all other purposes operate like nonunitized investment partnerships. For per share operating performance, those funds are not considered unitized. If a fund is not unitized, only investment returns (either total return or internal rate of return) and net investment income and expense ratios are required to be disclosed as indicated in paragraphs 7.67 and 7.68.*

c. Theoretical investment. *The term theoretical investment in paragraph 7.68(c) should be considered as the actual aggregate amount of capital invested by each reporting class of investor as of the beginning of the fiscal reporting period, adjusted for cash flows related to capital contributions or withdrawals during the period.*

.12 Paragraph 7.66 of the Guide, which requires per share information to be disclosed as financial highlights, is amended by adding the guidance shown in italics and underlined.[2]

7.66 The following per share information should be presented for registered investment companies and for investment companies that compute unitized net asset value (a more detailed discussion of calculation methods for registered investment companies may be found in the instructions for preparation of registration statements on Forms N-1A and N-2). *Nonregistered investment partnerships that compute unitized net asset value should disclose information for each reporting share class related to nonmanaging investors. The information should be disclosed for each major category affecting net asset value per share (as shown in the statement of operations and statement of changes in net assets of the fund). The caption descriptions in the per share data should be the same captions used in the statement of operations and statement of changes in net assets to allow the reader to determine which components of operations are included in or excluded from various per share data.*

a. Net asset value at the beginning of the period.

b. Per share net investment income or loss, which, for registered investment companies, is calculated in accordance with the requirements of Form N-1A or N-2. Other methods, such as dividing net investment income by the average or weighted average number of shares outstanding during the period, are acceptable. If used by a registered investment company, the method employed must be disclosed in a note to the table in conformity with SEC requirements.

c. Realized and unrealized gains and losses per share, which are balancing amounts necessary to reconcile the change in net asset value per share with

[2] SOP 03-5, *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies [section 10,900] also amends paragraph 7.66 of the Guide.

the other per share information presented. The amount shown in this caption might not agree with the change in aggregate gains and losses for the period. If such is the case, the reasons should be disclosed.

d. Total from investment operations, which represents the sum of net investment income or loss and realized and unrealized gain or loss.

e. Distributions to shareholders should be disclosed as a single line item except that tax return of capital distributions should be disclosed separately. Details of distributions should conform to those shown in the statement of changes in net assets.

f. Purchase premiums, redemption fees, or other capital items.

g. Payments by affiliates (paragraphs 7.49 through 7.51).

h. Net asset value at the end of the period.

i. Market value at the end of the period (Form N-2 registrants only).

.13 Paragraph 7.67 of the Guide, which provides guidance as to the disclosure of the expense and net investment income ratios, is amended by adding the guidance shown in italics and underlined:

7.67 Ratios of expenses and net investment income to average net assets are generally annualized for periods less than a year. The ratio of expenses to average net assets should be increased by brokerage service and expense offset arrangements (see paragraphs 7.40 and 7.41).

a. When determining expense and net investment income ratios, nonregistered investment partnerships should calculate average net assets (ANA) by using the fund's (or class's) weighted-average net assets as measured at each accounting period or periodic valuation (for example, daily, weekly, monthly, quarterly), adjusting for capital contributions or withdrawals from the fund occurring between accounting periods or valuations. (This provision is not intended to require any additional interim accounting period or periodic valuation date beyond that which may be provided in offering or organizational documents of the partnership.)

The expense and net investment income ratios should be calculated by nonregistered investment partnerships based on the expenses allocated to each common or investor class (for example, the limited partner class) prior to the effects of any incentive allocation. Adequate disclosure should be made to indicate that the net investment income ratio does not reflect the effects of any incentive allocation. Expenses directly related to the total return of the fund, such as incentive fees, and nonrecurring expenses, such as organizational costs, should not be annualized when determining the expense ratio. Disclosure should be made of the expenses that have not been annualized.

Generally, the determination of expenses for computing those ratios should follow the presentation of expenses in the fund's statement of operations. Accordingly, if the manager's or general partner's incentive is structured as a fee rather than an allocation of profits, the incentive fee would be factored into the computation of an expense ratio. Because an incentive allocation of profits is not presented as an expense, it should not be considered part of the expense ratio. However, to avoid potentially significant inconsistencies in ratio presentations based solely on the structuring of incentives as fees or allocations, all incentives should be reflected in the disclosure of financial highlights. See paragraph 7.87 for an example of that disclosure.

Additionally, for the expense ratio, disclosure should be made of the effect of any agreement to waive or reimburse fees and expenses to each reporting class as a whole, as described in paragraph 7.38, and of expense offsets, as described in paragraphs 7.40 and 7.41. Agreements to waive a portion or all of certain fees to a specific investor, which do not relate to the share class as a whole, do not require disclosure in the financial highlights. However, as ratios are calculated for each common class taken as a whole, the financial statements should disclose that an individual investor's ratio may vary from those ratios.

b. Investment companies that obtain capital commitments from investors and periodically call capital under those commitments to make investments (principally limited-life, nonregistered investment partnerships) should disclose in the financial highlights or in a note to the financial statements the total committed capital of the partnership (including general partner), the year of formation of the entity, and the ratio of total contributed capital to total committed capital.

c. Funds-of-funds should compute the expense and net investment income ratios using the expenses presented in the fund's statement of operations. Therefore, funds-of-funds typically should compute these ratios based on the net investment income and expense items at the fund-of-funds level only. Adequate disclosure should be made so that it is clear to users that the ratios do not reflect the funds-of-funds' proportionate share of income and expenses of the underlying investee funds. In a master-feeder structure, the feeder should include its proportionate share of the income and expenses of the master when computing the ratios at the feeder level. If, in a master-feeder structure, an incentive is levied as an allocation at the master level, the feeder should present its share of the incentive allocation as a separate line item in the statement of operations.

.14 Paragraph 7.68 of the Guide, which provides guidance relative to total return disclosure in the financial highlights, is amended by adding the guidance shown in italics and underlined.

7.68 Total return is required to be presented for all investment companies (for interim periods, the disclosure should include whether or not total return is annualized), and should be computed as follows:

a. For nonregistered investment companies organized in a manner utilizing unitized net asset value and for N-1A registrants, based on the change in the net asset value per share during the period, and assuming that all dividends are reinvested.

b. For Form N-2 registrants, based on change in market value of the fund's shares taking into account dividends reinvested in accordance with the terms of the dividend reinvestment plan or, lacking such a plan, at the lesser of net asset value or market price on the dividend distribution date. (Total investment return computed based on net asset value per share may also be presented if the difference in results between the two calculations is explained.)

c. For investment companies not utilizing unitized net asset value, including investment partnerships, based on the change in value during the period of a theoretical investment made at the beginning of the period. *The change in value of a theoretical investment is measured by comparing the aggregate ending value of each class of investor with the aggregate beginning value of each such class, adjusted for cash flows related to capital contributions or withdrawals during the period.*

If capital cash flows occur during the reporting period, returns are geometrically linked based on capital cash flow dates. In general, geometrically linking requires the computation of performance for each discrete period within a year in which invested capital is constant (that is, for each period between investor cash flow dates), then multiplying those performance computations together to obtain the total return for a constant investment outstanding for the entire year.

Because incentive allocations or fees may vary among investors within a class, total return for reporting classes subject to an incentive allocation or fee should report total return before and after the incentive allocation or fee for each reporting class taken as a whole. The effect of incentive allocations on total return is computed on a weighted-average aggregate capital basis. That results in an incentive computation less than the maximum if, for example, certain partners had loss carryovers at the beginning of the period. See paragraph 7.89 for an example of that total return calculation and related disclosures.

d. Investment companies, as defined in paragraphs 1.03 through 1.06, that by the terms of their offering documents (1) have limited lives, (2) do not continuously raise capital and are not required to redeem their interests upon investor request (obtaining initial capital commitments from investors at time of organization and subsequently drawing on those commitments to make investments is not considered "continuous" for this purpose), (3) have as a predominant operating strategy the return of the proceeds from disposition of investments to investors, (4) have limited opportunities, if any, for investors to withdraw prior to termination of the entity, and do not routinely acquire (directly or indirectly) as part of their investment strategy market-traded securities and derivatives (as described in paragraphs 2.30 through 2.33). should, instead of disclosing annual total returns before and after incentive allocations and fees, disclose the internal rate of return since inception (IRR) of the investment company's cash flows and ending net assets at the end of the period (residual values) as presented in the financial statements, net of all incentive allocations or fees, to each investor class, as of the beginning and end of the period. A footnote to the financial highlights should disclose that the IRR is net of all incentives. The IRR should be based on a consistent assumption, no less frequently than quarterly, as to the timing of cash inflows and outflows (for example, on actual cash-flow dates or cash inflows at the beginning of each month or quarter and cash outflows at the end of each month or quarter). All significant assumptions should be disclosed in the footnotes to the financial highlights. See paragraph 7.88 for an example of an IRR calculation and related disclosures.

.15 Paragraphs 7.87 through 7.89 are added to provide illustrative examples for calculating and disclosing certain financial highlights by nonregistered investment partnerships:

Illustrations of Calculations and Disclosures When Reporting Expense and Net Investment Income Ratios

7.87 The following are illustrations of average net assets (ANA) computations related to determining expense and net investment income ratios, in which there are various capital flows, assuming a single class of investment interest. Other ANA computation methods (for example, summing and averaging monthly net assets, including the beginning and ending net assets for the year, or a method that also weights ending net assets) are also appropriate if the result is reasonable and consistently applied.

Example 1: Computation of average net assets in a nonregistered investment partnership that allows quarterly contributions and distributions and has quarterly accounting periods (that is, capital can flow in and out only at these times):

Net assets at the beginning of the period:	$100,000,000 x 3/12 =	$ 25,000,000
Valuation adjustment of $10 million and capital contribution of $25 million at April 1, 2002:	$135,000,000 x 3/12 =	$ 33,750,000
Valuation adjustment of $(5) million, capital contribution of $10 million, and capital withdrawals of $30 million at July 1, 2002:	$110,000,000 x 3/12 =	$ 27,500,000
Valuation adjustment of $20 million, capital contribution of $15 million, and capital withdrawals of $25 million at October 1, 2002:	$120,000,000 x 3/12 =	$ 30,000,000
Average net assets		$116,250,000

Example 2: Computation of average net assets in a nonregistered investment partnership that does not have predetermined accounting periods (that is, capital can be called and distributed at any time), with significant write-up in fair value during the year:

Net assets at the beginning of the period:	$100,000,000 x 2/12 =	$ 16,666,667
$25m Capital call at February 28, 2002:	$125,000,000 x 1/12 =	$ 10,416,667
$20m Write-up at March 31, 2002:	$145,000,000 x 6/12 =	$ 72,500,000
$55m Capital call at September 30, 2002:	$200,000,000 x 1/12 =	$ 16,666,667
$25m Distribution at October 31, 2002:	$175,000,000 x 2/12 =	$ 29,166,667
Average net assets		$145,416,668

Disclosure for Incentive and Allocation Fees

For incentive fee:	
Operating (and interest/short dividends) expense	2.25%
Incentive fee	7.35%
Total expenses	9.60%
For incentive allocations:	
Operating (and interest/short dividends) expense	2.25%
Incentive allocation	7.35%
Total expenses and incentive allocation	9.60%

The expense ratio (expense and incentive allocation ratio) is calculated for each common class taken as a whole. The computation of such ratios based on the amount of expenses and incentive fee or incentive allocation assessed to an individual investor's capital may vary from these ratios based on different management fee and incentive arrangements (as applicable) and the timing of capital transactions.

Illustration of Calculation and Disclosure When Reporting the Total Return Ratio

7.88 The following is an illustration of how to compute Internal Rate of Return since inception (IRR) for nonregistered investment partnerships that meet the criteria described in paragraph 7.68(*d*). Other nonregistered investment partnerships should calculate a total rate of return as described in paragraph 7.68(*c*) and illustrated in paragraph 7.89.

The following illustrates how an IRR is computed by a limited-life nonregistered investment partnership, from the perspective of the investor, at the end of its first and second years of operations. The formula used to compute the IRR is $0 = CF_0 + (CF_1/(1+IRR)) + (CF_2/(1+IRR)^2) + \ldots + (CF_T/(1+IRR)^T)$.

Assume that Year 01 activity includes an initial investment (capital contribution) on January 1 of $1,000,000, $50,000 of appreciation (profit) reported on March 31, an additional capital contribution of $1,000,000 on April 1, additional appreciation of $80,000 reported on June 30, a distribution of $500,000 on July 1, and depreciation (loss) of $30,000 reported on December 31, resulting in a residual value on December 31, 01 of $1,600,000. The "residual value," the ending net assets at the end of the period and considered a theoretical distribution, is calculated as follows: $1,000,000 (initial capital contribution) plus $1,000,000 (additional capital contribution) minus $500,000 (cash distribution) plus the net gain of $100,000 (50,000 + 80,000 – 30,000) equals $1,600,000.

Assume that Year 02 activity includes: $150,000 of appreciation (profit) reported on March 31, a capital contribution of $500,000 on April 1, $350,000 of additional appreciation (profit) reported on June 30, $150,000 of additional appreciation (profit) reported on September 30, a distribution of $300,000 on December 14, and $150,000 of depreciation (loss) reported on December 31, resulting in a residual value on December 31, 02 of $2,300,000 (calculated the same way as in Year 01).

					IRR Cash Flows	
Date	*Description*	*Capital Call*	*Cash Distribution*	*Residual Value*	*Through 12/31/01*	*Through 12/31/02*
1-Jan-01	Initial contribution	1,000,000			(1,000,000)	(1,000,000)
1-Apr-01	Additional capital contribution	1,000,000			(1,000,000)	(1,000,000)
1-Jul-01	Cash distribution		500,000		500,000	500,000
31-Dec-01	Residual Value			1,600,000	1,600,000	N/A
1-Apr-02	Additional capital contribution	500,000				(500,000)
14-Dec-02	Distribution		300,000			300,000
31-Dec-02	Residual Value			2,300,000		2,300,000
		IRR through December 31, '01			6.69%	
		IRR through December 31, '02				16.68%

The following illustrates the note disclosure of the IRR by the limited-life nonregistered investment partnership at the end of the second year of operations based on the assumptions outlined above.

Note X—Financial Highlights

The Internal Rate of Return since inception (IRR) of the Limited Partners, net of all fees and profit allocations (carried interest) to the manager (general partner), is 6.7% through December 31, 01 and 16.7% through December 31, 02.

The IRR was computed based on the actual dates of the cash inflows (capital contributions), outflows (cash and stock distributions), and the ending net assets at the end of the period (residual value) of the Limited Partners' capital account as of each measurement date.

7.89 The following are illustrations of how to compute the total return ratio for nonregistered investment partnerships as required by 7.68(*c*):

Example 1: The following are illustrations of how a geometrically linked cash flow is computed assuming a beginning equity of $1,000,000, a capital contribution of $1,000,000 on April 1, and a capital withdrawal of $500,000 on July 1:

					Percent Return		
Period	*Cash Flows*	*Beginning Equity*	*Period Return*	*Ending Equity*	*Period*	*Year to Date*	*Year to Date Formula*
1/1–3/31		1,000,000	50,000	1,050,000	5.00%	5.00%	(1+.05)-1
4/1–6/30	1,000,000	2,050,000	80,000	2,130,000	3.90%	9.10%	[(1+0.05)*(1+0.0390)]-1
7/1–12/31	(500,000)	1,630,000	(30,000)	1,600,000	(1.84)%	7.09%	[(1+0.0910)*(1-0.0184)]-1

Example 2: The following is an illustration of a presentation of total return considering an incentive allocation or fee:

	Limited Partner or Common Class
Total return before incentive allocation/fee	7.09%
Incentive allocation/fee	(1.60%)
Total return after incentive allocation/fee	5.49%

Total return is calculated for each common class taken as a whole. An individual investor's return may vary from these returns based on participation in hot issues, private investments, different management fee and incentive arrangements (as applicable) and the timing of capital transactions.

.16 Paragraph 7.90 is added to provide an illustrative example of the condensed schedule of investments:

7.90 The following is an illustration of a condensed schedule of investments. Net assets are assumed to be $50,000,000.

Condensed Schedule of Investments*
December 31, 20XX

Principal Amount, Shares or No. of Contracts	*Description*	*Fair Value*
	COMMON STOCKS (54.9%)	
	United States (33.7%)	
	Airlines (7.2%)	
53,125	Flight Airlines, Inc.	$ 1,811,297
	Other (3.6%)	1,819,074
		3,630,371
	Banks (1.9%)	937,099
	Financial Services (2.9%)	1,433,210
	Foods (7.1%)	
106,607	Andrews Midlands Co.	2,825,078
	Other (1.4%)	702,824
		3,527,902

(continued)

Principal Amount, Shares or No. of Contracts	*Description*	*Fair Value*
100,404	Hospital Supplies and Services (5.6%)	
	Chelsea Clinics, Inc.	2,811,297
	Technology (4.1%)	2,039,578
	Utilities (4.9%)	2,480,556
	Total United States (cost $16,850,954)	16,860,013
	Hong Kong (5.8%)	
	Drugs (0.7%)	330,741
	Retail (4.0%)	1,984,445
	Utility Telephone (1.1%)	552,235
	Total Hong Kong (cost $2,756,959)	2,867,421
	Italy (5.6%)	
	Airlines (0.2%)	110,247
	Financial Services (1.8%)	881,975
	Leisure Related (3.5%)	1,763,951
	Office Supplies (0.1%)	55,123
	Total Italy (cost $2,912,465)	2,811,296
	Spain (5.4%)	
	Banks (2.4%)	1,212,716
	Oil (1.7%)	826,852
	Railroads (1.3%)	661,482
	Total Spain (cost $2,643,197)	2,701,050
	United Kingdom (4.4%)	
	Financial Services (2.3%)	1,157,593
	Technology (2.1%)	1,047,346
	Total United Kingdom (cost $2,145,246)	2,204,939
	TOTAL COMMON STOCKS (cost $27,308,821)	27,444,719
	DEBT SECURITIES (41.3%)	
	United States (21.4%)	
	Airlines (2.0%)	
$1,000,000	Flight Airlines Inc. 12%, 7/15/05	1,000,000
	Government (19.4%)	
$3,000,000	U.S. Treasury Bond, 4.50%, 11/15/07	3,031,791
	U.S. Treasury Bonds, 3.00%–4.75%, 1/30/05–7/15/07	6,686,175
		9,717,966
	Total United States (cost $15,015,200)	10,717,966

Principal Amount, Shares or No. of Contracts	*Description*	*Fair Value*
	Mexico (19.9%)	
	Government	
	United Mexican States, 8.625%–9.125% 3/12/08–12/7/09 (cost $10,000,000)	9,922,224
	TOTAL DEBT SECURITIES (cost $25,015,200)	20,640,190
	LONG PUT AND CALL OPTIONS (2.4%)	
	United States	
	Telecommunications (cost $1,225,800)	1,212,716
	INTEREST IN INVESTMENT PARTNERSHIP (10.0%) (cost $4,000,000)	5,000,000
	XYZ Hedge Fund LP (35% owned) (XYZ Hedge Fund LP owns 6,000 shares, valued $9,000,000 of Leisure Cruises Inc., which is a United States Company in the travel industry. The partnership's share of this investment is valued at $3,150,000 as of December 31, 20XX.)	
	TOTAL INVESTMENTS (108.6%) (COST $57,549,821)	$54,297,625
	SECURITIES SOLD SHORT (9.6%)	
	COMMON STOCKS (5.7%)	
	United States	
	Energy	
100,000	ABC Resources Co. (proceeds $2,715,000)	$2,825,078
	DEBT SECURITIES (3.7%)	
	Canada (3.7%)	
	Telecommunications (proceeds $1,950,000)	1,867,000
	WRITTEN OPTIONS (0.2%)	
	United States (0.2%)	
	Manufacturing (proceeds $130,000)	127,309
	TOTAL SECURITIES SOLD SHORT (proceeds $4,795,000)	$4,819,387

(continued)

Principal Amount, Shares or No. of Contracts	Description	Fair Value	Expiration Dates	No. of Contracts
	FUTURES CONTRACTS (12.5%)			
	Financial (5.2%)			
	Eurodollar (5.2%)	$ 2,611,825	Feb-Apr 200X	122
	Indices (5.6%)			
	S&P 500 (5.6%)	2,788,000	Mar-May 200X	89
	Metals (1.7%)	840,000		
	TOTAL FUTURES CONTRACTS	$ 6,239,825		
	FORWARDS (11.5%)			
	Argentinean Peso (5.8%)	$ 2,910,000	Oct-Nov 200X	
	Other currencies (5.7%)	2,876,315		
	TOTAL FORWARDS	$ 5,786,315		
	SWAPS (13.4%)			
	Interest rate swaps (5.7%)	$ 2,875,000		
	Currency swaps (7.7%)			
	Yen/US Dollar swaps (6.0%)	2,999,016	Jan-Feb 200X	
	Other (1.7%)	868,000		
	TOTAL SWAPS	$ 6,742,016		

The accompanying notes are an integral part of these financial statements.

* This schedule does not include the disclosures, relative to the investment objective and restrictions on redemption, required by amended paragraph 7.12*f* of the Guide (paragraph 10 of SOP 03-4) because it is presumed that those disclosures are presented in notes to the financial statements.

Effective Date and Transition

.17 The provisions of this SOP, except for the provisions to require certain nonregistered investment partnerships to compute and disclose IRR, are effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. The provisions to require certain nonregistered investment partnerships to compute and disclose IRR are effective for annual financial statements issued for fiscal years beginning after December 15, 2003, with early application encouraged. Nonregistered investment partnerships that do not early adopt the disclosure of IRR should disclose a total rate of return. Presentation of previously issued financial highlights is not required; however, if comparative financial highlights are presented, the presentation should be on a comparable basis.

The provisions of this Statement of Position need not be applied to immaterial items.

.18

Appendix A

Basis for Conclusions

A-1. This section discusses considerations that were deemed significant by the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position. In July 2003, AcSEC issued for public comment an exposure draft of a proposed SOP, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships. During the 60-day comment period, AcSEC received 12 comment letters.

Condensed Schedule of Investments

Additional Disclosures for Investments by Nonregistered Investment Partnerships in Other Nonregistered Investment Partnerships

A-2. AcSEC discussed whether disclosures in addition to those required by paragraph 7.12 of the AICPA Audit and Accounting Guide *Audits of Investment Companies* (Guide) and paragraph 11 of AICPA SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships* [section 10,660.11] (as amended by SOP 01-1, *Amendment to Scope of Statement of Position 95-2*, Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools* [section 10,820]), should be required for investments in nonregistered investment partnerships by funds-of-funds. Paragraph 7.12 of the Guide and paragraph 11 of SOP 95-2 [section 10,660.11]] require the presentation of a condensed schedule of investments in the financial statements of investment partnerships and require, among other items, disclosure in the condensed schedule of investments of *the name, shares or principal amount, value, and type* of each investment (including short sales), constituting more than 5 percent of net assets.

A-3. The hedge fund industry has seen the increasing use of investments in other nonregistered investment partnerships, particularly in the area of funds-of-funds. There is financial statement issuer, user, and regulatory concern over whether merely disclosing the name of a nonregistered investment partnership in an investment portfolio by itself provides meaningful information to the financial statement user. AcSEC believes that a qualitative description of the investee's principal investment objectives would allow for a better understanding of the nature of the investment.

A-4. One respondent commented that the qualitative disclosures are prohibited by the confidentiality terms of the underlying partnership agreements. The respondent believes the additional qualitative disclosures would allow competitors to have access to confidential information about the partnerships' holdings, which can then negatively affect both the value of such holdings as well as their possible disposition and therefore is likely to prove detrimental to an investor in obtaining access to top tier private equity firms.

A-5. AcSEC considered the respondent's concerns that the required disclosures in paragraph 10 of the SOP [section 10,660.10] (paragraph 7.12*f* of the Guide) are prohibited by the confidentiality terms of the underlying partnership agreements and that the disclosures would allow competitors to have access to confidential information. AcSEC concluded that the disclosure relative to the investment objective and the restrictions on redemption (liquidity provisions) should be disclosed because that information does not relate to specific investments or contractual terms, is typically included in offering documents made available to all prospective investors, and is not narrowly focused. However, AcSEC eliminated the requirement to disclose either the total amount of management fees and incentive allocations or fees borne indirectly during the period or the management fee and incentive allocations or fee rates applicable to the investment, because AcSEC believes that the two required qualitative disclosures would be sufficient to allow for a better understanding of the nature of the investment. The elimination of the requirement to disclose either the total amount of management fees and incentive allocations or fees borne indirectly during the period, or the management fee and incentive allocations or fee rates applicable to the investment does not exempt investment partnerships from disclosing management fees and incentive allocations that would be required to be disclosed under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 57, *Related Party Disclosures.*

A-6. AcSEC concluded that a qualitative description of each investee fund exceeding 5 percent of net assets should be included in the financial statements to permit the financial statement user to more fully understand the nature of the investment. The summary of qualitative disclosure may be made either in the schedule of investments, a note thereto, or in the notes to the financial statements.

Presentation of Derivatives in the Condensed Schedule of Investments

A-7. AcSEC discussed whether derivatives should be required to be presented in the condensed schedule of investments based on a method that would result in a consistent presentation of similar contracts by funds of similar size.

A-8. AcSEC observed that, upon the issuance of SOP 01-1 [section 10,820], which extended the requirements of SOP 95-2 [section 10,660] to many commodity pools registered with the Commodity Futures Trading Commission (CFTC), SOP 95-2 [section 10,660] was being applied to funds with much greater levels of derivatives activity than had previously been the case. Paragraph 7.12 of the Guide requires disclosure of derivative positions exceeding 5 percent of net assets based on their fair value. Questions have been raised as to whether the fair value of a derivative position is always the best determinant of whether information about that position should be presented in the schedule of investments, or whether other determinants, such as notional amounts, would result in more useful reported information.

A-9. AcSEC agreed that fair value of a derivative position is in most cases the appropriate measure of its significance. AcSEC noted that paragraph 512 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, concluded that disclosures of notional amounts should not be required, stating

> . . . although the face or contract amount of derivative instruments held provides some indication of derivatives activity, their usefulness for that purpose may be suspect given that some derivatives are commonly neutralized either by canceling the original derivative—which lowers the reported amount or by acquiring or issuing an offsetting derivative-which increases the reported amount.

However, AcSEC agreed that for open futures contracts of a particular underlying, cumulative appreciation (depreciation) is a better determinant of whether information about that position should be presented in the schedule of investments, because it results in a consistent presentation of similar contracts by funds of similar size.

A-10. AcSEC concluded that the information disclosed about derivative positions in the condensed schedule of investments should reflect the market risk of an investment company's significant investments. Accordingly, AcSEC concluded that derivatives should be summarized by type of instrument and underlying (for example, specific equity index, U.S. Treasury Bond, or natural gas) and presented, for open futures contracts, on the basis of cumulative appreciation (depreciation), and for all other derivatives, fair value at period end, with the number of contracts and the range of expiration dates identified in the condensed schedule of investments for those derivatives in excess of 5 percent of net assets. AcSEC concluded that, if the underlying is not a security, summarization of the derivative positions by country or geographic region and industry may be of limited applicability in certain cases, and that summarization by broad category of underlying provides relevant and usable information to users.

A-11. This SOP also amends footnote 13 to chapter 7 of the Guide to clarify that only investment partnerships regulated as brokers and dealers in securities under the Securities Exchange Act of 1934 that manage funds for those who are officers, directors, or employees of the general partner are excluded from the requirement to provide a portfolio of investments under paragraph 7.12.

A-12. One respondent commented that the SOP should address a practice issue relating to guidance on reporting of repurchase and reverse repurchase agreements (repos). They indicate that due to the lack of guidance for repos, industry practice has been to include repos on the condensed schedule of investments of nonregistered investment partnerships. They indicate that repos are frequently used by nonregistered investment partnerships for financing purposes, not investments, and thus should be specifically excluded from being reported in the condensed schedule of investments (paragraph 7.12). AcSEC concluded, however, that the issue was not within the scope of this SOP and that any decision on this matter should include applicability to registered investment funds.

Financial Highlights

A-13. AcSEC concluded that the Guide should be amended to clarify the application of certain provisions to result in more meaningful financial highlights disclosures for nonregistered investment partnerships. Those provisions needed clarification because of the inherent operational and tax differences between an investment company registered under the Investment Company Act of 1940 and a nonregistered investment partnership. AcSEC's basis for conclusions to amend the financial highlights disclosures provisions is as follows.

Clarification of Certain Terms

A-14. AcSEC observed that although the disclosure of financial highlights (as required by the Guide) applies to both registered investment companies and nonregistered investment partnerships, the Guide focuses primarily on registered investment companies, and thus certain terms are not readily applicable to nonregistered investment partnerships. Therefore, AcSEC concluded that terms such as *classes, units*, and *theoretical investment* should be clarified for nonregistered investment partnerships.

Disclosure of Per Share and Per Unit Data by Classes

A-15. AcSEC also concluded that the information required to be disclosed in the per share data required by paragraph 7.66 of the Guide should be clarified for nonregistered investment partnerships. AcSEC concluded that nonregistered investment partnerships should disclose information for each reporting share class related to nonmanaging investors. AcSEC notes that, generally, a *class* has certain rights as governed by underlying legal documents or offering documents, and local law. Rights to certain investments that do not otherwise affect the rights available under the underlying legal or offering documents and local law do not ordinarily represent a separate share class. For example, rights to income and gains from a specific investment attributed solely to investors at the date the investment is made (side-pocket investments) are not considered a share class. Similarly, a temporary series of shares (for example, a series established to track interim computations of incentive allocations or fees and then exchanged into a permanent series when the interim period is completed) is not considered a share class.

A-16. One respondent to the exposure draft commented that hot issues and side-pocket investments should constitute a separate *class* for the purpose of reporting financial highlights. As previously indicated, AcSEC continues to believe that side-pockets investments are not considered a *class* because only specific investors within a class (or classes) have rights to income and gain from a specific investment, rather than rights attributed to the investor class as a whole by underlying legal documents or offering documents. AcSEC also concluded that hot issues do not constitute a *class*. Although recognizing that hot issues allocations are imposed by external regulation, AcSEC notes that the allocation only exists if certain investors are determined to be ineligible under regulation to participate in hot issues securities, so that two identical funds could report different financial highlights based solely on the nature of their investors. AcSEC was concerned that considering rights to certain investments to be a class due to special arrangements, even based on regulation, would create the potential for numerous other distinctions to be made among investors in the presentation of financial highlights. AcSEC believes that the intent of providing financial highlights is to report on the performance of an investment partnership as a whole. However, AcSEC notes that if the effect of hot issues is considered material to investment performance, partnerships could elect to disclose in the financial statements the total profits or losses recognized from hot issues investments, and/or their effect on total return, for the period, and believes that such disclosure ordinarily would provide a valuable perspective on how a partnership generated its performance during a reporting period given the typically nonrecurring nature of hot issues profits.

Determining Average Net Assets When Computing Financial Ratios and Computation of the Expense and Net Investment Income Ratios

A-17. AcSEC discussed how the current requirement of paragraph 7.67 of the Guide to disclose the expense and net investment income ratio to average net assets (ANA) should be applied to produce useful information to investors of nonregistered investment partnerships.

A-18. AcSEC observed that the calculation of meaningful expense and net investment income ratios depends on the nonregistered investment fund's ability to calculate meaningful ANA values by class of investment interest. The more frequently a nonregistered investment fund measures its net assets, the more meaningful the ANA will be.

A-19. AcSEC concluded that when a nonregistered investment partnership computes expense and net investment income ratios, the ANA should be calculated using the fund's (or class's) weighted ANA as measured at each accounting period or periodic valuation (for example, daily, weekly, monthly, quarterly), adjusting for capital contributions or withdrawals from the fund between accounting periods. If a fund does not have predetermined accounting periods (for example, certain limited-life nonregistered investment partnerships) and capital is called and distributed at various times during the year, the net asset values used in the computation of ANA should be weighted and should include a measure of net assets after each capital contribution or distribution and each significant change in net assets.

A-20. A respondent to the exposure draft recommended that the Guide permit certain expenses not to be annualized when nonregistered investment partnerships calculate their expense ratios for a period of less than 12 months. In particular, AcSEC observed that incentive fees or allocations are typically based on the total return of the fund. Although the Guide requires disclosure of whether or not total return is annualized, AcSEC was informed that various regulatory bodies have expressed a preference that total return not be reported on an annualized basis. AcSEC concluded that it was inconsistent to report incentive fees and allocations in the expense ratio on an annualized basis if the total return that gave rise to them was not reported on an annualized basis. AcSEC was also advised that nonregistered investment partnerships are more likely to incur material amounts of expenses than other types of investment companies in an initial operating period of less than one year for which annualization may be inappropriate, such as organizational costs. In such circumstances, AcSEC recognized that annualization could result in distortion of the expense ratio as a measure of the ongoing operating expenses of the fund and concluded that these expenses should not be annualized.

A-21. Several respondents to the exposure draft commented that nonregistered investment partnerships for which expenses are based on a percentage of committed capital pay its expenses (principally management fees) by calling additional committed capital from the investors, particularly in the early years of the partnerships. Those respondents indicated that, in some cases, those partnerships allow for management fees to be called from the limited partners outside of their committed capital. They further indicated that the capital called to fund the payment of expenses has almost no impact on ANA since the capital is generally called and contributed by limited partners immediately before the management fee is paid to the investment manager. Because of those reasons the respondents indicated that an ANA-based expense ratio would not be appropriate.

A-22. AcSEC concluded that an ANA-based expense ratio is more appropriate as it results in a consistent presentation of the ratio among all types of investment companies. Also, AcSEC was concerned that a ratio based on committed capital would not provide a clear representation of the actual expenses paid on invested capital if, for various reasons, a fund's net assets never reached the amount of capital committed. AcSEC observed that investment partnerships could supplementally provide the ratio of expenses to committed capital if considered meaningful.

A-23. AcSEC also concluded that expense and net investment income ratios should be calculated based on the expenses allocated to each common or investor class (for example, the limited partner class) prior to the effects of any incentive allocation. Adequate disclosures should be made so that it is clear to users that the net investment income ratio does not reflect the effects of any incentive allocation.

A-24. AcSEC observes that, generally, the determination of expenses for computing the expense ratio should follow the presentation of expenses in the fund's statement of operations. Accordingly, if the manager's or general partner's incentive is structured as a fee rather than an allocation of profits, the incentive fee would be factored into the computation of the expense ratio. Because an incentive allocation of profits is not presented as an expense, it should not be considered part of the standard expense ratio. However, to avoid potentially significant inconsistencies in ratio presentation based solely on the structuring of incentives as fees or allocations, all incentives should be reflected in the disclosure of financial highlights. Additionally, disclosure should be made in the expense ratio of the effect of any agreement to waive or reimburse fees and expenses to each reporting class as a whole, as described in paragraph 7.38 of the Guide, and of expense offsets, as described in paragraphs 7.40 and 7.41 of the Guide. Agreements to waive a portion or all of certain fees to a specific investor which do not relate to the share class as a whole do not require disclosure in the financial highlights. However, as ratios are calculated for each common class taken as a whole, the financial statements should disclose that an individual investor's ratio may vary from those ratios. One respondent to the exposure draft had requested reconsideration of the requirement that the expense ratio should be based on expenses incurred by the investor class as a whole, expressing preference for presentation of the ratio based on a *standard rate* (for advisory fees and/or incentives) stated in offering documents. The respondent stated that this would be more useful to prospective investors, and also noted that investors charged other than the standard rate could more easily make adjustments to the expense ratio (and other highlights) presented in this manner to reflect their own rate. AcSEC noted, however, that in certain cases only a minority of the capital of a fund may be subject to the standard rate, so that presentation of a ratio in this manner may not be representative of the actual operations of the fund. Also, AcSEC noted that a fund's ability to present incentives in the expense ratio on a standard rate based on historical data could be extremely difficult if investors' incentive charges were reduced because of the existence of loss carryforwards. Accordingly, AcSEC declined to change the guidance in the SOP.

Additional Financial Highlights Disclosures for Certain Limited-Life Nonregistered Investment Partnerships

A-25. AcSEC observed that because investments in certain limited-life nonregistered investment partnerships (typically venture capital partnerships and private equity funds) involve long-term commitments and investment performance depends upon the deployment of committed capital, other key comparative factors among those partnerships are of importance to investors, such as (*a*) total amount of capital commitments of investors (*b*) the year of formation of the entity, and (*c*) ratio of total contributed capital to total committed capital. Therefore, AcSEC concluded that those disclosures were useful and meaningful, and should be required to be disclosed in the financial highlights or notes to financial statements by those partnerships.

Computation of Financial Ratios by Funds-of-Funds and Master-Feeder Funds

A-26. AcSEC discussed how nonregistered funds-of-funds and master-feeder funds should calculate expense and net investment income ratios. As stated in paragraph .13 of this SOP, the determination of expenses for computing those ratios should follow the presentation in the fund's statement of operations. Therefore, funds-of-funds typically should compute these ratios based on the net investment income and expense items at the fund-of-funds level only. In the statement of operations, earnings from investee funds usually are not considered a component of net investment income. Therefore, AcSEC concluded that the funds-of-funds' proportionate share of the expenses and profits of the underlying investee funds generally would not be considered when calculating these ratios. Additionally, AcSEC believes that adequate disclosure should be made so that it is clear to users that the ratios do not reflect the funds-of-funds' proportionate share of income and expenses of the underlying investee funds. In addition, in response to a comment received on the exposure draft, AcSEC concluded that, if an incentive allocation is levied at the master level in a master/feeder relationship, the feeder should present its share of that allocation as a separate line item in the statement of operations. AcSEC noted that incentives levied at the master level implicitly flow through the feeder's statement of operations through the change in value of its investment in the master, and observed that, without such a provision, the financial statement disclosures (and transparency of the incentive) could differ significantly depending solely on whether an incentive was levied at the master or feeder level.

Computation of the Total Rate of Return

A-27. AcSEC discussed how a nonregistered investment partnership should compute the change in value of a theoretical investment when disclosing the total rate of return as required by paragraph 7.68(c) of the Guide.

A-28. AcSEC concluded that the change in value of a theoretical investment for a nonregistered investment partnership, except for certain limited-life nonregistered investment partnerships, is measured by comparing the aggregate ending net asset value of each class of investors with the aggregate beginning net asset value of each such class, adjusted for cash flows related to capital contributions or withdrawals during the period. If capital cash flows occur during the reporting period, returns are geometrically linked based on capital cash flow dates. In general, geometrically linking requires the computation of performance for each discrete period within a year for which invested capital is constant (that is, for each period between investor cash flow dates), then multiplying those performance computations together to obtain the total return for a constant investment outstanding for the entire year. Additionally, because incentive allocations or fees may vary among investors within a class, total return for reporting classes subject to an incentive allocation or fee should report total return before and after the incentive allocation or fee for each reporting class taken as a whole. The effect of incentive allocations on total return is computed on a weighted average aggregate capital basis. That may result in an incentive computation less than the maximum if, for example, certain partners had loss carryovers at the beginning of the period.

Reporting Total Return for Certain Limited-Life Nonregistered Investment Partnerships

A-29. Preparers of financial statements of limited-life nonregistered investment partnerships have indicated that the total return computation required by paragraph 7.68 of the Guide focuses on single-year returns and ignores the long-term nature of limited-life nonregistered investment partnerships. Further, the geometric linking calculation methodology, which this SOP requires for other investment partnerships, can distort actual returns of limited-life nonregistered investment partnerships by, for example, reporting overall negative returns when large profitable investments are sold and distributed to investors early in the year and the value of the small residual balances declines for the remainder of the year. These distortions occur because, in effect, geometric linking assumes reinvestment of capital at the end of each accounting period, which ordinarily does not occur in limited-life partnerships.

A-30. Those preparers indicated that these concerns arise because limited-life nonregistered investment partnerships typically invest to form or develop companies with new ideas, products, or processes with a primary investment objective of long-term capital growth and realize gains on those investments over a relatively long holding period. The investments are typically in privately held companies whose securities have no ready market and are illiquid. The value of the investments increases over time as effort is expended and products are developed. Further, under the terms of their offering agreements or organization documents, these partnerships normally have limited lives, requiring the disposition of investments purchased. However, the disposition of the investments typically does not occur within a single year. AcSEC considered that investors typically are not provided the opportunity to redeem their interests in the partnership, and that transfers to other owners of partnership interests are extremely rare due to contractual and legal restrictions. Accordingly, investors typically realize returns only upon disposition of the investments and distribution of the proceeds or by the distribution of the investments themselves, not by an earlier sale of interests in the partnership. Thus, investors, and even the partnership itself, may consider single-year return of limited value in measuring the overall investment performance of a limited-life nonregistered investment partnership.

A-31. Additionally, the investment decision by an investor in limited-life nonregistered investment partnerships occurs at the time of fund formation. The total size of the investment pool for limited-life nonregistered investment partnerships typically is fixed at formation. All investors make proportionate capital contributions based on their capital commitments at the same time when cash resources are required by the limited-life nonregistered investment partnership in order to carry out its affairs. Combined with restrictions on redemption, the cash flows into or out of a limited-life nonregistered investment partnership are outside the control of the investor.

A-32. Historically, investors in limited-life nonregistered investment partnerships have evaluated overall returns on their commitments to such entities by taking into account the pace of the capital deployment over the life of each entity by the manager, the timing of distributions from the entity back to the investor, and, prior to the termination of the entity, the remaining net asset value of the investors' interest in the entity. The most common measure for this purpose has been the internal rate of return since inception (IRR) because it reflects the effects of the timing of the cash flows. IRR is a commonly recognized performance measure used for such investments by investors and investment professionals. The IRR measure is sometimes the basis on which general partners or investment managers are compensated, and it is generally provided to investors. Numerous cash flows and residual values are capable of being measured by an IRR.

A-33. AcSEC believes that the performance measures described in paragraph 7.68 of the Guide (total return based on unitized net asset value and on theoretical investment) are not the most relevant performance measures for a limited-life nonregistered investment partnership, primarily because those measures reflect the cash flows controlled by the investor, rather than the cash flows controlled by the manager of the limited-life nonregistered partnership.

AcSEC concluded that IRR is a better measure of the performance of a limited-life nonregistered partnership because it reflects the cash flows controlled by the manager of the partnership. AcSEC also discussed whether the IRR calculation would produce any difficulties or mathematical problems. AcSEC considered that mathematical problems are uncommon because the total number of investors is generally fixed at the formation of the fund, the fund has a limited life, and the nature of the cash flows is not complicated. AcSEC concluded that limited-life nonregistered investment partnerships should use an IRR as a performance measurement ratio instead of the annual total rate of return. AcSEC, however, determined that only investment companies that meet operating characteristics such as, limited life, commitments from investors only at the time of fund formation, the inability to request redemption of investment interests, the typical return of the proceeds from disposition of investments to investors, limited opportunities, if any, for investors to withdraw prior to termination of partnership, and typical acquisitions of nonmarketable investments, should be provided this alternative measure. AcSEC considered indefinite life, the continual replenishment of capital, the ability to request redemption of investment interests, frequent reinvestment of proceeds, and frequent purchase of investments that are market-traded (and thus presumed to be readily convertible to cash) to be factors indicating that an annual rate of return would be a useful and preferable measure for partnerships exhibiting those characteristics.

A-34. AcSEC acknowledged that the basic principles of IRR calculation are reasonably well known and numerous software programs exist for the calculation of IRR. However, AcSEC determined that a range of simplifying assumptions exists in measuring the timing of cash flows to assist in the calculation, such as assuming that all cash inflows occur at the beginning and all cash outflows occur at the end of uniform monthly or quarterly reporting periods. AcSEC concluded that the timing assumptions used should be disclosed in the financial statements so users can understand the underlying calculation method, and that the reporting period used should be no less frequently than quarterly to avoid potential distortions in calculations.

A-35. This SOP requires that, unlike for other funds, only a single IRR after incentives would be presented, instead of the returns gross and net of incentive allocations or fees provided by other funds. AcSEC considered that there were significant computational difficulties in determining annualized returns before and after incentives. Further, AcSEC considered that, in many instances, all investors in the funds to which IRR would apply are charged incentives at a uniform rate, so that the concerns about varying incentive rates and loss carryforward periods that gave rise to the gross and net calculations for other funds are substantially less likely to exist among these funds.

Effective Date

A-36. One respondent commented that more time should be given to adopt the IRR presentation requirement for limited-life nonregistered investment partnerships. They indicated that many calendar year-end nonregistered investment partnerships issue their audited financial statements in January and February. Therefore, the determination of and the auditor's testing of the IRR computation since inception could be burdensome in terms of time and availability of information, especially for older funds, that may have to provide audit support for cash flows as far back as 10 years ago or longer. AcSEC concluded that the effective date for the computation and disclosure of the IRR should be effective for annual financial statements issued for fiscal years beginning after December 15, 2003, with early application encouraged.

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Appendix B

Effect on Other Pronouncements

B-1. This SOP amends the reporting provisions established by AICPA SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships* [section 10,660].[1]

Paragraph 11 of SOP 95-2 [section 10,660.11] is amended by adding the guidance shown in italics and underlined:

Condensed Schedule of Investments

.11 *Schedule of Investments.* The financial statements of an investment partnership, when prepared in conformity with GAAP, should, at a minimum, include a condensed schedule of investments in securities owned by the partnership at the close of the most recent period. Such a schedule should do the following.

a. Categorize investments by the following:

1. Type (such as common stocks, preferred stocks, convertible securities, fixed-income securities, government securities, options purchased, options written, warrants, futures, loan participations, short sales, other investment companies, and so forth).
2. Country or geographic region.
3. Industry.

Report the percent of net assets that each such category represents and the total value and cost for each category in (*a*)(1) and (*a*)(2). *Derivatives for which the underlying is not a security should be categorized by broad category of underlying (for example, grains and feeds, fibers and textiles, foreign currency, or equity indices) in place of categories (a)(2) and (a)(3).*

b. Disclose the name, shares or principal amount, value, and type of the following:

1. Each investment (including short sales), constituting more than 5 percent of net assets, *except for derivative instruments as discussed in items (d) and (e) below.*
2. All investments in any one issuer aggregating more than 5 percent of net assets, *except for derivative instruments as discussed in items (d) and (e) below.*

In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.

c. Aggregate other investments (each of which is 5 percent or less of net assets) without specifically identifying the issuers of such investments and categorize them as required by (*a*) above.

d. Disclose the number of contracts, range of expiration dates, and cumulative appreciation (depreciation) for open futures contracts of a particular underlying (such as wheat, cotton, specified equity index, or U.S. Treasury Bonds), regardless of exchange, delivery location, or delivery date, if cumulative appreciation (depreciation) on the open contracts exceeds 5 percent of net assets.

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[1] As amended by AICPA SOP 01-1, *Amendment to Scope of Statement of Position 95-2*, Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools* [section 10,820].

In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.

e. *Disclose the range of expiration dates and fair value for all other derivatives (such as forwards, swaps [such as interest rate and currency swaps], and options) of a particular underlying (such as foreign currency, wheat, specified equity index, or U.S. Treasury Bonds) regardless of counterparty, exchange, or delivery date, if fair value exceeds 5 percent of net assets.*

In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.

f. *Provide the following additional qualitative description for each investment in another nonregistered investment partnership whose fair value constitutes more than 5 percent of net assets:*

- *The investment objective*
- *Restrictions on redemption (that is, liquidity provisions)*

Accounting Standards Executive Committee (2003–2004)

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Section 10,900

Statement of Position 03-5 Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide Audits of Investment Companies

December 29, 2003

> **NOTE**
>
> Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, as amended, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) provides guidance on reporting financial highlights by separate accounts of insurance enterprises.

This SOP requires, among other things, the following:

- *Disclosure of ranges.* Separate accounts with more than two levels of contract charges or net unit values per subaccount may elect to present the required financial highlights for contract expense levels that had units issued or outstanding during the reporting period (including the number of units, unit fair value, net assets, expense ratio, investment income ratio, and total return) for either:
    1. Each contract expense level that results in a distinct net unit value and for which units were issued or outstanding during each reporting period; or
    2. The range of the lowest and highest level of expense ratio and the related total returns, and unit fair values during each reporting period.

  The financial highlights table in the separate account's financial statements should state clearly that the expense ratio considers only the expenses borne directly by the separate account and excludes expense incurred indirectly by the underlying funds or charged through the redemption of units. The disclosure should include ranges of all fees

that are charged by the separate account and whether those fees are assessed as direct reductions in unit values or through the redemption of units.

- *Expense ratio.* The expense ratio represents the annualized contract expenses of the separate account, consisting primarily of mortality and expense charges, for each period indicated. This ratio includes only those expenses that result in a direct reduction to unit values. Charges made directly to contract owner accounts through the redemption of units and expenses of the underlying fund are excluded. The financial highlights note should also provide disclosure of the ranges of all charges assessed to the separate account, including discussion of the manner in which the charges are assessed.
- *Total return ratio.* The total return ratio represents the total return for the periods indicated, including changes in the value of the underlying fund, which reflects the reduction of unit value for expenses assessed. This ratio does not include any expenses assessed through the redemption of units. The total return is calculated for each period indicated or from the effective (fund inception) date through the end of the reporting period.
- *Investment income ratio.* The investment income ratio represents the dividends, excluding distributions of capital gains, received by the subaccount from the underlying mutual fund, net of management fees assessed by the fund manager, divided by the average net assets. This ratio excludes those expenses, such as mortality and expense charges, that result in direct reductions to contract owner accounts either through reductions in the unit values or the redemption of units. The recognition of investment income by the subaccount is affected by the timing of the declaration of dividends by the underlying fund(s) in which the subaccount invests.

This SOP is effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis is permitted, but not required. The provisions of this SOP should be applied prospectively from the beginning of the year of adoption. However, if adopting this SOP results in presentation different from prior periods, companies should explain the effects of adoption on their financial highlights calculations.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least 10 of AcSEC's 15 members, and (3) a proposed final document that has been approved by at least 10 of AcSEC's 15 members. The document is cleared if at least four of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Introduction and Background

.01 In December 2000, the AICPA issued a revised Audit and Accounting Guide *Audits of Investment Companies* (the Guide), that required financial highlights to be disclosed for separate accounts including net assets, unit fair value, and expenses ratio, investment income ratio, and total return ratio as a percentage of average net assets. Constituents raised a number of questions and implementation issues in applying the original guidance in the Guide to separate accounts.

.02 Separate accounts often have multiple accumulation unit values that arise from having different product designs and fee structures on the underlying variable contracts. One of the causes of this proliferation in the number of distinct unit values is that a new series of units is often established within each separate account for each new product and combination of optional riders elected by customers. Paragraph 10.54 of the Guide states:

> Certain disclosures required of registered investment companies for compliance with SEC rules and regulations are not presented in the following illustrative financial statements because they are not otherwise required by generally accepted accounting principles. In addition, certain disclosures are impractical due to the characteristics of the separate account.

In recent years, there has been significant growth in (*a*) the number of subaccounts (or investment portfolios) offered to variable contract customers, particularly for *wraparound* annuities in which assets are invested in mutual funds; (*b*) the number of different products in which supporting assets reside in a single separate account (for example, both variable annuities and variable life insurance contracts); and (*c*) the number of optional riders that may be chosen by variable contract customers, either individually or singularly or in various combinations, with contract charges that vary depending on customer elections.

.03 In January 2002, in response to the implementation questions, the AICPA issued a series of Technical Practice Aids (TPAs) (section 6910.11–.15)[1] to address whether the requirement for presentation of financial highlights as noted in the Guide applies to separate accounts, and if so, what information should be presented. Questions still remained after the issuance of the TPAs about the application of the required financial highlight disclosures.

Applicability and Scope

.04 This Statement of Position (SOP) applies to all entities that are separate accounts within the scope of the Guide.

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[1] TPAs 6910.11 through 6910.15 are rescinded upon the effective date of this SOP.

Conclusions

.05 Paragraph 7.66 of the Guide, which requires per share information to be disclosed as financial highlights, is amended by adding the underlined text as follows.[2]

> **7.66** The following per share information should be presented for registered investment companies, and for investment companies that compute unitized net asset value (a more detailed discussion of calculation methods for registered investment companies may be found in the instructions for preparation of registration statements on Forms N-1A and N-2):
>
> *a.* Net asset value at the beginning of the period.
>
> *b.* Per share net investment income or loss, which, for registered investment companies, is calculated in accordance with the requirements of Form N-1A or N-2. Other methods, such as dividing net investment income by the average or weighted average number of shares outstanding during the period, are acceptable. If used by a registered investment company, the method employed must be disclosed in a note to the table in conformity with SEC requirements.
>
> *c.* Realized and unrealized gains and losses per share, which are balancing amounts necessary to reconcile the change in net asset value per share with the other per share information presented. The amount shown in this caption might not agree with the change in aggregate gains and losses for the period. If such is the case, the reasons should be disclosed.
>
> *d.* Total from investment operations, which represents the sum of net investment income or loss and realized and unrealized gain or loss.
>
> *e.* Distributions to shareholders should be disclosed as a single line item except that tax return of capital distributions should be disclosed separately. Details of distributions should conform to those shown in the statement of changes in net assets.
>
> *f.* Purchase premiums, redemption fees, or other capital items.
>
> *g.* Payments by affiliates (paragraphs 7.49 through 7.51).
>
> *h.* Net asset value at the end of the period.
>
> *i.* Market value at the end of the period (Form N-2 registrants only).
>
> The information required in items *b* through *g* above is not required for separate accounts that represent an ownership interest in the underlying separate account portfolios or mutual funds. Refer to paragraphs 10.53 through 10.58 of the Guide for information regarding financial highlights for separate accounts and illustrative financial statements.

.06 Paragraph 10.54 of the Guide, including related footnotes, is amended by adding the underlined text as follows.

> **10.54** Certain disclosures required of registered investment companies for compliance with SEC rules and regulations are not presented in the following illustrative financial statements because they are not otherwise required by generally accepted accounting principles. In addition, certain disclosures are impractical due to the characteristics of the separate account. These disclosures include the following:
>
> - The total cost, for federal income tax purposes, of the portfolio of investments according to rule 12-12 of Regulation S-X.

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[2] The Statement of Position (SOP) 03-4, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2*, Financial Reporting by Nonpublic Investment Partnerships [section 10,890], will also amend paragraph 7.66 of the AICPA Audit and Accounting Guide *Audits of Investment Companies*.

- The components of net assets presented as a separate schedule or in the notes to the financial statements according to rule 6-05.5 of Regulation S-X. However, the net asset values per unit at the beginning and end of each period and the total net assets at the end of the period are to be provided for the most recent five years.

Separate accounts with more than two levels of contract charges or net unit values per subaccount may elect to present the required financial highlights for contract expense levels that had units issued or outstanding during the reporting period (including number of units, unit fair value, net assets, expense ratio, investment income ratio, and total return), for either:

a. Each contract expense level that results in a distinct net unit value and for which units were issued or outstanding during each reporting period; or

b. The range of the lowest and highest level of expense ratio and the related total return and unit fair values during each reporting period.[5]

The Form S-6[~~*~~6] expense table requires the presentation, under separate captions, of the expense ratio of each separate account and the underlying fund(s) in which it may invest, as well as a combined expense ratio. The financial highlights table in the separate account's financial statements need not aggregate these ratios; however, the table should state clearly that the expense ratio considers only the expenses borne directly by the separate account and excludes expenses incurred directly by the underlying funds or charged through the redemption of units. If the ranges of expense ratios, total returns, and unit fair values are presented, the insurance enterprise should disclose instances in which individual contract values do not fall within the ranges presented (for example, if a new product is introduced late in a reporting period and the total return does not fall within the range). The expense disclosure should also include ranges of all fees that are charged by the separate account and a description of those fees, including whether they are assessed as direct reductions in unit values or through the redemption of units for all policies contained within the separate account.

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[5] The calculation of the ranges for the total return ratio and unit fair values should correspond to the groupings that produced the lowest and highest expense ratios.

[~~*~~6] In April 2002, the SEC adopted a new Form N-6 to replace Forms N-8B-2 and S-6 (Release No. 33-8088), with the objectives of improving disclosure and streamlining the registration process by introducing a single form tailored directly to variable life products. See paragraph 10.30 for effective date information.

.07 Paragraph 10.58(6) of the Guide, which presents illustrative footnotes, is amended by adding the underlined text and deleting the crossed out text as follows.

10.58 6. Unit Values [~~6~~, 8] A summary of unit values and units outstanding for variable annuity contracts, net assets, net investment income ratios, total return ratios, and the expense ratios, excluding expenses of the underlying funds and expenses charged through the redemption of units, for each of the five years in the period ended December 31, 20X3, follows.

~~[6] See AICPA *Technical Practice Aids*, section 6910, *Investment Companies*, paragraphs .11 through .15, related to reporting financial highlights by separate accounts.~~

[8] See SOP 03-5, *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies.

a. The following format should be presented if the insurance enterprise chooses to disclose each contract expense level that results in a distinct net unit value and for which units were issued or outstanding during each of the five years ended December 31, 20X3.

Units	Net Assets: Unit Fair Value	Net Assets: (000s)	~~Net Investment Income as a % of Average Net Assets~~ Investment Income Ratio[9]	~~Expenses as a % of Average Net Assets**~~ Expense Ratio[10]	Total Return[11]
Money Market Investment Division					
December 31					
20X3					
4,136,795	$13.83	$57,232	5.25%	1.00%	5.30%
20X2					
5,028,360	13.13	66,042	5.02	1.00	5.07
20X1					
5,873,517	12.50	73,398	8.46	1.00	8.54
20X0					
2,058,353	11.52	23,705	8.23	1.00	8.31
20W9					
967,550	10.63	10,291	6.24***	1.00***	6.30
7/1/W9*					
500,000	10.00	5,000			

Units	Net Assets: Unit Fair Value	Net Assets: (000s)	~~Net Investment Income as a % of Average Net Assets~~ Investment Income Ratio[9]	~~Expenses as a % of Average Net Assets**~~ Expense Ratio[10]	Total Return[11]
Equity Index Division					
December 31					
20X3					
19,674,291	$17.83	$350,752	2.23%	1.00%	12.68%
20X2					
8,412,134	15.82	133,110	2.35	1.00	24.16
20X1					
3,140,024	12.74	40,009	3.12	1.00	(9.50)
20X0					
3,879,972	14.08	54,630	3.24	1.00	11.94
20W9					
2,162,080	12.58	27,195	3.98	1.00	6.20

~~* Commenced operations.~~

~~** For the year ended December 31, excluding the effect of the expenses of the underlying fund portfolios and charges made directly to contract holder accounts through the redemption of units.~~

~~*** Annualized.~~

9 These amounts represent the dividends, excluding distributions of capital gains, received by the subaccount from the underlying mutual fund, net of management fees assessed by the fund manager, divided by the average net assets. These ratios exclude those expenses, such as mortality and expense charges, that are assessed against contract owner accounts either through reductions in the unit values or the redemption of units. The recognition of investment income by the subaccount is affected by the timing of the declaration of dividends by the underlying fund in which the subaccount invests.

10 These amounts represent the annualized contract expenses of the separate account, consisting primarily of mortality and expense charges, for each period indicated. These ratios include only those expenses that result in a direct reduction to unit values. Charges made directly to contract owner accounts through the redemption of units and expenses of the underlying fund have been excluded.

11 These amounts represent the total return for the periods indicated, including changes in the value of the underlying fund, and expenses assessed through the reduction of unit values. These ratios do not include any expenses assessed through the redemption of units. Investment options with a date notation indicate the effective date of that investment option in the variable account. The total return is calculated for each period indicated or from the effective date through the end of the reporting period.

b. The following format should be presented if the insurance enterprise chooses to present the range of the lowest to highest level of expense ratio and the related total return and unit fair values during each of the five years ended December 31, 20X3. Certain of the information is presented as a range of minimum to maximum values, based on the product grouping representing the minimum and maximum expense ratio amounts.

	At December 31			*For the Year Ended December 31*		
	Units (000s)	*Unit Fair Value Lowest to Highest*	*Net Assets (000s)*	*Investment[12] Income Ratio*	*Expense Ratio[13] Lowest to Highest*	*Total Return[14] Lowest to Highest*
Money Market Investment Division						
20X3	4,137	$10.51 to $14.06	$57,232	5.25%	1.00% to 2.65%	4.10% to 5.30%
20X2	5,028	10.00 to 13.20	66,042	5.02	1.00 to 2.60	4.01 to 5.07
20X1	5,874	9.37 to 13.21	73,398	8.46	1.00 to 2.60	7.45 to 8.54
20X0	2,058	8.72 to 12.23	23,705	8.23	1.00 to 2.55	5.65 to 8.31
20W9	968	8.25 to 12.50	10,291	6.24	1.00 to 2.45	5.25 to 6.30

(continued)

	At December 31			For the Year Ended December 31		
	Units (000s)	Unit Fair Value Lowest to Highest	Net Assets (000s)	Investment[12] Income Ratio	Expense Ratio[13] Lowest to Highest	Total Return[14] Lowest to Highest
Equity Index Division						
20X3	19,674	$10.51 to $19.06	$350,752	2.23%	1.00% to 2.65%	5.10% to 12.18%
20X2	8,412	10.00 to 20.20	133,110	2.35	1.00 to 2.60	6.80 to 24.16
20X1	3,140	9.37 to 14.21	40,009	3.12	1.00 to 2.60	(9.50) to 9.10
20X0	3,880	8.72 to 15.23	54,630	3.24	1.00 to 2.55	5.65 to 11.94
20W9	2,162	8.25 to 13.50	27,195	3.98	1.00 to 2.45	5.25 to 6.20

[12] These amounts represent the dividends, excluding distributions of capital gains, received by the subaccount from the underlying mutual fund, net of management fees assessed by the fund manager, divided by the average net assets. These ratios exclude those expenses, such as mortality and expense charges, that are assessed against contract owner accounts either through reductions in the unit values or the redemption of units. The recognition of investment income by the subaccount is affected by the timing of the declaration of dividends by the underlying fund in which the subaccount invests.

[13] These amounts represent the annualized contract expenses of the separate account, consisting primarily of mortality and expense charges, for each period indicated. The ratios include only those expenses that result in a direct reduction to unit values. Charges made directly to contract owner accounts through the redemption of units and expenses of the underlying fund have been excluded.

[14] These amounts represent the total return for the periods indicated, including changes in the value of the underlying fund, and expenses assessed through the reduction of unit values. These ratios do not include any expenses assessed through the redemption of units. Investment options with a date notation indicate the effective date of that investment option in the variable account. The total return is calculated for each period indicated or from the effective date through the end of the reporting period. As the total return is presented as a range of minimum to maximum values, based on the product grouping representing the minimum and maximum expense ratio amounts, some individual contract total returns are not within the ranges presented.

c. An insurance enterprise may choose to present all expenses that are charged by the separate account in either a table or narrative format. The disclosure should list all fees that are charged by the separate account and a description of those fees, including whether they are assessed as direct reductions in unit values or through the redemption of units for all policies contained within the separate account. For this example, expenses disclosed are based on the ranges of all products within the separate account; the expenses may also be listed in more detail (for example, individual charges broken out by products within the separate account) in either table or narrative format.

ABC Variable Annuity Separate Account I

Mortality and Expense Charge	
Basic charges are assessed through reduction of unit values.	1.00%–1.70%
Death Benefit Options	
The options are assessed through reduction in unit values:	
• Ratchet Option—Equal to the highest account balance among prior specified anniversary dates adjusted for deposits less partial withdrawals since the specified anniversary date	0.15%–0.20%
• Roll Up Option—Equal to the total of deposits made to the contract less an adjustment for partial withdrawals, accumulated at a specified interest rate	0.20%–0.40%
Guaranteed Minimum Income Benefits	
These benefits are assessed through reduction in unit values and provide that the periodic annuity benefits will:	
• Not fall below a contractually specified level.	0.20%–0.55%
• Be based on the higher of actual account values at the date the policy owner elects to annuitize or a contractually specified amount.	0.30%–0.40%
Administrative Charge	
This charge is assessed through the redemption of units.	Years 1–5: $30 Years 6 +: $10

Alternatively, the expense ratio represents the annualized contract expenses of ABC Variable Annuity Separate Account I for the period indicated and includes only those expenses that are charged through a reduction of the unit value. Included in this category are mortality and expense charges, and the cost of any riders the policy holder has elected. These fees range between 1.00 percent and 2.65 percent, depending on the product and options selected. Expenses of the underlying fund portfolios and charges made directly to contract owner accounts through the redemption of units are excluded. For this separate account, charges made through the redemption of units ranged from $10 to $30 per policy annually.

Effective Date and Transition

.08 The provisions of this SOP are effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis is permitted, but not required. The provisions of this SOP should be applied prospectively from the beginning of the year of adoption. However, if adopting this SOP results in presentation different from prior periods, companies should explain the effects of adoption on their financial highlight calculations.

The provisions of this Statement of Position need not be applied to immaterial items.

.09

Appendix

Basis for Conclusions

A-1. This section discusses considerations that were deemed significant by the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position (SOP). In July 2003, AcSEC issued for public comment an exposure draft of a proposed SOP, *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies. During the 60-day comment period, AcSEC received four comment letters.

Applicability of Financial Highlights

A-2. As defined in SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts* [section 10,870], a legal separate account is:

> A separate investment account established and maintained by an insurance enterprise under relevant state insurance law to which funds have been allocated for certain contracts of the insurance enterprise or similar accounts used for foreign originated products. Often for administrative purposes, separate account subaccounts with differing investment objectives are created within a single separate account.

A-3. AcSEC concluded that separate accounts should provide relevant financial highlights in their financial statements as discussed in chapter 7 of the AICPA Audit and Accounting Guide *Audits of Investment Companies* (the Guide), because paragraph 1.03 of the Guide includes "certain separate accounts of life insurance companies" in the reference to types of investment companies. Paragraph 10.01 of the Guide specifies that "separate accounts are registered investment companies under the Investment Company Act of 1940 (the 1940 Act), without an applicable exemption."

A-4. AcSEC also clarified the scope of this SOP from the exposure draft, specifying that this SOP is applicable to all entities that are separate accounts that are within the scope of the Guide. Paragraph 11 of SOP 03-1 [section 10,870.11] specifies conditions that must be met to obtain separate account accounting for generally accepted accounting principles (GAAP) purposes. Separate account arrangements that do not meet the specified conditions are to be accounted for (measured and presented) the same as other general account assets as prescribed in paragraphs 45 through 51 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 60, *Accounting and Reporting by Insurance Enterprises,* as amended. This SOP applies to all separate accounts that are within the scope of the Guide, including arrangements that do not meet the separate account conditions of SOP 03-1 [section 10,870] and separate accounts of life insurance enterprises under FASB Statement No. 60.

A-5. AcSEC discussed whether the financial highlights disclosures prescribed by paragraph 7.66(*b*) through (*g*) of the Guide are required for separate accounts that comprise units that represent an ownership interest in the underlying separate account or mutual funds portfolios.[1] AcSEC concluded that because this information is also separately disclosed by the mutual fund,

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[1] In the United States, this type of separate account is generally referred to as a *unit investment trust*.

there is no need for it to be disclosed by the separate account. If the separate account held and managed its own investments (that is, not units in a separate mutual fund), the disclosures would be required. AcSEC also noted that differences in expense levels that result from customers' selection of a specific product within an array of products or election of optional riders are not considered to result in separate classes of units, as discussed in paragraph A-7 of this SOP [paragraph .09]. As a result, AcSEC concluded that the disclosures required by paragraph 7.66(*b*) through (*d*) of the Guide would be redundant with information already presented in the statement of operations, except that such amounts would be presented on a per-unit basis, determined using the aggregate number of units outstanding during the period. The disclosures required by paragraphs paragraph 7.66(*e*) through (*g*) of the Guide are not relevant to separate accounts due to the manner in which these products are taxed.

Disclosing Range of Expenses

A-6. It is not unusual for separate accounts to have 50 or more subaccounts, 10 or more products, and multiple combinations of elective contract benefits or *riders* (for example, enhanced death benefits), each having different contract charges associated with them. AcSEC noted that for such accounts, the volume of information that would be required if each contract variation and fee structure was treated as a separate class of shareholder in accordance with paragraphs 7.65 through 7.68 of the Guide would likely be overwhelming and detract from the relevance and usefulness of the financial statements. For example, a separate account having 50 subaccounts, 10 products, and 7 combinations of contract riders would require 87,500 items of information (including unit fair values, number of units, expense ratio, investment income ratio, and total return) to be presented to comply with the financial highlights requirement (50 x 10 x 7 x 5 items x 5 years). Proliferation in the number of different unit values leads to the need to consider the level of additional information required by paragraphs 7.65 through 7.68 of the Guide that would be most useful to the users of the financial statements.

A-7. AcSEC discussed whether the presence of multiple products and fee structures within a separate account creates multiple reporting classes or units that must be separately disclosed when reporting financial highlights, and concluded that differences in expense levels that result from customers' selection of a specific product within an array of products or election of optional riders are not considered to result in separate classes of units. This is based on the considerations that all units are invested in the same classes of underlying fund shares and all unit holders have similar claims on the assets held by the separate account (that is, there are not different *classes* or legal standings among the unit holders). If the units were to differ in a manner other than the expense level associated with the contracts, separate disclosure would be appropriate. Based on that discussion, AcSEC concluded that an insurance enterprise may elect to present the required financial highlights for contract expense levels either for (*a*) each contract expense level that results in a distinct net unit value and for which units were issued or outstanding during the reporting period or (*b*) the ranges of the lowest and highest level of expense ratio and the related total return and unit fair value during each reporting period. AcSEC noted that an insurance enterprise should be allowed to choose the presentation format, as some insurers may wish to disclose individual expense amounts in some instances, such as when a separate account does not have many products. AcSEC also believes that comparability of ratios between companies is not diminished by the presentation of ranges because separate accounts contain different mixes of products across companies and within individual separate accounts. Respondents to the exposure draft generally agreed, commenting that the use of ranges for disclosure should alleviate some of the practical difficulties associated with the volume of disclosures required when separate accounts have multiple subaccounts containing multiple products and combinations of elective contract benefits. One respondent disagreed with the disclosure of ranges rather than each specific and distinct unit value highlights, but also noted that disclosure for each unit value would add such excessive material to the reports that most investors would not use it.

Expense Ratio

A-8. Preparers of separate account financial statements have indicated that the comparability of the expense ratio between various variable products is difficult because some charges are assessed to the contract owner through a direct reduction in unit value, while other charges (for example, annual contract maintenance charge) are charged directly to contract owner accounts through the redemption of separate account units.

A-9. AICPA *Technical Practice Aids* (TPA) 6910.12, *Reporting of Per Share or Per Unit Data When Reporting Financial Highlights by Separate Accounts*, states in part the following:

> [The expense ratio represents] the annualized contract expenses of the separate account, consisting primarily of mortality and expense charges, for each period indicated. [This ratio includes] only those expenses that result in a direct reduction to unit values. Charges made directly to contract owner accounts through the redemption of units and expenses of the underlying funds are excluded.

Because the expense ratio excludes charges made directly to contract owner accounts through the redemption of units, different expense ratios may be presented for products that may have similar fee levels and that are otherwise comparable from an economic perspective.

A-10. AcSEC concluded that the expense ratio calculation for separate accounts should exclude charges made directly to contract owner accounts through the redemption of units because these represent capital transactions and the various charges that may be assessed against a particular contract are already disclosed in the product prospectus. Respondents to the exposure draft generally agreed that the expense ratio should only include charges made through a direct reduction to unit values. One respondent to the exposure draft disagreed with the expense ratio conclusion because of the potential lack of comparability between separate accounts.

A-11. AcSEC also concluded that the expense ratio calculation is consistent with the discussion in paragraph 5.52 of the Guide because the expense ratio includes charges that are reported in the statement of operations, and excludes charges that are reported in the statement of changes in net assets and are assessed through the redemption of units.

> **5.52** *Financial Highlights.* The financial highlights for the reporting fund in a fund-of-funds structure are usually similar to a standalone feeder fund in a master-feeder structure. Net investment income and expense ratios should be computed based upon the amounts reported in the statement of operations, and portfolio turnover should be measured based on the turnover of investments made by the reporting fund in the investee funds, not looking through the investee funds to their portfolio activity.

A-12. AcSEC also noted that the various product-specific fees are disclosed in the product prospectus and in the related statement of additional information (SAI). The prospectus and SAI are provided to all contract holders at the time of purchase. The prospectus is also provided annually to contract holders, and the SAI is available annually on request. For a contract holder, the fee rates and manner of assessment generally do not change for the duration of the particular product. Additionally, fees are generally assessed consistently across all funds within a single product. The contract holder is not dependent upon the separate account financial statements for product level comparisons in determining which product to purchase, because the relevant individual product information is provided in its prospectus. As noted in paragraph .02 of this SOP, there currently exists a number of unit values for each new product and combination of contract riders elected by contract holders that represent charges that reduce the unit values. AcSEC noted that calculating the expense ratio by including all charges assessed, whether through reduction of unit values or redemption of units, would only add to the proliferation of unit values and data disclosed. The expense ratio would be an aggregation of all products included in the specific separate account, and may not reflect the various product combinations selected by the contract holders nor be presented in any manner that the contract holder will recognize.

A-13. AcSEC also noted that requiring preparers to consider the many possibilities of different combinations of products and riders by including all charges assessed in the determination of the range of expense ratios would enhance neither the comparability of expense ratios nor the usefulness of the financial statements. The comparability of separate account financial statements is limited due to the fact that separate accounts frequently include the financial activity of products currently being offered as well as those products no longer being marketed. It would not be unusual for an insurance company to have ten or more separate accounts, and for a separate account to contain 20 or more insurance products, each with a unique product prospectus, and each having numerous elective features. It would be virtually impossible for a contract holder to determine which product's financial results are being depicted in a particular separate account, or to use the separate account financial statements to compare products of two or more competitors. Comparability is further challenged by the manner in which insurance charges are assessed. For example, some contracts reduce certain customer charges after specified policy anniversary dates. Comparison of the expense ratio of such contracts with newly issued contracts may not be useful.

A-14. AcSEC concluded that to help the contract holder understand the components of the expense ratio, additional disclosure in the financial highlights note should present either the ranges or summary of individual charges assessed to the contract holder for the products within a separate account with an explanation of how the charges are assessed (such as, monthly through the redemption of units) and whether the charges are included in the expense ratio amount. For those contracts that have multiple features available, the individual feature charges may be described in narrative form or through the use of a table if the options and charges are complex.

A-15. AcSEC also discussed whether the calculation of lowest to highest ranges for the expense ratio, total return ratio, and unit fair value should be calculated independently of one another, or whether all categories should be calculated based on the product combination that produced the lowest to highest ranges for the expense ratio.

A-16. AcSEC concluded that, even though an expense ratio may not be provided in the financial highlights, the lowest to highest ranges should first be determined for the expense ratio for contracts issued, and then the total return ratio and unit fair value should be calculated from the same product groupings. AcSEC noted that this presents the amounts on a consistent basis and allows the users of the financial statements to clearly understand the relationship between the expense ratio and the total return ratio and unit fair value. It was also noted that there may be contracts that fall outside the total return ratio and unit fair value ranges due to the introduction of new products during the year and other market factors. AcSEC concluded that the separate account notes should include an explanation of how the ranges in the total return ratio and unit fair value categories are related to the expense ratio, and why some contracts may be outside the disclosed ranges. Respondents to the exposure draft agreed, commenting that providing the total return ratio and unit fair value disclosures relating to the lowest and highest expense ratio range will provide users with the most relevant information while effectively addressing the cost/benefit of providing additional disclosures for each unique product design.

Total Return Ratio

A-17. AcSEC considered whether the total return ratio also should include only mortality and expense charges deducted from the separate account through a reduction in unit value. The current definition of total return, according to the Guide, is based on the change in net asset value per share during the period. AcSEC concluded that the definition of total return according to the Guide supports including only charges that result in a direct reduction to unit values and not including charges that are assessed through the redemption of units. AcSEC also discussed whether it would be feasible to convert the expenses assessed through the redemption of units to amounts that could be reliably included in the total return ratio. The conversion of charges assessed through the redemption of units into equivalent reductions in unit values would introduce hypothetical numbers into the total return calculation. The resulting amounts would not be on a comparable basis since the hypothetical expenses would be annualized, and the total return is calculated for the actual effective period. AcSEC concluded that the benefit of disclosing a combined total return ratio would not outweigh the possible misleading results, and the significant cost and time involved with producing hypothetical amounts. Consistent with the treatment of other 1940 Act funds, AcSEC concluded that the total return should not be annualized for funds that did not have units outstanding for the entire year. Respondents to the exposure draft generally agreed that the total return should not include charges made through a direct redemption of units or be annualized for units that were not outstanding for the full year, but commented that both facts should be clearly disclosed.

Investment Income Ratio

A-18. AcSEC discussed how the investment income ratio should be determined for each subaccount of the separate account. The current definition of the investment income ratio is set forth in TPA 6910.12, which states in part the following:

> [The investment income ratio represents] the dividends, excluding distributions of capital gains, received by the subaccount from the underlying mutual fund, net of management fees assessed by the fund manager, divided by the average net assets. These ratios exclude those expenses, such as mortality and expense charges, that result in direct reductions in the unit values. The recognition of investment income by the subaccount is affected by the timing of the declaration of dividends by the underlying fund in which the subaccounts invest.

A-19. AcSEC concluded that the investment income ratio should be disclosed by the separate account, and should be calculated based on the distribution of dividends from the fund(s) since that is the amount that is presented in the statement of operations as investment income. It was noted that the investment income ratio disclosed by the separate account is wholly dependent on the distributions made by the fund(s), and would fluctuate based on the timing of the distributions.

Effective Date and Transition

A-20. Respondents to the exposure draft commented that the proposed effective date for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial adoption, provides a reasonable period of time to adopt the provisions of this SOP, since the majority of the guidance in this SOP is the same as the guidance contained in the previously issued TPAs. AcSEC also considered requiring restatement of previously issued separate account financial highlights, but again noted that the majority of the guidance is the same as the TPAs that were issued before December 15, 2001. AcSEC agreed that restatement should be permitted but not required, since the potential benefit would not exceed the cost due to the volume of data for companies with large separate accounts.

Accounting Standards Executive Committee (2003–2004)

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AcSEC gratefully acknowledges the contributions of Daniel McLaughlin and Kim Orton.

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Section 10,910

Statement of Position 04-2 Accounting for Real Estate Time-Sharing Transactions

December 9, 2004

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, as amended, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) provides guidance on a seller's accounting for real estate time-sharing transactions.

- A time-share seller should recognize profit on time-sharing transactions as specified under the profit recognition guidance in the sections in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate*, that specify the accounting for other than retail land sales. For purposes of recognizing profit, nonreversionary title should be transferred. If title transfer is reversionary, the seller should account for the transaction as if it were an operating lease.
- Certain sales incentives provided by a seller to a buyer to consummate a transaction should be recorded separately by reducing the stated sales price of the time-share by the excess of the fair value of the incentive over the amount the buyer pays. For purposes of testing for buyer's commitment under FASB Statement No. 66, the seller should reduce its measurement of the buyer's initial and continuing investments by the excess of the fair value of the incentive over the stated amount the buyer pays, except in certain situations in which, to receive the incentive, the buyer is required to make specific payments on its note.
- A reload transaction is considered to be a separate sale of a second interval, and the second interval is accounted for in accordance with the profit recognition guidance of FASB Statement No. 66. For an

upgrade transaction, that guidance is applied to the sales value of the new (upgrade) interval, and the buyer's initial and continuing investments from the original interval are included in the profit recognition tests related to the new interval.

- As used in this SOP, the term *uncollectibles* should be interpreted broadly to include all situations in which, as a result of credit issues, a time-share seller collects less than 100 percent of the contractual cash payments of a note receivable, except for certain transfers of receivables to independent third parties by the seller. An estimate of uncollectibility that, from a historical and statistical perspective, is expected to occur should be recorded as a reduction of revenue at the time that profit is recognized on a time-sharing sale recorded under the full accrual or percentage-of-completion method. Subsequent changes in estimated uncollectibles should be recorded as an adjustment to estimated uncollectibles and thereby as an adjustment to revenue. Under the relative sales value method, the seller effectively does not record revenue, cost of sales, or inventory relief for amounts not expected to be collected. There generally is no accounting effect on inventory when, as expected, a time-share is repossessed or otherwise reacquired.
- The seller should account for cost of sales and time-sharing inventory in accordance with the relative sales value method.
- All costs incurred to sell time-shares should be charged to expense as incurred except for certain costs that are:
  - Incurred for tangible assets used directly in selling the time-shares.
  - Incurred for services performed to obtain regulatory approval of sales.
  - Direct and incremental costs of successful sales efforts under the percentage-of-completion, installment, reduced profit, or deposit methods of accounting.
- Rental and other operations during holding periods, including sampler programs and mini-vacations, should be accounted for as incidental operations, which requires that any excess of revenue over costs be recorded as a reduction of inventory costs.
- The accounting treatment for more complex time-sharing structures such as time-sharing special-purpose entities (SPEs), points systems, and vacation clubs should be determined using the same profit recognition guidance as for simpler structures, provided that the time-sharing interest has been sold to the end user. For balance-sheet presentation purposes, an SPE should be viewed as an entity lacking economic substance and established for the purpose of facilitating sales if the SPE structure is legally required for purposes of selling intervals to a class of nonresident customers, and the SPE has no assets other than the time-sharing intervals and has no debt. In those circumstances, the seller should present on its balance sheet as time-sharing inventory the interests in the SPE not yet sold to end users.
- If the seller, seller's affiliate, or related party operates an exchange, points, affinity, or similar program, the program's operations constitute continuing involvement by the seller, and the seller should determine its accounting based on an evaluation of whether it will

receive compensation at prevailing market rates for its program services.

- This SOP is effective for financial statements for fiscal years beginning after June 15, 2005, with earlier application encouraged. Initial application should be reported as a cumulative effect of a change in accounting principle.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least 10 of AcSEC's 15 members, and (3) a final document that has been approved by at least 10 of AcSEC's 15 members. The document is cleared if at least four of the seven FASB members do not object to AcSEC undertaking the project,[*] issuing the proposed exposure draft, or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Background

.01 The **real estate time-sharing**[1] industry has experienced significant growth since its inception, both in terms of sales volumes and in the variety of **time-sharing** structures used by sellers.[2] The accounting for real estate time-sharing transactions (also referred to in this Statement of Position [SOP] as *time-sharing transactions*) is based principally on Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate*. Time-sharing transactions are characterized by the following:

a. Volume-based, homogeneous sales

b. Seller financing

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[*] At the time the Accounting Standards Executive Committee (AcSEC) undertook this project, at least five of the seven Financial Accounting Standards Board members were required to not object to AcSEC undertaking this project.

[1] Terms defined in the Glossary are set in boldface type the first time they appear in this Statement of Position (SOP).

[2] The term *developer* is used interchangeably and synonymously with *seller* in this SOP.

c. Relatively high selling and marketing costs

d. Upon default, recovery of the time-sharing **interval** by the seller and some forfeiture of principal by the buyer

.02 The FASB issued FASB Statement No. 66 in 1982. The FASB concluded at that time that time-sharing transactions should be accounted for in accordance with the provisions of that Statement. However, the FASB noted that sales of **time-sharing interests** were not addressed in the specialized AICPA Industry Accounting Guides and SOPs whose principles were extracted in that Statement and decided not to provide specific additional guidance on time-sharing transactions as part of the extraction project leading to the issuance of that Statement.

.03 The time-sharing industry has certain characteristics that affect the evaluation of financial performance. Most sales of time-sharing intervals are to retail consumers, who often choose to use seller-provided financing. Although certain financial institutions will participate in the securitization or hypothecation of portfolios of time-sharing receivables, financial institutions typically will not finance the purchase of individual time-sharing intervals. Therefore, a majority of the sales price is often financed by the **time-share** seller through a promissory note (generally, with a term of five to ten years) signed by the buyer. The promissory note is typically a **recourse** note secured by the time-sharing interval. Delinquency and default rates on promissory notes vary widely among individual time-sharing companies and tend to fluctuate in line with the general state of the economy. Selling and marketing costs are significant in relation to sales revenue, and sales **incentives** and **inducements** are common.

.04 The time-sharing industry has introduced a variety of transaction structures to differentiate its products and enhance sales volumes. For example, buyers often have the right to **exchange** periodic use of their time-sharing intervals for use of other time-sharing intervals or for various consumer products, frequently through a third-party exchange company. Time-sharing transactions include the sale of **fixed time** and **floating time**, **points** (which may be redeemed so that a buyer may occupy a specific property), **vacation clubs**, and **fractional interests**; the use of **time-sharing special-purpose entities (SPEs)** to hold title to real estate; and providing the right to use real estate for a specified period.

.05 In an effort to manage cash flows, many time-share sellers will sell, hypothecate, securitize, or otherwise monetize their receivables through another party. In general, those transactions are completed with some recourse to the time-share seller (that is, if receivables are uncollectible, the seller is liable for the bad debts up to stated limits).

.06 All of the above factors illustrate the complexity of the time-sharing industry and the need for accounting guidance. Limited specific guidance on accounting for time-sharing transactions, combined with the varied and numerous structures that time-sharing arrangements have assumed, have resulted in diversity in practice. Areas of diversity addressed in this SOP include accounting for **uncollectibility**, recovery or repossession of time-sharing intervals, selling and marketing costs, operations during **holding periods**, developer subsidies to interval **owners associations**, and **upgrade** and **reload** transactions.

.07 AcSEC understands that the FASB will amend FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to accommodate this SOP's requirements. The FASB will indicate, in the sections entitled "Incidental Operations" and "Costs Incurred to Sell Real Estate Projects" of FASB Statement No. 67, that paragraphs 10 and 17 through 19 of that Statement do not apply to time-sharing transactions.

Scope

.08 This SOP provides guidance on the accounting by a seller for all real estate time-sharing transactions.[3] Those include:

a. Fee simple transactions in which nonreversionary title and ownership of the real estate pass to the buyer or an SPE

b. Transactions in which title and ownership of all or a portion of the real estate remain with the seller

c. Transactions in which title and ownership of all or a portion of the real estate pass to the buyer and subsequently revert to the seller or transfer to a third party

d. Transactions by a time-share reseller

.09 Paragraphs 3 through 43, 53 through 69, 77 through 90, and portions of Appendixes E and F of FASB Statement No. 66 provide guidance for recognition of profit on **other than retail land sales (OTRLS)** of real estate, including real estate time-sharing transactions. This SOP provides guidance to illustrate the application of the provisions of FASB Statement No. 66 to the specific terms typically encountered in time-sharing transactions. This SOP also establishes standards for accounting issues not addressed in FASB Statement No. 66.

.10 This SOP applies to both annual and interim reporting periods.

Conclusions

Profit Recognition Under FASB Statement No. 66

.11 As noted in paragraph .09 of this SOP, a time-share seller should recognize profit on time-sharing transactions as specified under the profit recognition guidance in the OTRLS sections of FASB Statement No. 66. Paragraphs 25 through 43 of that Statement provide guidance for scenarios under which a seller retains **continuing involvement** with real estate that has been transferred to a purchaser. Appendix C [paragraph .69] of this SOP lists those scenarios and provides comments as to whether they typically do or do not apply to time-sharing transactions.

.12 Paragraph 37 of FASB Statement No. 66 prescribes the **percentage-of-completion** method of profit recognition for time-sharing transactions provided that certain criteria are met. Costs to sell time-sharing intervals (also referred to as *sales and marketing costs*) should be excluded from the calculations of costs under that method.

.13 Paragraphs 22(c) and 22(g) of FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases*, require that title must be transferred in order to recognize

[3] Financial Accounting Standards Board (FASB) Interpretation No. 43, *Real Estate Sales (an interpretation of FASB Statement No. 66)*, provides guidance that is useful in determining what constitutes real estate for purposes of this SOP.

a sale of real estate. For purposes of recognizing profit on time-sharing transactions under FASB Statement No. 66, such transfer should be nonreversionary. A **contract-for-deed** arrangement meets this criterion. If the title transfer is reversionary, the seller should account for the transaction as if it were an operating lease.

Seller Identification of Projects and Phases

.14 Throughout this SOP, reference is made to a **project** or to a **phase** of a project. A project may consist of a single phase. A time-share seller should establish and delineate a project and its phases at the outset of the project. Each phase should be accounted for separately.

.15 A change in the delineation of a project or its phases that results from a significant change in facts and circumstances related to the project's development—for example, significant revisions in sales prices or discount programs, construction contract price or inflation changes, temporary construction delays, design changes, or a decision by the seller to increase significantly the proportion of luxury versus standard **units** in a project—should be accounted for as a change in accounting estimate on a retrospective basis using a current-period adjustment as discussed in paragraph .41 of this SOP. A change in the delineation of a project or its phases without a significant change in facts and circumstances related to the project's development should be accounted for as a change in the method of applying an accounting principle under Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, that is, by a cumulative effect of a change in accounting principle. An example of this latter change would be a decision to divide the same development of a project into more or fewer phases, which would be a change only in how the project is accounted for rather than a change in the nature (that is, the facts and circumstances) of the project itself.

Determination of Sales Value

.16 The stated sales price in a time-sharing transaction should be adjusted to determine the **sales value** of the time-sharing interval. This section discusses some of the adjustments that are common in time-sharing sale transactions. This section is not intended to be all-inclusive, and other adjustments to the stated sales price may be necessary to reflect the sales value of a time-sharing interval. See Appendix E, "Illustration of Determination of Sales Value of Time-Share Interval" [paragraph .71], for illustrations of the determination of sales value.

.17 The stated sales price should be reduced by the excess of the fair value of products or services that the seller, as part of consummating the sale, has provided or is legally or otherwise committed to provide the buyer over the stated compensation for those products or services. This deemed compensation to the seller for those products and services, plus the stated compensation, if any, should be accounted for as a reduction in the stated sales price of the time-sharing interval. Often those products or services represent sales incentives provided by the seller to the buyer in order to consummate a time-sharing transaction.[4] The seller should follow the guidance in Emerging Issues Task Force (EITF) Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)," and therefore the accounting for the amount by which the stated sales price was reduced for

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[4] The reduction in sales value for the fair value of an incentive to be delivered at a later date should reflect the effects of the timing of the delivery. See Example 1 in Appendix E [paragraph .71] for an illustration.

an incentive depends on whether the incentive is noncash or cash. For noncash incentives that amount should be accounted for as a separate deliverable with an associated cost of sales, whereas for cash incentives that amount should be accounted for as a discount to the stated sales price.

.18 For purposes of this SOP, a cash incentive is either cash or an incentive provided to a buyer that the buyer would otherwise be required to pay, such as required first-year maintenance fees to an owners association or required closing costs on a time-sharing interval. A noncash incentive is an incentive provided to a buyer that the buyer could elect to purchase, such as a first-year membership in an optional exchange program, amusement park tickets, or a voucher that can be used to obtain airline tickets from an airline at no charge. If a seller provides, at no charge, a noncash incentive, such as an airline voucher, to a buyer in order to consummate a time-sharing transaction, the seller should reduce the stated sales price of the time-sharing interval by the fair value of the voucher and record the fair value of the voucher as a separate revenue item. Alternatively, if a seller sells a time-sharing interval together with a membership in an exchange program and provides the first-year membership at no charge to the buyer, the fair value of the exchange program fees should be treated as a cash incentive because those fees would be required to be paid. Therefore, the stated sales price of the time-sharing interval should be reduced by the fair value of the fees and that fair value should be treated as a reduction in the seller's cost of the fees (rather than as a separate revenue item).

.19 If a seller obtains an incentive through an arm's-length, cash-denominated transaction with an **independent third party** at or near the time that the incentive is delivered to the buyer, that cash-denominated transaction would generally be considered the best estimate of fair value.[5] The determination of incentives excludes any products or services that a buyer pays for, at market rates, through future maintenance charges or other separate fees.

.20 If the seller provides an inducement, which is provided regardless of whether a sale is consummated (for example, providing amusement park tickets to a potential buyer as an inducement to attend a time-sharing sales presentation), the seller should record the cost of the inducement as a selling cost in accordance with paragraphs .44 through .48 of this SOP.

.21 If the seller charges a buyer a fee that is unrelated to financing, such as a sales document preparation fee, the fee should be added to the stated sales price in determining sales value. An exception occurs if the seller charges a buyer a "pass-through" fee that the seller collects to pay to a third party, such as a municipality or taxing authority; the fee should not be added to the sales value or included in the buyer's initial and **continuing investments** (see the next section of this SOP). If the seller charges a buyer a fee that is related to financing the time-share purchase, such as a loan origination fee, the fee should be recorded in accordance with FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, as an adjustment to the stated interest rate on the financing.

.22 Sellers may have programs to accelerate collections of receivables or contract provisions that encourage prepayment, with a reduction of payments

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[5] The FASB has issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Fair Value Measurements*. Readers should be alert to any final pronouncement.

as the major inducement for prepayment. If a seller offers such programs to buyers at the time of sale or has a consistent past practice of offering such programs during the term of the buyers' notes, the seller should incorporate estimated reductions of payments into the determination of sales value.

.23 If a time-sharing transaction is partially or fully financed by the seller and the stated interest rate is less than the prevailing market rate for a purchaser of similar credit quality in a similar transaction, the sales value and recorded amount of the note receivable should be reduced in accordance with APB Opinion No. 21, *Interest on Receivables and Payables*.

Application of Test of Buyer's Commitment

.24 In applying the tests for adequacy of buyer's commitment in paragraph 5(b) of FASB Statement No. 66, the seller should reduce its measurement of the buyer's initial and continuing investments by the excess described in paragraph .17 of this SOP, unless the incentive is conditioned on sufficient future performance (in the form of the buyer meeting his or her contractual obligations associated with the purchase of the time-sharing interval) by the buyer. One example is the seller offering to pay the buyer's second year of maintenance fees if the buyer remains current on his or her contractual obligations for one year. Another example is the seller offering the buyer an airline voucher if the buyer makes the first six monthly payments in a timely manner. If the incentive is conditioned on future performance by the buyer, the seller should determine whether the future performance is sufficient to meet the initial and continuing investments criterion for the buyer's commitment.

.25 In order for future performance by the buyer to be sufficient, the contractual payments (principal and interest) required from the buyer in order to receive the incentive should be at least equal to the fair value of the incentive. For example, upon the sale of a $10,000 time-sharing interval, the seller receives a $1,000 down payment and will provide the buyer with a $500 incentive, conditioned on future performance of the buyer. The buyer's contractual monthly note payment is $175. If the buyer is directly or indirectly required to make at least three monthly payments (totaling $525) before becoming entitled to the incentive, the buyer's initial and continuing investments under paragraph 5(b) of FASB Statement No. 66 would not be reduced for the incentive. The buyer's required contractual payments should cover both the value of the incentive and interest on the unpaid portion of the incentive (that interest was ignored in this example for simplicity).

.26 If future performance is not sufficient, the seller should reduce the measurement of the buyer's commitment by the excess of the fair value of the incentive over the amount the buyer paid for the incentive, in applying the criterion in paragraph 5(b) of FASB Statement No. 66. In the example in the preceding paragraph, assume instead that the buyer was required to make only one monthly payment of $175 prior to receiving the incentive (the $175 is the first payment on the loan, not an incremental payment for the incentive). For purposes of applying the buyer's initial and continuing investments criterion, the initial down payment of $1,000 would be reduced by the $325 excess ($500 incentive less $175 required future performance) to $675. The seller would therefore be considered to have received a $675 initial payment, and the sales value of the time-sharing interval would be $9,500. If, for example, the required level of commitment is 10 percent, to satisfy the initial and continuing investments criterion, the seller would have to receive an additional $275 in cash from the buyer ($675 plus $275 is $950, which is 10 percent of $9,500).

.27 Any portion of the buyer's down payment that is considered to apply toward payment of an incentive—for example, the $325 in the illustration in paragraph .26—rather than toward payment on a time-sharing interval should not be included in determining the buyer's initial or continuing investments.

Upgrade and Reload Transactions

.28 The profit recognition guidance in FASB Statement No. 66 should be applied to determine the appropriate accounting for a reload interval or an upgrade interval. A reload transaction is a sale of a new interval that should be treated as a separate transaction for accounting purposes. Therefore, additional cash or other qualifying consideration is necessary to meet the buyer's commitment criterion in paragraph 5(b) of FASB Statement No. 66. Because a reload is considered a second, separate transaction, the seller should not include the buyer's initial and continuing investments from the original time-sharing interval toward the measurement of the buyer's commitment for the second interval.

.29 An upgrade transaction is a modification and continuation of the original transaction. For an upgrade transaction, the seller should include the buyer's initial and continuing investments from the original (ceded) interval toward meeting the buyer's commitment criterion. The profit recognition guidance in FASB Statement No. 66, including the test for buyer's commitment, is applied to the sales value of the new (upgrade) interval.

Accounting for Uncollectibility

.30 The collection of notes receivable is an important function for sellers of time-sharing intervals. Time-share sellers experience some level of uncollectibility in a notes receivable portfolio in the ordinary course of business. To maximize collections, sellers use several kinds of collection programs, including **modifications**, **deferments**, **assumptions**, and **downgrades**. Sellers incur various costs in using those collection programs. This section provides guidance on accounting for various forms of uncollectibility and the associated costs.

.31 Uncollectibility incorporates losses of both principal and interest. Accrued interest income receivable that is determined to be uncollectible should be charged against interest income at the time the receivable is determined to be uncollectible.

.32 Uncollectibility occurs whenever a receivable either becomes wholly uncollectible or is modified in some manner that results in less than 100-percent collection of the original note. The measurement of uncollectibility should be based on actual receivables collection experience (and other considerations)—whether the seller or a third party is the servicer of the receivables—rather than the amounts a seller receives as proceeds for receivables sales, securitizations, or hypothecations.

.33 An estimate of uncollectibility that, from a historical and statistical perspective, is expected to occur should be recorded as a reduction of sales revenue at the time that profit is recognized on a time-sharing sale recorded under the **full accrual** or percentage-of-completion method. That estimate should incorporate all forms of uncollectibility (for example, note cancellations and collection programs). See Appendix D [paragraph .70] for an illustration of the determination of the reduction of revenue for estimated uncollectibles. Under the **relative sales value method** (see paragraph .41), a corresponding adjustment is made to cost of sales and inventory, through the application of the cost-of-sales percentage, to reflect the reduction of revenue for estimated uncollectibles. See Appendix B [paragraph .68] for illustrations of the relative sales value method.

.34 A note receivable modification, deferment, or downgrade represents a troubled debt restructuring involving only the modification of the terms of a note receivable. Therefore, the creditor (time-share seller) should account for those transactions in accordance with FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*. Any reductions in the recorded investment in a note receivable resulting from the application of FASB Statement No. 114 should be charged against the allowance for uncollectibles, because the estimated losses were recorded against revenue at the time the time-share sale was recognized or were recorded subsequently against revenue as a change in estimate. Incremental, direct costs associated with uncollectibility, such as costs of collection programs, should be charged to expense as incurred.

.35 A note receivable assumption should be accounted for as two separate activities with two different parties. The first—the termination of the arrangement with the original buyer—results in an amount uncollectible to the seller equal to the remaining investment in the original note receivable. That amount should be charged to the allowance for uncollectible receivables. The second activity—a time-sharing transaction with a new buyer—should be accounted for in accordance with the profit recognition criteria in FASB Statement No. 66.

.36 Once an initial time-sharing sale transaction has been recorded (which includes a reduction of recognized revenue for estimated uncollectibles), accounting for the allowance for uncollectibles follows similar valuation principles as any receivable, except that there is no "bad debt expense." Each reporting period and at least quarterly a seller evaluates its receivables, estimates the amount it expects to ultimately collect, and evaluates the adequacy of its allowance pursuant to FASB Statement No. 5, *Accounting for Contingencies*.[6] The allowance is then adjusted, with a corresponding adjustment to current-period revenue through the estimated uncollectibles account, which is a contra-revenue account. A corresponding adjustment is also made to cost of sales and inventory.

.37 The allowance for uncollectibles should be determined based on consideration of uncollectibles by year of sale, as well as the aging of notes receivable and factors such as the location of the time-sharing units, contract terms, collection experience, economic conditions, and other qualitative factors as appropriate in the circumstances. See Appendix D [paragraph .70] for an illustration of the determination of the allowance for uncollectibles.

.38 If a time-share seller sells a portfolio of receivables without recourse, any gain or loss should be recorded as an adjustment of interest income if it is attributable to a change in market interest rates between the date the receivables are generated and the date they are sold, and as an adjustment of revenue otherwise (for example, if the gain or loss is related to a difference in perceived credit quality of the portfolio between the date the receivables are generated and the date they are sold).

Accounting for Cost of Sales and Inventory

.39 This section applies to all time-sharing sale transactions accounted for under the full accrual, percentage-of-completion, installment, cost recovery,

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[6] In June 2003, AcSEC issued an exposure draft of a proposed SOP, *Accounting for Credit Losses*. Readers should be alert to any final pronouncement.

or reduced profit methods of revenue recognition as discussed in paragraphs 3 through 43, 53 through 64, 68, and 69 of FASB Statement No. 66. If a time-sharing transaction is accounted for under the **deposit method**, as discussed in paragraphs 65 through 67 of FASB Statement No. 66, this section does not apply.

.40 Sellers of time-sharing intervals should account for cost of sales and time-sharing inventory using the relative sales value method, which is illustrated in Appendix B [paragraph .68] of this SOP. The relative sales value method should be applied to each phase separately. **Common costs**, including **amenities**, should be allocated to inventory among the phases that those costs will benefit.

.41 The relative sales value method is similar to a "gross profit" method and is used to allocate inventory cost and determine cost of sales in conjunction with a sale. Under the relative sales value method, cost of sales is calculated as a percentage of net sales using a *cost-of-sales percentage*—the ratio of total estimated cost (including costs to complete, if any) to total estimated time-sharing revenue. At least quarterly, both estimates should be recalculated.[7] The estimate of total revenue (actual to-date plus expected future revenue) should incorporate factors such as incurred or estimated uncollectibles, changes in sales prices or sales mix, repossession of intervals that the seller may or may not be able to resell, effects of upgrade programs, and past or expected sales incentives to sell slow-moving inventory units. The cost-of-sales percentage should be similarly recalculated each time estimated revenue or cost is adjusted, using the new estimate of total revenue and total cost (including costs to complete, if any). The effects of changes in estimate should be accounted for in each period on a retrospective basis using a current-period adjustment, that is, the time-share seller should account for a change in estimate in the period of change so that the balance sheet at the end of the period of change and the accounting in subsequent periods are as they would have been if the revised estimates had been the original estimates. The effects of changes in estimate should be disclosed in accordance with paragraph 33 of APB Opinion No. 20. See Appendix B [paragraph .68] for illustrations of the relative sales value method; Examples 2 and 4 of that appendix illustrate changes in estimate. The inventory balance reported in the balance sheet, plus estimated costs to complete that inventory, if any, represents a pool of costs that will be charged against future revenue.

.42 As discussed in paragraph .33 of this SOP, the recording of a sales revenue adjustment for expected uncollectibles is accompanied by a corresponding adjustment to cost of sales and inventory that is effected through the application of the cost-of-sales percentage. However, under the relative sales value method, there is no accounting effect on inventory if a time-sharing interval is repossessed or otherwise reacquired unless the repossession causes a change in expected uncollectibles (and, thereby, estimated revenue) as discussed in the preceding paragraph. The seller should, however, perform impairment testing on its inventory in accordance with paragraphs 34 through 37 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

.43 Costs incurred by a seller that are related to financing, such as loan origination costs, should be accounted for in accordance with FASB Statement No. 91.

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[7] A time-sharing entity should adjust at least quarterly even if it does not issue quarterly financial reports under Securities and Exchange Commission (SEC) reporting requirements.

Costs to Sell Time-Sharing Intervals

.44 All costs incurred to sell time-sharing intervals should be charged to expense as incurred unless they specifically qualify for capitalization under paragraphs .45 through .48 of this SOP.

.45 Costs incurred to sell time-sharing intervals should be deferred until a sale transaction occurs if the costs are:

a. Reasonably expected to be recovered from the sale of the time-sharing intervals or from **incidental operations**; and

b. Incurred for either of the following:

(1) Tangible assets[8] that are used directly throughout the selling period to aid in the sales of the time-sharing intervals

(2) Services that have been performed to obtain regulatory approval of sales

Examples of costs incurred to sell time-sharing intervals that meet the condition of item *b*(1) include the costs of model units and their furnishings, sales property and equipment, and semipermanent signs. An example of costs that meet condition *b*(2) is the costs of preparation and filing of prospectuses, including printing and legal fees. If a transaction occurs, the costs should be allocated proportionately to that transaction based on the relative fair value of the intervals available for sale in the project or phase to which the selling costs are applicable.

.46 Other costs incurred to sell time-sharing intervals should be deferred until a sale transaction occurs if the costs are (*a*) reasonably expected to be recovered from the sale of the time-sharing units, (*b*) directly associated with sales transactions that are being accounted for under the percentage-of-completion, installment, reduced profit, or deposit method of accounting, and (*c*) incremental, that is, the costs would not have been incurred by the seller had a particular sale transaction not occurred. Under the deposit method of accounting, deferred selling costs should be limited to the nonrefundable portion of the deposits received by the seller. Examples of directly associated, incremental costs include commissions, and payroll and payroll benefit-related costs of sales personnel for time spent directly on successful sales efforts.

.47 Deferred selling costs should be charged to expense in the period in which the related profit is recognized. If a sales contract is canceled (with or without refund) prior to profit recognition, the related unrecoverable deferred selling costs should be charged to expense in the period of cancellation.

.48 Examples of costs that do not meet any of the criteria in paragraph .45 or .46 for deferral, and that should therefore be charged to expense as incurred, include all costs incurred to induce potential buyers to take sales tours (for example, the costs of telemarketing call centers); all costs incurred for unsuccessful sales transactions; and all sales overhead such as on-site and off-site sales office rent, utilities, maintenance, and telephone expenses. Advertising costs should be accounted for in accordance with SOP 93-7, *Reporting on Advertising Costs* [section 10,590]. Direct incremental costs of tour fulfillment, such as costs of airline tickets to bring customers to a tour location, should be charged to expense at the time the tour takes place.

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[8] This guidance on "tangible" assets is not intended to prohibit capitalization specifically addressed in other literature, such as internal use software under SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* [section 10,720].

Operations During Holding Periods

.49 For time-sharing operations, the holding period (as that term is used in the definition of incidental operations in FASB Statement No. 67) begins at the time that intervals are held for and are available for sale—for example, when units in domestic locations are legally registered for sale as time-shares. If rental activities occur other than during the holding period, the corresponding units should be depreciated and those activities should be accounted for as rental operations in accordance with FASB Statement No. 13, *Accounting for Leases*, and related authoritative literature. A seller should evaluate each period as to whether units previously considered held for and available for sale should continue to be characterized as such.

.50 Revenue from and costs of rental and other operations during holding periods should be accounted for as incidental operations. Incremental revenue from incidental operations in excess of incremental costs from incidental operations should be accounted for as a reduction of inventory costs—that is, the pool of inventory costs under the relative sales value method as described in paragraph .41 of this SOP. Estimates of future amounts of such excess should not be factored into the calculations of the relative sales value method. Incremental costs in excess of incremental revenue should be charged to expense as incurred.

.51 Holding period operations include **sampler programs** and **mini-vacations** (see paragraph .53). During holding periods, time-sharing intervals should be accounted for as inventory and should not be depreciated. Costs of operations during holding periods include (*a*) **seller subsidies** and (*b*) maintenance and related costs on time-sharing intervals held for sale.

.52 Costs incurred to rent units during holding periods should be deferred if they are (*a*) directly associated with, and their recovery is reasonably expected from, transactions involving the rental of units during holding periods and (*b*) incremental, that is, the costs would not have been incurred by the seller had a particular holding period rental transaction not occurred. An example of a directly associated, incremental cost is a commission. Deferred costs to rent time-sharing units during holding periods should be charged to expense, or netted in the reduction of inventory costs (as described in paragraph .50), in the period in which the rental takes place.

Sampler Programs and Mini-Vacations

.53 If a buyer pays for a sampler program or mini-vacation but buys a unit without using the entire sampler program or mini-vacation, and the seller applies the unused payment to the sales price, the payment should be treated as part of the buyer's initial and continuing investments for purposes of determining the buyer's commitment (see paragraph .24 of this SOP). Conversely, an amount the seller receives for a sampler program or mini-vacation that a prospective buyer fully uses should not, upon subsequent sale of an interval to the prospective buyer, be included in the buyer's initial and continuing investments, even if the legal documents state or suggest that the payment for the sampler program or mini-vacation is applied to the sales price.

.54 See paragraphs .49 through .52 of this SOP for the accounting for amounts received for sampler programs and mini-vacations.

Special-Purpose Entities, Points Systems, Vacation Clubs, and Similar Structures

.55 The accounting treatment for time-sharing structures such as SPEs, points systems, vacation clubs, and variations and hybrids of those structures should be determined using the profit recognition guidance in the OTRLS sections of FASB Statement No. 66. In applying that guidance, the transactions should be evaluated from the time-sharing seller's perspective rather than from the buyer's perspective, that is, it is necessary to evaluate transactions based primarily on what the seller has transferred and secondarily on what the buyer has received. There should be assessments of whether the seller has transferred nonreversionary title to a time-sharing interval (see paragraph .13 of this SOP), whether the seller has continuing involvement with the buyer, and other matters with respect to meeting the other profit recognition criteria of FASB Statement No. 66. The seller should recognize profit in the same manner and use the same profit recognition guidance as for simple-structure transactions (such as fixed time) provided that the time-sharing interval has been sold to the end user. If the seller has transferred title (for example, to an SPE) but no ultimate buyer has consummated a transaction for the time-sharing interval, no profit should be recognized.

.56 For balance-sheet presentation purposes, an SPE should be viewed as an entity lacking economic substance and established solely for the purpose of facilitating sales if (*a*) the SPE structure is legally required by the applicable jurisdiction(s) to sell time-sharing intervals to the nonresident customers that the developer-seller wishes to sell to (for example, for purposes of being able to sell intervals to United States citizens in a country in which citizens of other countries are not allowed to own real estate) and (*b*) the SPE has no assets, other than the time-sharing intervals, and the SPE has no debt. In those circumstances, the seller should show on its balance sheet as time-sharing inventory the interests in the SPE not yet sold to end users. If an SPE does not meet the conditions in both items *a* and *b* above, the accounting and presentation should be consistent with investments in other SPE structures (for example, the consolidation of controlled SPEs and SPEs in which no other entity has adequate capital at risk).[9]

.57 If the seller, an affiliate of the seller, or other related party operates a points program, vacation club, exchange program, **affinity program**, or similar program, the operation of the program constitutes continuing involvement by the seller.[10] The seller should evaluate whether it receives compensation at prevailing market rates for that service. If the seller provides the service without compensation or at compensation less than prevailing market rates for the service required or on terms not usual for the service to be rendered, compensation should be imputed when the sale is recorded (by reducing the sales value of the interval) and profit should be appropriately recorded under the guidance on continuing involvement in FASB Statement No. 66 (see paragraph 31 of that Statement; also see Appendix C [paragraph .59] of this SOP).

Owners Associations[11]

.58 Time-share projects typically incur significant operating costs, such as costs of property taxes, repairs and maintenance, and reservation systems.

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[9] FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities*, provides guidance on whether special-purpose entities (SPEs) that represent variable interest entities should be consolidated.

[10] The terms *affiliate* and *related party* have the same meaning here as in FASB Statement No. 57, *Related Party Disclosures*.

[11] The AICPA Audit and Accounting Guide *Common Interest Realty Associations* provides additional information on owners associations and similar entities.

Time-share owners are responsible for paying for the costs of owning their intervals. Because there are many time-share owners for a given project, a centralized mechanism generally is used to collect each owner's share of those costs of ownership and to pay for operating costs. A time-share seller typically forms an owners association (OA) to manage the day-to-day operations of a project. Time-share owners pay assessments to the OA. The activities of an OA are governed by its bylaws and by a board of directors. Typically, an OA will hire a manager to handle the day-to-day operations. Often, an affiliate of the original time-share seller is hired by an OA to manage a project. Because the time-share seller owns a majority of units at the beginning of the sellout of a project, it typically will appoint members of the OA's board of directors.

.59 During early stages of project sellout, there are typically not enough dues-paying time-sharing interval owners to support the financial obligations of the OA. Often a time-share seller, for a limited period of time, subsidizes the operations of the OA rather than paying the dues or maintenance fees on the time-sharing intervals that it owns (that is, the unsold intervals in the project). Subsequent to that period, the time-share seller pays dues or maintenance fees on the time-sharing intervals that it owns. Payments by the seller of dues or maintenance fees, except when accounted for as incidental operations during holding periods under paragraphs .49 through .52 of this SOP, should be charged to expense as incurred. Payments by the seller of additional amounts to subsidize losses should be charged to expense as incurred. If a seller is contractually entitled to recover from the OA all or a portion of its subsidy, the seller should record a receivable only if recovery is probable and measurable with reasonable reliability.

.60 A time-share seller hired as the manager of an OA typically is entitled by agreement to a management fee. The seller should recognize that fee as revenue only if it is earned and it is realized or realizable. If a seller is currently subsidizing operations of an OA, to the extent the seller receives a management fee on intervals it owns, the seller should offset the management fee revenue and related subsidy expense.

.61 The guidance in the preceding paragraph applies if the time-share seller does not consolidate the OA. This SOP does not provide guidance as to when (or how) a time-share seller should consolidate an OA. Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, and FASB Statement No. 144; FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities*; and related EITF Issues provide the relevant guidance. AcSEC notes that FASB Statement No. 144 amended ARB No. 51 to remove the prior exception allowing for the nonconsolidation of an entity when control is likely to be temporary.

Statement of Cash Flows

.62 Changes in time-sharing notes receivable, including sales of the notes, should be reported in the statement of cash flows as cash flows from operating activities.

Presentation and Disclosures

.63 A time-share seller's balance sheet should include gross notes receivable from time-sharing sales, a deduction from notes receivable for the allowance for uncollectibles (see paragraphs .36 and .37 of this SOP), and a deduction from notes receivable for any profit deferred under FASB Statement No. 66.

.64 As noted in paragraph .41 of this SOP, the effects of changes in estimate in the relative sales value method should be disclosed in accordance with paragraph 33 of APB Opinion No. 20. In addition to the information otherwise required by generally accepted accounting principles (GAAP), the financial statements of entities with time-sharing transactions should disclose the following:

a. Maturities of notes receivable for each of the five years following the date of the financial statements and in the aggregate for all years thereafter. The total of the notes receivable balances displayed with the various maturity dates should be reconciled to the balance-sheet amount of notes receivable.

b. The weighted average and range of stated interest rates of notes receivable.

c. The estimated cost to complete improvements and **promised amenities**.

d. The activity in the allowance for uncollectibles, including the balance in the allowance at the beginning and end of each period, additions associated with current-period sales, direct writeoffs charged against the allowance, and changes in estimate associated with prior-period sales. If the developer sells receivables with recourse, the seller should provide the same disclosure of activity on receivables sold.

e. The seller's policies with respect to meeting the criteria for buyer's commitment and collectibility of sales prices in paragraphs 5(b) and 37(d), respectively, of FASB Statement No. 66.

Effective Date and Transition

.65 This SOP should be applied to financial statements for fiscal years beginning after June 15, 2005. Earlier application is encouraged as of the beginning of fiscal years for which financial statements or information have not been issued.

.66 Initial application of this SOP should be reported as a cumulative effect of a change in accounting principle, as described in APB Opinion No. 20. When adopting this SOP, an entity is not required to report the pro forma effects of retroactive application. An entity is required to disclose the effect of adopting this SOP on income before extraordinary items and on net income (and on the related per share amounts) of the period of the change. An entity should not restate previously issued financial statements.

The provisions of this Statement need not be applied to immaterial items.

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Appendix A

Basis for Conclusions

Scope

A-1. The scope of this Statement of Position (SOP) is restricted to time-sharing transactions in real estate and excludes time-sharing transactions in other long-lived assets such as cruise ships, corporate jets, and other kinds of transportation equipment. The Accounting Standards Executive Committee (AcSEC) concluded, accordingly, that the specialized real estate guidance for time-sharing transactions in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate*, should be one of the principal foundations for the conclusions in this SOP. Consequently, analogies of the guidance in this SOP to non-real estate transactions may not be appropriate.

A-2. AcSEC concluded that the SOP should apply to time-share resellers as well as time-share developers because many of the same issues apply to both.

Profit Recognition Under FASB Statement No. 66

A-3. The exposure draft of this SOP incorporated a revenue recognition model for time-sharing transactions that was largely based on the fundamental principles of the retail land sales model of FASB Statement No. 66. At its initial meeting to clear a final SOP, the FASB determined that AcSEC should not include a fundamental change in revenue recognition guidance in the SOP. The Board considered a number of factors in arriving at its conclusion, including (*a*) the Board's comprehensive revenue recognition project and the potential for requiring preparers to change their revenue recognition practices twice in a short time frame, (*b*) the "rules based" nature of the proposed revenue recognition requirements, and (*c*) changes in revenue recognition practices that had occurred since AcSEC originally added the project to its agenda. Accordingly, this SOP does not modify the requirement of FASB Statement No. 66 to account for time-sharing transactions under the other-than-retail-land-sales (OTRLS) model of that Statement. Rather, this SOP provides limited guidance relating to revenue recognition by illustrating the application of the revenue recognition provisions of the OTRLS model to the specific terms typically encountered in time-sharing transactions.

A-4. Paragraph 37 of FASB Statement No. 66 prescribes the application of the percentage-of-completion method to time-sharing transactions provided certain criteria are met. FASB Statement No. 66 provides specific guidance on applying the percentage-of-completion method to retail land sales but does not provide similar guidance for OTRLS. AcSEC believes that the guidance appropriate for time-sharing transactions (see paragraphs B-3 through B-6 in Appendix B [paragraph .68] of this SOP) consists of elements of both that guidance in FASB Statement No. 66 and the percentage-of-completion method guidance in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* [section 10,330], which applies to "contracts in the construction industry, such as those of general building, earth moving, dredging, demolition, design-build contractors, and specialty contractors (for example, mechanical, electrical or paving)." Because AcSEC does not believe that selling and marketing costs constitute "contract costs" or that the selling and marketing effort constitutes "contract performance," as those terms are used in paragraphs 4 and 22, respectively, of SOP 81-1 [section 10,330.04 and .22], AcSEC concluded that selling and marketing costs should not be included in the percentage-of-completion calculations for time-sharing transactions. AcSEC believes that a time-share developer should recognize profit under the percentage-of-completion method only for costs incurred that benefit the customer by bringing the time-share unit closer to completion and a certificate of occupancy.

A-5. Some respondents to the exposure draft disagreed with the prescribed use of the percentage-of-completion method in the situation in which a developer sells time-sharing intervals prior to the completion of related amenities of a phase that is fully constructed (see footnote 2 to paragraph B-3 in Appendix B [paragraph .68] of this SOP). Those respondents commented that substantial risks and rewards of ownership transfer to the purchaser even if amenities are not complete and, therefore, the full accrual method should be permitted. AcSEC believes, however, that until the applicable amenities are completed, a seller has not fulfilled all of its contractual obligations to the buyer and should therefore delay recognition of a portion of profit until such obligation is fulfilled.

A-6. AcSEC concluded in paragraph .13 of this SOP that transfer of title should be nonreversionary in order to satisfy the requirement under FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases*, that title be transferred in order to recognize a sale of real estate. Paragraph 22(c) of FASB Statement No. 98 indicates that a lease involving real estate must meet the criterion in paragraph 7(a) of FASB Statement No. 13, *Accounting for Leases*, for the lessor to classify the lease as a sales-type lease. Under that criterion, ownership must be transferred by the end of the lease term. AcSEC believes that only a nonreversionary transfer of title satisfies that criterion.

Determination of Sales Value

A-7. AcSEC's conclusion in paragraph .17 of this SOP that the seller's transfer of a time-sharing interval and other products and services (including incentives) that may be "bundled" with the time-sharing interval should be recorded as separate transactions was based on paragraphs 7(b) and 31 (applied, by analogy, to products as well as services) of FASB Statement No. 66. Paragraph 7(b) of that Statement requires that net present value be used as the measure of the other products and services but does not specify what discount rate to use. AcSEC believes, however, that for the typical other products and services associated with time-sharing transactions, fair value represents the intended objective of net present value and may be more readily determinable than the appropriate discount rate. Fair value is also consistent with more recent accounting standards. Accordingly, AcSEC prescribed fair value rather than net present value.

A-8. Some respondents commented that all incentives represent and therefore should be accounted for as selling and marketing expenses, similar to commissions and other direct selling costs, with any stated fees (for example, a nominal [below fair value] fee that a time-share purchaser pays for an airline voucher used as an incentive) being a reduction of those expenses. Those respondents suggested that the sales value of the interval not be adjusted for incentives. AcSEC considered the comment but did not believe an accounting treatment other than that prescribed in paragraphs 7(b) and 31 (applied, by analogy, to products as well as services) of FASB Statement No. 66 could be justified.

A-9. AcSEC's conclusion in paragraphs .17 and .18 of this SOP about the seller's income statement classification of cash and noncash incentives to buyers was based on Emerging Issues Task Force (EITF) Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)," and FASB Statement No. 66. A cash incentive represents a discount or reduction of the selling price of the time-sharing interval under (paragraphs 9 and 17 of) EITF Issue No. 01-9, that is, with no recording of expense for the cash consideration paid. AcSEC believes that a noncash incentive represents a separate deliverable that should be recorded consistent with paragraph 10 of EITF Issue No. 01-9 and paragraphs 7(b) and 31 (applied, by analogy, to products as well as services) of FASB Statement No. 66, that is, as a separate revenue item (with an associated cost of sales). EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables," addresses "the accounting, by a vendor, for contractual arrangements in which multiple revenue-generating activities will be performed by the vendor." However, paragraph 4 of that Issue states that the Issue does not apply to a specific situation if higher-level authoritative literature, such as FASB Statement No. 66, provides guidance for that situation.

A-10. AcSEC concluded in paragraph .18 of this SOP that a cash incentive is either cash or an incentive provided to a buyer that the buyer would otherwise be required to pay. AcSEC believes that the seller's providing that incentive to the buyer is equivalent to the seller reimbursing the buyer for the cash the buyer would otherwise have had to pay in any case, which is equivalent to a cash discount from the stated sales price. Similarly, AcSEC's conclusion that a noncash incentive is an incentive a buyer could elect to purchase was based on AcSEC's belief that in this case the seller is not reimbursing the buyer for cash that the buyer would otherwise have had to pay.

A-11. As an illustration of the recording of incentives, assume the seller gives the buyer of a $20,000 interval a voucher with a fair value of $250 that can be used to obtain airline tickets at no charge. The voucher would be considered a noncash incentive. The seller would report revenue from the sale of the interval of $19,750, revenue from the sale of the voucher of $250, and cost of sales for the voucher of $250. If, instead, the seller pays the buyer's first year's worth of required owners association maintenance fees having a fair value of $250, the payment would be considered a cash incentive. The seller would report revenue from the sale of the interval of $19,750 and no revenue or cost for the fees.

A-12. AcSEC observed that time-share sellers frequently offer a variety of incentives, including both payment of assessments/ fees and amusement park or airline tickets, at one time to the same group of customers. The particular incentive given to a particular customer is based on which one the seller believes will induce the customer to close a sale. AcSEC believes that the time-sharing industry is different in this respect from the transactions that the EITF considered. AcSEC believes that the EITF contemplated transactions in which the seller provided one type of incentive to a class of customers. In the time-share industry, the seller is essentially indifferent between offering a voucher for airline tickets with a fair value of $250 or offering to pay $250 of maintenance fees. AcSEC struggled with the fact that under the EITF consensus, a time-share seller could report different revenue based on which of two incentives it provided to buyers, even though the choice between incentives is so flexible and discretionary. Nonetheless, although it might be more understandable to report the same revenue and cost of sales regardless of the form of the incentive given to buyers, AcSEC concluded that the benefit of consistency with the EITF consensus outweighed creating an exception to the consensus for a single type of transaction (time-sharing).

Application of Test of Buyer's Commitment

A-13. Under paragraph 5(b) of FASB Statement No. 66, profit recognition is affected by the buyer's initial and continuing investments. Given AcSEC's conclusions about how to compute sales value (see paragraphs .16 through .23 of this SOP), it became necessary to provide guidance on how the seller should allocate cash received from the buyer between the interval and the incentives or other "bundled" products or services. AcSEC initially concluded that the fair value of other products or services should be subtracted from the buyer's initial and continuing investments, based on the belief that, as a general rule, any cash received by the seller should be applied first towards the sale of the other products or services and second towards the sale of the time-sharing interval. However, if the buyer is directly or indirectly required to make payments on the note to receive the other products or services, AcSEC concluded that it was too harsh to subtract the full fair value from the initial and continuing investments. AcSEC also considered an alternative, favored by some respondents, of allocating all cash received from the buyer pro rata between the interval and the other products or services based on relative fair values. AcSEC rejected that alternative, because it implied that the seller extended the same credit terms to the interval and the other products or services. AcSEC thought it was unlikely that a seller would allow a buyer to pay for incentives, such as airline tickets, amusement park tickets, or maintenance fees, over the typical five- to ten-year term of time-share notes. In the end, AcSEC endorsed a compromise approach that AcSEC believes is a reasonable way to allocate the cash received. Under that compromise approach, any note payments that the buyer is directly or indirectly required to make to receive the other products or services should be subtracted from the fair value of those other products and services, and only the excess (if any) of that fair value over those payments should be subtracted from the buyer's initial and continuing investments for the interval. AcSEC believes that approach is consistent with practice under FASB Statement No. 66—in particular, with regard to how sellers account for their provision of management services at less than prevailing market rates.

A-14. AcSEC believes it is reasonable to apply all buyer payments—including both principal and interest—before seller delivery of the other products or services, and that those payments should cover both the value of the other products or services and interest on the unpaid portion. For accounting purposes, the seller allocates cash received as if there were two separate notes (with the same interest rate)—one for the purchase of the interval (with a term equal to the term of the note the buyer signs) and one for the other products or services (with a term ending on the date the buyer can use them). AcSEC believes that this approach represents a systematic and rational allocation of the cash received between the interval and other products or services. AcSEC observes that under this approach, the hypothetical note for the purchase of the interval may have a period of negative amortization, because the cash receipts allocated to that note might be less than the accrued interest. AcSEC concluded that it was not necessary to reduce the buyer's initial or continuing investments for that negative amortization, because the buyer's continuing performance on the legal note provides sufficient assurance of the buyer's commitment to fulfill its obligations and because that legal note has no negative amortization. Further, AcSEC believes that products or services integral to the time-sharing interval (for example, seller payment of buyer maintenance or exchange fees) reinforce the buyer's commitment to fulfill his or her obligations.

A-15. AcSEC considered providing guidance on distinguishing de minimis promotional items, the costs of which should be considered selling and marketing costs, from incentives. AcSEC elected not to provide such guidance because AcSEC believes that time-share sellers will be able to adequately distinguish between "thank you" gifts, which are inexpensive items such as champagne, flowers, candy, or photographs given to buyers at closing, that would not reasonably be expected to influence the customer's decision, and incentives, which are given only to interval purchasers and might reasonably be expected to influence a customer to close a transaction that day. AcSEC noted that the tests of initial and continuing investment under FASB Statement No. 66 are intended to be stringent, however, and the decision not to provide guidance on distinguishing thank-you gifts from incentives was not intended to provide a means of avoiding the requirements of those tests by allowing the classification of the costs of incentives as selling and marketing costs. Accordingly, AcSEC believes sellers should not exclude de minimis incentives from the calculations of the initial and continuing investment tests.

Upgrade and Reload Transactions

A-16. AcSEC's determination that a reload transaction requires an additional cash payment in order to satisfy the initial and continuing investment tests was based on EITF Issue No. 88-12, "Transfer of Ownership Interest as Part of Down Payment under FASB Statement No. 66." The consensus reached in that Issue was that "purchased property or other assets pledged as security for a note should not be included as part of the buyer's initial investment." AcSEC considered a reload to be the purchase of a second interval unrelated to the equity accumulated in the first interval.

A-17. In contrast, AcSEC believes an upgrade is, in substance, an exchange transaction in which the ultimate interval sold by the developer is the new (upgrade) interval. Because an upgrade transaction can be viewed as the developer buying back the original time-share buyer's equity in the original interval for cash and the buyer then applying that cash towards the purchase of the upgrade interval, AcSEC believes it is appropriate to include the equity in the original interval (measured as the buyer's initial and continuing investments on the ceded interval and excluding changes in market value of the interval) towards the tests of initial and continuing investments on the upgrade interval.

A-18. Under the exposure draft, the sales value in an upgrade transaction was the difference between the sales value of the upgrade interval and the sales value of the original interval at the date of the original sale. The initial and continuing investment tests were to be applied to that incremental sales value. AcSEC had looked to paragraph 9 of FASB Statement No. 66 to conclude that a buyer's equity in its original interval could not be applied toward the initial or continuing investment tests for the upgrade interval.

A-19. Many respondents to the exposure draft commented that both reloads and upgrades should be considered together with the original sale for purposes of applying the initial and continuing investment tests. Comments included the following:

a. Reload transactions are typically undertaken by "mature" timeshare owners who have made cumulative payments on their existing obligations that typically total 25 to 35 percent of the combined purchase prices of the original and reload intervals. In many cases, the purchase obligations are consolidated into a single monthly payment, often involving a single note. Thus, a reload is viewed by both seller and buyer as merely an expansion of the original obligation, with cash paid on the original interval crediting toward the remaining combined obligation on the two intervals.

b. The intent of the initial and continuing investment tests is to demonstrate the buyer has made cash payments that provide a reasonable likelihood of the seller collecting the receivable. Because reload transactions generally are entered into only with customers current on their existing obligation, the resulting note on the second interval is of high quality.

c. EITF Issue No. 88-12 addresses requirements related to an initial down payment, whereas FASB Statement No. 66 and the SOP exposure draft incorporate both initial and continuing investment requirements rather than a down payment requirement. Because the intent of the initial and continuing investment tests is to ensure a reasonable likelihood of collectibility, the test as applied to reloads and upgrades should take into account the buyer's performance and initial and continuing investments with respect to the original interval.

A-20. AcSEC considered the comments and, although EITF Issue No. 88-12 could be interpreted as not being relevant to a test of initial or continuing investment, AcSEC believes that the objective of paragraphs 9 and 10 of FASB Statement No. 66 is that payments on real estate transactions for distinct and separate parcels of real estate should be treated separately for purposes of sale or revenue recognition, even if the two transactions are combined into a single note receivable or are cross-collateralized. Therefore, AcSEC concluded it should not modify its original accounting for reload transactions from that in the exposure draft of this SOP. However, in reconsidering upgrade transactions and observing that the original interval is ceded or, in essence, traded in in such transactions, AcSEC concluded that an upgrade transaction is a modification of the original purchase rather than a purchase of an additional distinct and separate interval, and that it is reasonable to consider the initial and continuing investments on an initial purchase as part of the initial and continuing investments on a modification of that purchase.

Accounting for Uncollectibility

A-21. AcSEC considered the following three alternatives for the classification and display of uncollectibles:

a. Adjust revenue and cost of sales (the approach in this SOP).

b. Record bad debt expense.

c. Adjust revenue and cost of sales for the initial estimates of uncollectibles and record bad debt expense for subsequent increases in estimated uncollectibles.

A-22. The first alternative AcSEC considered was to adjust revenue and cost of sales. AcSEC selected that alternative for this SOP primarily for the following reasons:

a. Some AcSEC members view time-share uncollectibles as having some elements of a right of return as discussed in FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*, because, typically, it is not cost-effective for a time-share seller to pursue buyers for collection after a certain point. Once a time-share seller forecloses on a time-share interval, the seller typically stops pursuing the buyer for collection of the unpaid note, even if the note balance exceeds the fair value less costs to sell of the interval to the seller. Another similarity with a right of return is that a repossessed interval is essentially "good as new" and can be resold at substantially the same price as an interval that never was sold. In contrast to the uncollectible that results from a trade receivable, the sold item (that is, the time-sharing interval) is repossessed in the time-sharing arrangement. As a result, the foreclosure is akin to a sales return that reduces revenue.

b. Time-sharing transactions are characterized by a number of attributes that distinguish them from typical OTRLS transactions. Primary among these attributes are high volume and seller financing. Other distinguishing attributes include relatively low down-payment requirements and marketing and selling efforts with a high cost relative to the price of time-sharing intervals. Paragraph 1 of FASB Statement No. 66 states, "The Statement distinguishes between retail land sales and other sales of real estate because differences in terms of sales and selling procedures lead to different profit recognition criteria and methods." Under the description of retail land sales in paragraph 100 of FASB Statement No. 66, and in view of similarities between their sales and selling procedures, retail land sales and time-sharing transactions share many more of the same attributes than do retail land sales and typical OTRLS transactions. Paragraph 70 of FASB Statement No. 66 provides the following guidance for retail land sales: "Cost of sales...are based on sales net of those sales expected to be canceled in future periods." Although FASB Statement No. 66 provides no comparable guidance for cost of sales in OTRLS transactions, AcSEC believes that the retail land sales concept of not recording transactions expected to be canceled in future periods is also appropriate for time-share transactions.

c. If uncollectibles are recorded as bad debt expense, the seller records revenue (and cost of sales) for more than 100 percent of the intervals constructed, because foreclosed intervals are resold. In fact, the worse the collection experience, the more intervals that are repossessed are resold, leading to higher reported revenue (and cost of sales). AcSEC believes that approach overstates revenue.

d. The time-share industry has, in practice, recorded repossessed intervals at their original cost rather than at fair value on the date of foreclosure. However, FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (as amended by paragraph C24 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*), states that foreclosed assets should be recorded at fair value less cost to sell. AcSEC concluded that if foreclosed intervals were recorded at fair value less cost to sell, there would be significant issues over the proper approach to measuring fair value less cost to sell. Some argue for an approach that would essentially eliminate allowances for uncollectibles for many developers that have the selling and marketing infrastructure to sell repossessed intervals at a price close to the original sales price. Others would reject that approach because it fails to reflect an allocated cost of maintaining that infrastructure. Some would make the measurement equal to the net proceeds that an existing time-share owner would receive if the time-share were sold on the secondary market. Some would measure fair value based on reproduction cost. Finally, some would apply the definition of market in paragraph 8 ("Statement 6") of Chapter 4 of Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*, which states that for purposes of pricing inventory, market is replacement cost, subject to a floor and a ceiling:[1]

> As used in the phrase *lower of cost or market* [footnote omitted], the term *market* means current replacement cost (by purchase or by reproduction, as the case may be) except that:
>
> (1) Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal); and
>
> (2) Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin.

AcSEC chose not to debate those approaches. AcSEC's preferred solution (the alternative presented in item *a* in paragraph A-21 of this SOP), through the application of the relative sales value method, does not require an assessment of fair value.

A-23. AcSEC recognizes that its preferred solution has some disadvantages:

a. It differs from general practice in other industries (other than the retail land sales industry).

b. It includes in inventory the cost of some intervals for which legal title has passed from seller to buyer.

c. It creates an issue of how to address changes in estimates of revenue and cost of sales.

On balance, however, AcSEC believes that the method chosen for this SOP is the best of the alternatives.

A-24. The second alternative AcSEC considered was to record uncollectibles as bad debt expense, measured as the excess of the expected uncollectible receivables over the historical inventory cost of the intervals expected to be repossessed. The advantages of that alternative are the following:

a. This approach would be similar to existing practice in the time-share industry.

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[1] The Financial Accounting Standards Board (FASB) has issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Fair Value Measurements*. Under paragraph C18 of that exposure draft, the Board "clarified that in ARB 43, Chapter 4 the 'market value' measurement resulting from the application of the lower of cost or market measurement required for inventories is not fair value. It places upper and lower limits on the measurement that may not result in a fair value measurement." Readers should be alert to any final pronouncement.

b. This approach would clearly display on the face of the income statement two important metrics for time-share developers—namely, sale transactions closed in the current reporting period and the charge for credit losses net of inventory recoveries. Under AcSEC's approach, those amounts are not required to be displayed in the income statement.

c. Gross profit percentages calculated under this approach may be easier to interpret than under AcSEC's approach.

The disadvantages of the bad debt expense alternative generally are discussed in paragraph A-22 as advantages of AcSEC's approach. Many respondents to the exposure draft expressed a preference for the bad debt expense alternative, largely for the reasons noted in items *a* and *b* of paragraph A-23. Respondents commented also that AcSEC's approach compromises the seller's ability to separately measure the performance of its selling and financing processes because the approach distorts the measurement of both the efficiency of the selling and marketing efforts to produce sales revenue and the performance of the seller's portfolio of notes receivable.

A-25. Finally, AcSEC considered a hybrid approach under which estimated uncollectibles for a short time after a sale (six to twelve months) would be classified as reductions of revenue, but increases in estimated uncollectibles after that time would be classified as bad debt expense. The idea was that uncollectibility that occurs within a short time following the sale transaction is more akin to a return, as if the buyer had a change of heart, whereas uncollectibility after the buyer has built some equity in the property is more akin to "credit losses" in other industries. AcSEC believes strongly, however, that all uncollectibles should be classified in the same line in the income statement. In addition, AcSEC members were concerned that if there were a bright line, sellers could time their changes in estimate and their foreclosure strategies to achieve the classification that they desired. As a result, AcSEC did not pursue this approach.

A-26. AcSEC concluded in paragraphs .30 through .32 of this SOP that the term *uncollectibles* should be interpreted broadly. AcSEC based its conclusion upon certain guidance in FASB Statements No. 15 and No. 114, *Accounting by Creditors for Impairment of a Loan*. Although paragraph 6 of FASB Statement No. 114 states that the Statement does not apply to "large groups of smaller balance homogenous loans that are collectively evaluated for impairment"—characteristics of time-sharing receivables—paragraph 9 of that Statement states that a creditor shall apply the provisions of FASB Statement No. 114 to such smaller balance homogeneous loans if they are restructured.

A-27. A debt restructuring is "troubled" in accordance with paragraph 2 of FASB Statement No. 15 "if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider." A loan is impaired under paragraph 8 of FASB Statement No. 114 when "it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement." AcSEC believes that many situations in which time-share buyers fail to make their original contractual payments fall within the scope of those Statements and that, therefore, any losses that occur as a result of applying those Statements constitute, under this SOP, uncollectibility. Those situations include but are not limited to assumptions, modifications of terms, foreclosures, and downgrades. An assumption, involving the substitution of another borrower for the buyer, would typically result in a loss (that is, uncollectibility) under paragraph

42 of FASB Statement No. 15. An assumption of the kind described in EITF Issue No. 87-19, "Substituted Debtors in a Troubled Debt Restructuring," would result in the creditor recognizing a loss on the disposition of the original loan and recording an asset for the fair value of the payments to be received from the substituted debtor (which is less than the creditor's net investment in the original loan). A modification of terms or a partial satisfaction of a receivable in combination with a modification of terms would typically result in a loss under paragraphs 28 and 33 of FASB Statement No. 15 (as amended by paragraph 22(c) of FASB Statement No. 114). A foreclosure or other repossession of a time-sharing interval would typically result in a loss under paragraph 34 of FASB Statement No. 15, as modified by paragraph 22(d) of FASB Statement No. 114.

A-28. In concluding that a downgrade represents a kind of uncollectible, AcSEC considered charging directly against sales the difference between the sales prices of the new and old intervals. AcSEC believes, however, that a downgrade represents primarily a modification in terms and that any associated losses under FASB Statement No. 114 should, just as with any other kind of uncollectible, be taken into account in determining expected and actual uncollectibles. In support of that belief, AcSEC observed that the new reduced loan under a downgrade may have different terms (term of note, interest rate, payment schedule) than the original contractual financing.

A-29. AcSEC concluded in paragraph .34 of this SOP that incremental, direct costs associated with uncollectibles should be charged to expense as incurred. AcSEC analogized to paragraph 14 of FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, which indicates that costs related to a troubled debt restructuring should be charged to expense as incurred.

Accounting for Cost of Sales and Inventory

A-30. AcSEC concluded in paragraph .40 of this SOP that the relative sales value method is the appropriate method for time-sharing transactions. As discussed in paragraph A-22(*b*) of this SOP, AcSEC believes that paragraph 70 of FASB Statement No. 66 is appropriate for time-sharing transactions; specifically, paragraph 70(c) provides appropriate guidance for recording cost of sales. AcSEC also believes that treating inventory as a pool of costs is a more cost-effective approach than specific identification to account for large pools of homogeneous inventory.

A-31. AcSEC concluded in paragraph .41 of this SOP that changes in estimate under the relative sales value method should be accounted for on a fully retrospective basis using a current-period adjustment. AcSEC also considered the following two alternatives for accounting for changes in estimate:

a. Retrospectively, via a cumulative, current-period adjustment from the beginning of the fiscal year of change

b. Prospectively, beginning with the period of change (for example, a quarter)

In its deliberations, AcSEC noted that the fully retrospective method prescribed in this SOP and alternative *a* have precedent in the accounting literature, and that alternative *b* is not unlike the method prescribed in FASB Statement No. 66 (paragraph 76) for the percentage-of-completion method of accounting for retail land sales. The fully retrospective method is similar to the cumulative catch-up described in paragraph 83 of SOP 81-1 [section 10,330.83]. The retrospective method in alternative *a* is consistent with paragraphs 36 and 107 through 109 of SOP 00-2, *Accounting by Producers or Distributors of Films* [section 10,800.36 and .107 through .109].

A-32. AcSEC believes that the principal basis for the method prescribed in SOP 00-2 [section 10,800] (that is, consistency with prior accounting in the superseded FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*) is not adequate to justify that method's application to changes in estimate under the relative sales value method. AcSEC believes also that the prospective method discussed in the preceding paragraph, although appearing to represent a reasonable means of reflecting changes in estimate, would introduce a new model of accounting for changes in estimate that would result in further diversity in how such changes are accounted for. AcSEC ultimately concluded that the fully retrospective method was most appropriate because, under that approach, the current carrying amounts of inventory and net receivables in the period of change would reflect the seller's best estimates at the end of the period.

A-33. AcSEC concluded (see paragraph B-4 of Appendix B [paragraph .68] of this SOP) that changes in estimate under the percentage-of-completion method should be accounted for under the same retrospective method as that used for all other changes in estimate under the relative sales value method. This results in consistency in the relative sales value method computations. AcSEC's conclusions in paragraphs .41 and .64 of this SOP regarding disclosure of changes in estimate are based on the first sentence of paragraph 33 of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*.

A-34. AcSEC's conclusion in paragraph .42 of this SOP that a seller should perform impairment testing on time-sharing inventory in accordance with FASB Statement No. 144 rather than ARB No. 43 is based on paragraphs B122 through B124 of that Statement.

Costs to Sell Time-Sharing Intervals

A-35. AcSEC's conclusions in paragraphs .45 and .46 of this SOP were based on paragraphs 17 through 19 of FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, but were modified to incorporate the more recent "incremental costs" guidance in paragraphs 6 and 7 of FASB Statement No. 91. AcSEC's conclusion in paragraph .48 of this SOP that tour generation costs—that is, costs to induce potential buyers to take sales tours—should be expensed as incurred is based on the guidance in paragraph 7 of FASB Statement No. 91 relating to the accounting for costs of soliciting potential borrowers.

A-36. Some respondents commented that time-share selling and marketing costs should be deferred until the related revenue is recognized. Those respondents commented that to charge those costs to expense as incurred while recognizing the related revenue during later periods is likely to distort reported results and fail to clearly and timely reflect trends, such as a downward trend in time-share sales. AcSEC believes, however, that deferred selling and marketing costs do not meet the definition of an asset and observed that similar conclusions have been drawn in other literature—for example, SOP 00-2 [section 10,800] and FASB Statement No. 2, *Accounting for Research and Development Costs*.

A-37. Some respondents commented that tour generation costs should be deferred until the tour occurs, based on analogy to the guidance on direct response advertising in SOP 93-7, *Reporting on Advertising Costs* [section 10,590]. Those respondents argued that solicited potential buyers could be shown to have responded specifically to the tour generation activity by taking a tour and purchasing a time-share interval, and that the documentation requirements in paragraph 34 of SOP 93-7 [section 10,590.34] are satisfied by the fact that time-share entities can document the response—namely, the customer name and the tour that generated the sale. AcSEC disagreed, however, based on the fact that there are significant additional sales activities (principally, the tour) involved following the tour generation activity, and that under paragraph 73 of SOP 93-7 [section 10,590.73] the costs of the tour generation activity would therefore not be considered direct response advertising. AcSEC did agree to clarify that the costs of the tour itself, for example, airline tickets, should be charged to expense in the period in which the tour occurs.

A-38. In its deliberations, AcSEC observed that similar costs to sell may be treated differently for accounting purposes depending on who the recipients are. For example, the costs of amusement park tickets given to all customers, regardless of whether or not those customers ultimately purchase a time-sharing interval, should be charged to expense as incurred as promotional items. However, if those same items are given only to customers who ultimately purchase a time-sharing interval, those items are incentives and should be accounted for as such under this SOP (see paragraphs .17 and .24 through .27).

A-39. Practice has been diverse as to the determination of which costs should be deferred as discussed in paragraph .46. It has been argued that direct commissions only, or incremental costs only, or costs fully loaded with overhead charges should be deferred. AcSEC made the determination, based on consideration of the guidance in FASB Statements No. 67 and No. 91, to defer certain selling costs only if they are both incremental and directly associated with successful sales transactions, and to expense as incurred nonincremental costs and costs associated with unsuccessful sales transactions. At the same time, AcSEC acknowledged that selling costs as a percentage of revenue could vary more from period to period under the incremental approach than under the nonincremental, "directly associated" approach of FASB Statement No. 67.

A-40. AcSEC concluded that all selling costs should be expensed under the cost recovery method of accounting because of uncertainties about the recoverability of deferred selling costs. AcSEC's conclusion to limit the amount of deferred selling costs under the deposit method to the nonrefundable portion of the deposits received by the seller was intended to eliminate the risk of not recovering deferred selling costs in the event of a buyer default.

Operations During Holding Periods

A-41. AcSEC clarified in paragraph .49 of this SOP the term *holding period* to address scenarios such as a time-sharing entity's purchase of a hotel and conversion of the units to time-shares over a multiple-year development period. Under that scenario, a particular occupancy unit would be depreciated until it was clearly held and available for sale as a time-sharing interval.

A-42. AcSEC concluded in paragraph .50 of this SOP that rental operations associated with time-sharing units during holding periods should be accounted for as incidental operations, as discussed in FASB Statement No. 67, rather than as rental revenue and expenses, because AcSEC believes that those rental operations are incidental to the time-sharing developer's principal business of selling intervals. Revenue from rentals helps the seller defray the costs associated with holding unsold intervals, such as the maintenance fees to the owners association (OA). In arriving at its conclusion, AcSEC considered and rejected two alternative accounting treatments:

a. Account for all unsold inventory as fixed assets and depreciate unsold time-sharing intervals.

b. Apply the SOP's prescribed holding-periods accounting to time-sharing intervals expected to be sold within one year, and apply the accounting in the alternative presented in item *a* to time-sharing intervals not expected to be sold within one year.

A-43. AcSEC also concluded in paragraph .50 that in recording incremental revenue in excess of incremental costs as a reduction of inventory costs, estimates of future amounts of such excess should not be factored into the calculations of the relative sales value method. AcSEC believes that because it may be impracticable to reliably estimate in advance the net of incremental rental revenue over associated incremental rental costs, such estimates should not be anticipated in determining (reducing) inventory for purposes of calculating (reducing) the cost-of-sales percentage in the relative sales value method.

A-44. AcSEC observed that, in situations in which incremental rental income exceeds incremental costs, its conclusions may be perceived as differing from those in International Accounting Standard (IAS) 16, *Property, Plant and Equipment*. Under paragraph 21 of IAS 16, in such situations occurring during a property's development period, the net rental income is recorded in earnings rather than as a reduction of the property's cost. Although AcSEC's conclusion applies to the holding period rather than the development period, that conclusion differs from the conclusion in IAS 16. AcSEC believes that its conclusion represents preferable accounting in the specific facts and circumstances of the real estate time-sharing industry. AcSEC also believes that its conclusion is more consistent with U.S. generally accepted accounting principles—in particular, FASB Statement No. 67.

Special-Purpose Entities, Points Systems, Vacation Clubs, and Similar Structures

A-45. AcSEC concluded that the accounting for a time-sharing transaction should follow the same profit recognition principles in the OTRLS sections of FASB Statement No. 66 for all forms of time-sharing transaction structures. AcSEC's conclusion that, for special-purpose entity (SPE) structures, profit should be recognizable only if the time-sharing interval has been sold to the end user is based on guidance in FASB Statement No. 66 and APB Opinion No. 29, *Accounting for Nonmonetary Transactions*. The guidance in paragraphs 33 and 34 of FASB Statement No. 66 on accounting for "partial sales" discusses the situation in which the seller retains an equity interest in either the real estate or the buyer. If the seller has an equity interest in the buyer, the seller can recognize profits to the extent of the outside interests in the buyer. Paragraph 34 states, "If the seller controls the buyer, no profit on the sale shall be recognized until it is realized from transactions with outside parties through sale or operations of the property." Paragraph 21 of APB Opinion No. 29 states that "an exchange of a productive asset not held for sale in the ordinary course of business for a similar productive asset or an equivalent interest in the same or similar productive asset" is a nonmonetary transaction that does not culminate an earnings process. Under that guidance, a seller's initial transfer of title to time-sharing real estate to an SPE in exchange for stock, beneficial interests, or other similar instruments in the real estate is considered a nonmonetary exchange, with no gain or loss to be recorded by the seller upon that initial transfer.

A-46. AcSEC believes that its use of the partial sales guidance in FASB Statement No. 66 as a basis for a time-sharing transaction involving an SPE structure is supported by EITF Issue No. 98-8, "Accounting for Transfers of Investments That Are in Substance Real Estate." The consensus of that Issue was that "the sale or transfer of an investment in the form of a financial asset that is in substance real estate should be accounted for in accordance with Statement 66." AcSEC believes that a seller's interest in a time-sharing SPE having no economic substance (see paragraph A-47 of this SOP) is in substance both real estate and a time-sharing interval. AcSEC observed that the Issue also states, "Paragraph 4 of Statement 140 [FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*] provides that transfers of ownership interests that are in substance the sale of real estate are outside the scope of Statement 140. Therefore, these transfers should follow the guidance in Statement 66. As a result, this issue is affirmed by the issuance of Statement 140."

A-47. Upon sale of time-sharing real estate to an SPE in exchange for interests in the SPE, the seller owns 100 percent of the interests in the SPE. As the seller sells the intervals, the seller's ownership percentage in the SPE decreases. Ordinarily, a seller should consolidate an SPE in the situation of control or an SPE ownership percentage over 50 percent, apply the equity method of accounting in the situation of significant influence or an SPE ownership percentage of 20 percent to 50 percent, and apply the cost method in the situation of no significant influence or an SPE ownership percentage below 20 percent. However, AcSEC believes that SPEs having no assets other than the time-sharing intervals and having no debt, and that are established solely to comply with legal requirements relating to the residency of the buyer, are simply a mechanism for selling intervals. For such SPEs, for balance-sheet classification purposes, AcSEC believes the seller should "look through" the SPE and classify intervals held by the SPE as inventory. By contrast, some SPEs would have economic substance, because they are legally required as a means of selling interests in multiple properties to a single buyer, rather than to comply with residency restrictions in local law. SPEs not meeting the narrow definition would be accounted for in accordance with the relevant standards, including FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities*; ARB No. 51, *Consolidated Financial Statements*, as amended and interpreted; and APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*.

A-48. AcSEC discussed time-sharing SPE structures in which the buyer's ownership period expires after a period of years. If the residual interest reverts to the seller, that constitutes a reversionary transfer of title; see paragraph .13 of this SOP. If, however, the transaction was structured in accordance with paragraph 38 of FASB Statement No. 66, AcSEC believes that the prescribed sale accounting of that paragraph of the Statement would apply to time-sharing transactions. Under that paragraph, sale accounting, rather than operating lease accounting, is prescribed for a situation in which a seller sells property improvements but leases the underlying land, provided that the term of the land lease:

a. Covers substantially all of the economic life of the property improvements; and

b. Is for a substantial period, for example, 20 years.

If either of conditions *a* or *b* is not met, under FASB Statement No. 66 the transaction is considered in substance to be a lease of both land and improvements and should be accounted for in the same manner as an operating lease.

A-49. If the buyer's ownership period expires after a period of years and the residual interest reverts to a substantive third party independent of the seller, AcSEC believes that the seller has relinquished all aspects of ownership and should apply the profit recognition guidance of FASB Statement No. 66 rather than operating lease accounting.

A-50. AcSEC's conclusions in paragraph .57 of this SOP relating to the seller's accounting for exchange, points, affinity, and similar programs are based on paragraph 31 of FASB Statement No. 66. See "Seller-Provided Management Services" in Appendix C [paragraph .69] of this SOP. With respect to the provision that a seller should evaluate whether it receives compensation at prevailing market rates for providing a program, some respondents to the exposure draft commented that because items (*rewards*) to be provided by the seller in exchange for a purchaser's interval may change over time, comparing the fair value of the exchanged items and the interval may be impracticable. AcSEC modified Appendix C [paragraph .69] to clarify its intent.

Owners Associations

A-51. AcSEC concluded in paragraph .59 of this SOP that seller subsidies to an owners association (OA) should be charged to expense as incurred. AcSEC considered the alternative of capitalizing those subsidies as development costs of time-share inventory but believes that subsidies represent a cost of operations and should therefore be treated as period costs. AcSEC concluded also that all or a portion of a subsidy that is contractually recoverable from an OA should be recorded as a receivable only if recovery is probable and measurable with reasonable reliability. Generally, AcSEC perceives that to record contractually recoverable subsidy recoveries as receivables requires assumptions that may involve a significant amount of uncertainty about (*a*) future operations of the OA and (*b*) the ability of the OA to increase future assessments to time-share owners.

Statement of Cash Flows

A-52. AcSEC's conclusion that changes in time-sharing notes receivable should be reported as cash flows from operating activities is based on paragraph 22(a) of FASB Statement No. 95, *Statement of Cash Flows*. That paragraph provides as examples of cash flows from operating activities cash receipts from collection or sale of both short- and long-term notes receivable that arise from sales of products or services.

Presentation and Disclosures

A-53. AcSEC believes that the disclosures required under paragraph .64 of this SOP, many of which are similar to those required in the retail land sales model in paragraph 50 of FASB Statement No. 66, are necessary to provide users with adequate information related to the financial positions of entities with time-sharing operations. AcSEC believes that, given the importance of the allowance for uncollectibles in the financial position of such entities, requiring disclosure of the components related to the determination of the allowance provides users of financial statements with information that is helpful in assessing the risks facing such entities.

Effective Date and Transition

A-54. AcSEC concluded that the effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle (in accordance with the provisions of APB Opinion No. 20) and that restatement of prior financial statements should be prohibited. AcSEC recognizes the benefits of comparable financial statements but believes that the effort and costs likely to be incurred outweigh the benefits. Under retroactive restatement (but not under a cumulative effect adjustment), for example, the seller would have to reconstruct the quarterly sales accounting for phases completely sold out as of the date of adoption. AcSEC further believes that to apply this SOP prospectively to new transactions only would result in confusing financial statements that could, for several years, include transactions recorded under both pre-adoption and post-adoption accounting guidance. Accordingly, AcSEC concluded that the effect of initial application of this SOP should be reported as the cumulative effect of a change in accounting principle.

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Appendix B

Illustration of Relative Sales Value Method Under Full Accrual and Percentage-of-Completion Accounting[1]

B-1. The purpose of this appendix is to illustrate the relative sales value method and changes in estimate under that method. Examples 1 through 4 illustrate the full accrual and percentage-of-completion methods of profit recognition under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate*.

Full Accrual Method

B-2. Under the full accrual method as discussed in the other-than-retail-land-sales (OTRLS) sections of FASB Statement No. 66, profit is recognized in full when a time-share is sold (or at a later date when the criteria for application of the method are met). Examples 1 and 2 illustrate the application of the relative sales value method of this Statement of Position (SOP) under full accrual accounting. In Example 1, it is assumed that there are no year-to-year changes in the cost-of-sales percentage. In Example 2, it is assumed that the cost-of-sales percentage changes from year to year.

Percentage-of-Completion Method

B-3. A seller may not have completed improvements on time-sharing units sold or may not have completed promised amenities, **planned amenities**, or other facilities (including utilities and off-site improvements such as access roads) applicable to units sold. Under the percentage-of-completion method prescribed under paragraph 37 of FASB Statement No. 66 for time-sharing transactions, the amount of revenue recognized (based on the sales value) at the time a sale is recognized is measured by the relationship of costs already incurred to the total of costs already incurred and future costs expected to be incurred. If performance[2] is incomplete, the portion of revenue related to costs not yet incurred is recognized as the costs are incurred. As discussed in paragraph .12 of this SOP, selling and marketing costs are excluded from the percentage-of-completion calculations. The costs of amenities that relate to more than one phase should be appropriately allocated to those phases for purposes of the calculations.

B-4. Estimates of future improvement costs should be reviewed at least quarterly. Changes in those estimates should be applied on a retrospective basis. That is, if cost estimates are revised, the relationship of the costs incurred (from project inception to date) to the adjusted total estimated cost of the project should be recalculated for purposes of recognition of revenue and cost of sales

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[1] For simplicity, certain change-in-estimate calculations in the examples are performed on an annual basis although paragraph .41 of this Statement of Position (SOP) requires that they be performed at least on a quarterly basis. Additionally, although percentages (cost-of-sales percentage and percentage of completion) are displayed to two decimal places, the exact percentages are used in the computations.

[2] *Performance* means completion of the improvements, amenities, or other facilities required under the sales contract by either the seller or contractors retained by the seller. However, payments made to municipalities or other governmental organizations not under the direct or joint control of the seller constitute performance by the seller if those organizations are not financed solely by liens on property in the project and they undertake to complete the improvements without further risk or obligation of the seller.

for prior performance as well as for performance that takes place in future periods. If the adjusted total estimated cost of the project exceeds the total expected revenue, the total anticipated loss should be charged to income if it meets the criteria in paragraph 8 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. If anticipated losses on time-sharing intervals sold are recognized, the seller should evaluate the unsold time-share intervals for impairment under FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

B-5. The effects of changes in estimate, as described in the preceding paragraph, should be included in the disclosures required under paragraph .41 of this SOP.

B-6. Examples 3 and 4 illustrate the application of the relative sales value method of this SOP under the percentage-of-completion method. Example 4 illustrates changes in estimate.

Time-Sharing Example 1
Relative Sales Value Method, Full Accrual Method, No Year-to-Year Changes in Cost-of-Sales Percentage

Assumptions for 20X1:

All requirements for full accrual sale accounting are met.

Estimated Sales Prices and Distribution

	20X1	*20X2*	*20X3*	*20X4 & Future*	*Total No. of Intervals*	*Sales Price*	*Expected Future Revenue*
Type X	250	250	100		600	$ 9,500	$5,700,000
Type Y	200	50	50		300	$10,000	3,000,000
Type Z	50	50			100	$13,000	1,300,000
	500	350	150		1,000		10,000,000
Sale of recovered intervals		10	40	50	100	$ 9,500	950,000**(1)**
	500	360	190	50	1,100		10,950,000
Estimated sales discounts							—
Estimated uncollectible notes							(985,500)
Estimated future revenue							$9,964,500

Sales for 20X1 are $5,025,000 (the 500 units from above at the respective sales prices shown above).

Inventory is complete, with no estimated costs to complete.

Initial down payment:	10% (on all sales; no cash sales)
Forfeiture on defaulted notes:	100% of cash paid
Inventory cost:	$2,500,000
COS percentage:	25.09% ($2,500,000 / $9,964,500)
Initial estimated default rates:	10% of note principal

Accounting Entries

20X1	Notes Receivable	4,522,500	
	Cash	502,500	
	Sales Contra (estimated uncollectible sales)	452,250	
	Sales		5,025,000
	Allowance for Uncollectible Notes Receivable		452,250
20X1	Cost of Sales	1,147,260	
	Inventory		1,147,260

Cost of Sales Calculation

Sales	$5,025,000
Estimated uncollectible sales	(452,250)
Net sales	4,572,750
COS %	25.09%
Cost of sales	$1,147,260

Ending Inventory Calculation

Total expected revenue, 20X1 & future	$9,964,500
Net sales—20X1	(4,572,750)
Remaining expected revenue	5,391,750
COS %	25.09%
Inventory balance	$1,352,740

12/31/20X1	Ending Inventory	$1,352,740	
	# of intervals defaulted	20	**(2)**
	# of intervals defaulted that are recovered	20	**(2)**, **(3)**
	Remaining intervals available for sale	520	= 1,000 – 500 + 20

Assumptions for 20X2:

Same assumptions as 20X1 except expected future revenue estimate excludes 20X1.

Beginning Inventory Balance $1,352,740

Estimated Sales Prices and Distribution

	20X1	*20X2*	*20X3*	*20X4 & Future*	*Total No. of Intervals*	*Sales Price*	*Expected Future Revenue*
Type X		250	100		350	$ 9,500	$3,325,000
Type Y		50	50		100	$10,000	1,000,000
Type Z		50			50	$13,000	650,000
		350	150		500		4,975,000
Sale of recovered intervals		10	40	50	100	$ 9,500	950,000
		360	190	50	600		5,925,000
Estimated sales discounts							—
Estimated uncollectible notes							(533,250)
Estimated future revenue							$5,391,750

Sales for 20X2 are $3,620,000 (the 360 units from above at the respective sales prices shown above).

COS percentage: 25.09% ($1,352,740 / $5,391,750)

Accounting Entries

20X2	Notes Receivable	3,258,000	
	Cash	362,000	
	Sales Contra (estimated uncollectible sales)	325,800	
	Sales		3,620,000
	Allowance for Uncollectible Notes Receivable		325,800
20X2	Cost of Sales	826,484	
	Inventory		826,484

Cost of Sales Calculation

Sales	$3,620,000
Estimated uncollectible sales	(325,800)
Net sales	3,294,200
COS %	25.09%
Cost of sales	$826,484

Ending Inventory Calculation

Total expected revenue, 20X2 & future	$5,391,750
Net sales—20X2	(3,294,200)
Remaining expected revenue	2,097,550
COS %	25.09%
Inventory balance	$ 526,256

12/31/20X2	Ending Inventory	$ 526,256	
	# of intervals defaulted	30	**(2)**
	# of intervals defaulted that are recovered	30	**(2)**, **(3)**
	Remaining intervals available for sale	190	= 520 – 360 + 30

Assumptions for 20X3:

Same assumptions as 20X1 except expected future revenue estimate excludes 20X1 and 20X2.

Beginning Inventory Balance	$ 526,256

Estimated Sales Prices and Distribution

	20X1	*20X2*	*20X3*	*20X4 & Future*	*Total No. of Intervals*	*Sales Price*	*Expected Future Revenue*
Type X			100		100	$ 9,500	$ 950,000
Type Y			50		50	$10,000	500,000
Type Z						$13,000	
			150		150		1,450,000
Sale of recovered intervals			40	50	90	$ 9,500	855,000
			190	50	240		2,305,000
Estimated sales discounts							—
Estimated uncollectible notes							(270,450)
Estimated future revenue							$2,097,550

Sales for 20X3 are $1,830,000 (the 190 units from above at the respective sales prices shown above).

COS percentage: 25.09% ($526,256 / $2,097,550)

Accounting Entries

20X3	Notes Receivable	1,647,000	
	Cash	183,000	
	Sales Contra (estimated uncollectible sales)	164,700	
	Sales		1,830,000
	Allowance for Uncollectible Notes Receivable		164,700
20X3	Cost of Sales	417,808	
	Inventory		417,808

Cost of Sales Calculation

Sales	$1,830,000
Estimated uncollectible sales	(164,700)
Net sales	1,665,300
COS %	25.09%
Cost of sales	$417,808

Ending Inventory Calculation

Total expected revenue, 20X3 & future	$2,097,550
Net sales—20X3	(1,665,300)
Remaining expected revenue	432,250
COS %	25.09%
Inventory balance	$ 108,447

12/31/20X3	Ending Inventory	$ 108,447	**(4)**
	# of intervals defaulted	35	**(2)**
	# of intervals defaulted that are recovered	35	**(2)**, **(3)**
	Remaining intervals available for sale	35	= 190 – 190 + 35

FOOTNOTES

(1) For simplicity purposes only. It is likely that the seller may not be able to sell all remaining units, as some units will be undesirable or the sales effort will not be cost-effective.

(2) Amount is a given for this example and is not derived from any assumptions. Of the 100 units expected to default and be recovered, only 85 occur during 20X1–20X3. The remaining 15 defaults are expected to occur and become available for sale after 20X3.

(3) For simplicity purposes only. Normally, not all interval sales that default will result in recovery of inventory by the seller, as a result of issues such as significant legal (foreclosure) costs and marketability of particular units. In determining estimated future revenue, the seller should take into account the effect of those intervals that would not be recovered versus the effect of those that would. To simplify the illustration, that effect has not been reflected.

(4) As part of its process of assessment of assets for impairment, the seller should evaluate ending inventory in view of the potentially prohibitive cost of marketing such a small quantity of units. Paragraph 34 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, would require that the inventory be measured, for purposes of determining a possible impairment, at the lower of carrying amount or fair value less cost to sell.

Time-Sharing Example 2
Relative Sales Value Method, Full Accrual Method, Year-to-Year Changes in Cost-of-Sales Percentage—Fully Retrospective

Assumptions for 20X1:

All requirements for full accrual sale accounting are met.

Estimated Sales Prices and Distribution

	20X1	*20X2*	*20X3*	*20X4 & Future*	*Total No. of Intervals*	*Sales Price*	*Expected Future Revenue*
Type X	250	250	100		600	$ 9,500	$5,700,000
Type Y	200	50	50		300	$10,000	3,000,000
Type Z	50	50			100	$13,000	1,300,000
	500	350	150		1,000		10,000,000
Sale of recovered intervals		10	40	50	100	$9,500	950,000**(1)**
	500	360	190	50	1,100		10,950,000
Estimated sales discounts							—
Estimated uncollectible notes							(985,500)
Estimated future revenue							$9,964,500

Sales for 20X1 are $5,025,000 (the 500 units from above at the respective sales prices shown above).

Inventory is complete, with no estimated costs to complete.

Initial down payment:	10% (on all sales; no cash sales)
Forfeiture on defaulted notes:	100% of cash paid
Inventory cost:	$2,500,000
COS percentage:	25.09% ($2,500,000 / $9,964,500)
Initial estimated default rates:	10% of note principal

Assume 100% of intervals defaulting on first-time sales are resold over the life of the project; no resales in 20X1.

Assume none of intervals defaulting on second-time sales are resold (for simplicity of illustration).

Accounting Entries

20X1	Notes Receivable	4,522,500	
	Cash	502,500	
	Sales Contra (estimated uncollectible sales)	452,250	
	Sales		5,025,000
	Allowance for Uncollectible Notes Receivable		452,250
20X1	Cost of Sales	1,147,260	
	Inventory		1,147,260

Cost of Sales Calculation

Sales	$5,025,000
Estimated uncollectible sales	(452,250)
Net sales	4,572,750
COS %	25.09%
Cost of sales	$1,147,260

Ending Inventory Calculation

Total expected revenue, 20X1 & future	$9,964,500
Net sales—20X1	(4,572,750)
Remaining expected revenue	5,391,750
COS %	25.09%
Inventory balance	$1,352,740

12/31/20X1	Ending inventory	$1,352,740	
	# of units defaulted	20	**(2)**
	# of units defaulted that are recovered	20	**(2)**, **(3)**
	Remaining units available for sale	520	= 1,000 – 500 + 20

During the first quarter of 20X2, and subsequent to the issuance of the 20X1 financial statements, the seller changes its estimate of 20X3 sales discounts, originally $0, to $50,000. Also, the seller estimates that only 35 intervals, versus the original estimate of 40, will be resold in 20X3, due to economic conditions. Under the SOP's retrospective treatment, a current-period adjustment is recorded to reflect the changes in estimate.

Redo the 20X1 COS %, using actual 20X1 data:

Estimated Sales Prices and Distribution

	20X1 Actual	*20X2*	*20X3*	*20X4 & Future*	*Total No. of Intervals*	*Sales Price*	*Expected Future Revenue*
Type X	250	250	100		600	$ 9,500	$5,700,000
Type Y	200	50	50		300	$10,000	3,000,000
Type Z	50	50			100	$13,000	1,300,000
	500	350	150		1,000		10,000,000
Sale of recovered intervals		10	35	50	95	$ 9,500	902,500
	500	360	185	50	1,095		10,902,500

Estimated sales discounts in 20X3	(50,000)
Estimated uncollectible notes	(976,725)
Estimated future revenue	$9,875,775

COS percentage: 25.31% ($2,500,000 / $9,875,775)

20X1 Adjusted Cost of Sales Calculation

Sales	$5,025,000
Estimated uncollectible sales	(452,250)
Net sales	4,572,750
COS %	25.31%
Cost of sales	$1,157,567

12/31/20X1 Adjusted Inventory Calculation

Total expected revenue, 20X1 & future	$9,875,775
Net sales—20X1	(4,572,750)
Remaining expected revenue	5,303,025
COS %	25.31%
Inventory balance	$1,342,433

Entry to record cost of sales and inventory relief should have been recorded as:

20X1	Cost of Sales	1,157,567	
	Inventory		1,157,567

12/31/20X1	Ending inventory	$1,342,433	
	# of units defaulted	20	**(2)**
	# of units defaulted that are recovered	20	**(2)**, **(3)**
	Remaining units available for sale	520	= 1,000 – 500 + 20

Calculation of 20X1 adjustment to be recorded in 20X2 financial statements:

Cost of sales	1,157,567	
As originally recorded	1,147,260	
Adjustment	10,307	An increase in COS would be recorded for 20X1 in 20X2.

Accounting Entry

20X2	Cost of Sales	10,307	
	Inventory		10,307

Assumptions for 20X2:

Same assumptions as 20X1, incorporating the changes in estimate, except expected future revenue estimate excludes 20X1.

Beginning Inventory Balance $1,342,433

Estimated Sales Prices and Distribution

	20X1	*20X2*	*20X3*	*20X4 & Future*	*Total No. of Intervals*	*Sales Price*	*Expected Future Revenue*
Type X		250	100		350	$ 9,500	$3,325,000
Type Y		50	50		100	$10,000	1,000,000
Type Z		50			50	$13,000	650,000
		350	150		500		4,975,000
Sale of recovered intervals		10	35	50	95	$ 9,500	902,500
		360	185	50	595		5,877,500
Estimated sales discounts in 20X3							(50,000)
Estimated uncollectible notes							(524,475)
Estimated future revenue							$5,303,025

Sales for 20X2 are $3,620,000 (the 360 units from above at the respective sales prices shown above).
COS percentage: 25.31% ($1,342,433 / $5,303,025)

Accounting Entries

20X2	Notes Receivable	3,258,000	
	Cash	362,000	
	Sales Contra (estimated uncollectible sales)	325,800	
	Sales		3,620,000
	Allowance for Uncollectible Notes Receivable		325,800
20X2	Cost of Sales	833,909	
	Inventory		833,909

Cost of Sales Calculation

Sales	$3,620,000
Estimated uncollectible sales	(325,800)
Net sales	3,294,200
COS %	25.31%
Cost of sales	$ 833,909

Ending Inventory Calculation

Total expected revenue, 20X2 & future	$5,303,025
Net sales—20X2	(3,294,200)
Remaining expected revenue	2,008,825
COS %	25.31%
Inventory balance	$ 508,524

Had there not been a change in estimate for 20X2, the COS % would have remained at 25.09% in 20X2, and the 20X2 cost of sales would have been $3,294,200 x 25.09%, or $826,484. Therefore, there is an increase of $7,425 ($833,909 less $826,484) in 20X2 cost of sales attributable to the change in estimate. In accordance with paragraph 41 of this SOP, the seller would disclose that the 20X2 results include a $17,732 decrease ($10,307 for 20X1 plus $7,425 for 20X2) in income (ignoring related tax effects, for simplicity) resulting from changes in estimate in the relative sales value method.

12/31/20X2	Ending inventory	$ 508,524	
	# of units defaulted	35	**(2)**
	# of units defaulted that are recovered	35	**(2)**, **(3)**
	Remaining units available for sale	195	= 520 – 360 + 35

During the first quarter of 20X3, and subsequent to the issuance of the 20X2 financial statements, the seller changes its estimate of 20X3 sales discounts from $50,000 to $75,000. Also, the seller estimates that only 30 intervals, versus the prior estimate of 35, will be resold in 20X3. The seller also estimates that only 40 intervals, versus the original estimate of 50, will be resold after 20X3. Under the SOP's retrospective treatment, a current-period adjustment is recorded to reflect the changes in estimate.

Redo the COS % for the 20X1–20X2 combined, using actual 20X1–20X2 data:

Estimated Sales Prices and Distribution

	20X1 Actual	*20X2 Actual*	*20X3*	*20X4 & Future*	*Total No. of Intervals*	*Sales Price*	*Expected Future Revenue*
Type X	250	250	100		600	$ 9,500	$5,700,000
Type Y	200	50	50		300	$10,000	3,000,000
Type Z	50	50			100	$13,000	1,300,000
	500	350	150		1000		10,000,000
Sale of recovered intervals		10	30	40	80	$9,500	760,000
	500	360	180	40	1,080		10,760,000

Estimated sales discounts in 20X3	(75,000)
Estimated uncollectible notes	(961,650)
Estimated future revenue	$9,723,350

COS percentage: 25.71% ($2,500,000 / $9,723,350)

Cost of Sales Calculation (20X1–20X2)

Sales	$8,645,000
Estimated uncollectible sales	(778,250)
Net sales	7,866,950
COS %	25.71%
Cost of sales, 20X1–20X2	$2,022,695

Ending Inventory Calculation

Total expected revenue, 20X1 & future	$9,723,350
Net sales—20X1–20X2	(7,866,950)
Remaining expected revenue	1,856,400
COS %	25.71%
Inventory balance, 12/31/20X2	$ 477,305

Entry to record cost of sales and inventory relief for 20X1–20X2 should have been recorded in total as:

20X1–20X2	Cost of Sales	2,022,695	
	Inventory		2,022,695

12/31/20X2	Ending inventory	$ 477,305	
	# of units defaulted	35	**(2)**
	# of intervals defaulted that are recovered	35	**(2), (3)**
	Remaining units available for sale	195	= 1,000 – 500 + 20 – 360 + 35

Calculation of 20X1–20X2 adjustment to be recorded in 20X3 financial statements:

Cost of sales	2,022,695	
As originally recorded	1,991,476	Includes 20X1 retro-adjusted COS
Adjustment	31,219	An increase in COS would be recorded for 20X1–20X2 in 20X3.

Accounting Entry

20X1	Cost of Sales	31,219	
	Inventory		31,219

Assumptions for 20X3:

Same assumptions as 20X1–20X2, incorporating the changes in estimate, except expected future revenue estimate excludes 20X1 and 20X2.

Beginning Inventory Balance	$ 477,305

Estimated Sales Prices and Distribution

	20X1	*20X2*	*20X3*	*20X4 & Future*	*Total No. of Intervals*	*Sales Price*	*Expected Future Revenue*
Type X			100		100	$ 9,500	$ 950,000
Type Y			50		50	$10,000	500,000
Type Z						$13,000	
			150		150		1,450,000
Sale of recovered intervals			30	40	70	$ 9,500	665,000
			180	40	220		2,115,000
Estimated sales discounts in 20X3							(75,000)
Estimated uncollectible notes							(183,600)
Estimated future revenue							$1,856,400

Sales for 20X3 are $1,660,000 (the 180 units from above at the respective sales prices, less sales discounts).

COS percentage: 25.71% ($477,305 / $1,856,400)

Accounting Entries

20X3	Notes Receivable	1,494,000	
	Cash	166,000	
	Sales Contra (estimated uncollectible sales)	149,400	
	Sales		1,660,000
	Allowance for Uncollectible Notes Receivable		149,400
20X3	Cost of Sales	388,395	
	Inventory		388,395

Cost of Sales Calculation

Sales	$1,660,000
Estimated uncollectible sales	(149,400)
Net sales	1,510,600
COS %	25.71%
Cost of sales	$ 388,395

Ending Inventory Calculation

Total expected revenue, 20X3 & future	$1,856,400
Net sales—20X3	(1,510,600)
Remaining expected revenue	345,800
COS %	25.71%
Inventory balance	$ 88,910

Had there not been a change in estimate for 20X3, the COS % would have remained at 25.31% in 20X3, and the 20X3 cost of sales would have been $1,510,600 x 25.31%, or $382,400. Therefore, there is an increase of $5,995 ($388,395 less $382,400) in 20X3 cost of sales attributable to the change in estimate. In accordance with paragraph 41 of this SOP, the seller would disclose that the 20X3 results include a $37,214 decrease ($31,219 for 20X1-20X2 plus $5,995 for 20X3) in income (ignoring related tax effects, for simplicity) resulting from changes in estimate in the relative sales value method.

12/31/20X3	Ending inventory	$ 88,910	**(4)**
	# of units defaulted	35	**(2)**
	# of units defaulted that are recovered	35	**(2)**, **(3)**
	Remaining units available for sale	50	= 195 – 180 + 35

FOOTNOTES

(1) For simplicity purposes only. It is likely that the seller may not be able to sell all remaining units, as some units will be undesirable or the sales effort will not be cost-effective.

(2) Amount is a given for this example and is not derived from any assumptions.

(3) For simplicity purposes only. Normally, not all interval sales that default will result in recovery of inventory by the seller, as a result of issues such as significant legal (foreclosure) costs and marketability of particular units. In determining estimated future revenue, the seller should take into account the effect of those intervals that would not be recovered versus the effect of those that would. To simplify the illustration, that effect has not been reflected.

(4) As part of its process of assessment of assets for impairment, the seller should evaluate ending inventory in view of the potentially prohibitive cost of marketing such a small quantity of units. Paragraph 34 of FASB Statement No. 144 would require that the inventory be measured, for purposes of determining a possible impairment, at the lower of carrying amount or fair value less cost to sell.

Time-Sharing Example 3
Relative Sales Value Method, Percentage-of-Completion Method

Assumptions for 20X1:

All requirements for full accrual sale accounting are met EXCEPT inventory is not complete. Requirements for percentage-of-completion accounting are met.

Inventory costs incurred:	$2,000,000
Estimated costs to complete inventory:	$ 500,000

Sales and Cost of Sales amounts are from Example 1.

Percent complete calculation:		
Inventory cost	$2,000,000	
Cost to complete	500,000	
Total estimated cost	$2,500,000	
Percent complete	80.0%	($2,000,000 / $2,500,000)

Sales and marketing costs are not considered in the percent complete calculation.

Accounting Entries

20X1	Inventory	2,000,000	
	Cash		2,000,000
20X1	Notes Receivable	4,522,500	
	Cash	502,500	
	Sales Contra (estimated uncollectible sales)	452,250	
	Sales		5,025,000
	Allowance for Uncollectible Notes Receivable		452,250
	Cost of Sales	1,147,260	
	Inventory		1,147,260
Percent complete adjustments:			
20X1	Sales	914,550	
	Delayed Revenue (20% of net sales)		914,550
	Delayed Cost of Sales (Inventory account)	229,452	
	Cost of Sales		229,452

The following entries for 20X2 and 20X3 are provided solely to illustrate the recording of completion of project construction and do not include the relevant sales and cost of sales entries for units sold in 20X2 or 20X3.

Assumption for 20X2: $200,000 is spent towards completion of inventory

Accounting Entries

20X2	Inventory	200,000	
	Cash		200,000
Percent complete adjustments:			
20X2	Delayed Revenue	365,820	
	Sales		365,820
	Cost of Sales	91,781	
	Delayed Cost of Sales (Inventory account)		91,781

To record adjustments for delayed revenue and delayed cost of sales for intervals sold in 20X1.

Assumption for 20X3: $300,000 is spent to complete the inventory

Accounting Entries

20X3	Inventory	300,000	
	Cash		300,000

Percent complete adjustments:

20X3	Delayed Revenue	548,730	
	Sales		548,730
	Cost of Sales	137,671	
	Delayed Cost of Sales (Inventory account)		137,671

To record adjustments for delayed revenue and delayed cost of sales for intervals sold in 20X1.

Time-Sharing Example 4
Relative Sales Value Method, Percentage-of-Completion Method, With Changes in Estimate

Assumptions for 20X1:

All requirements for full accrual sale accounting are met EXCEPT inventory is not complete. Requirements for percentage-of-completion accounting are met.

Est'd costs to complete inventory as of 12/31/20X1:
$500,000 (assume constant throughout 20X1)

Estimated Sales Prices and Distribution

	20X1	*20X2*	*20X3*	*20X4 & Future*	*Total No. of Intervals*	*Sales Price*	*Expected Future Revenue*
Type X	250	250	100		600	$ 9,500	$5,700,000
Type Y	200	50	50		300	$10,000	3,000,000
Type Z	50	50			100	$13,000	1,300,000
	500	350	150		1,000		10,000,000
Sale of recovered intervals		10	40	50	100	$ 9,500	950,000**(1)**
	500	360	190	50	1,100		10,950,000
Estimated sales discounts							—
Estimated uncollectible notes							(985,500)
Estimated future revenue							$9,964,500

Sales for 20X1 are $5,025,000 (the 500 intervals from above at the respective sales prices shown above), sold evenly throughout the 4 quarters of 20X1.

Initial down payment:	10% (on all sales; no cash sales)
Forfeiture on defaulted notes:	100% of cash paid
Inventory cost, including $500,000 est'd costs to complete:	$2,500,000
COS percentage:	25.09% ($2,500,000 / $9,964,500)
Percent complete:	80% ($2,000,000 / $2,500,000)
Initial estimated default rates:	10% of note principal

Assume 100% of intervals defaulting on first-time sales are resold over the life of the project; no resales in 20X1.

Assume none of intervals defaulting on second-time sales are resold (for simplicity of illustration).

Assume 50 defaults estimated in 20X1, 50 defaults estimated in 20X2, none in other years.

Note: For the year 20X1, sales are shown separately for the first three quarters combined and the 4th quarter. This is to illustrate the accounting, under the fully retrospective method in the SOP, for a change in estimate that occurs at the beginning of the 4th quarter. (Under the SOP, changes in estimate are reflected at least quarterly, but for simplicity the other examples in this appendix have all been accounted for on an annual rather than a quarterly basis.)

Accounting entries for sales recorded throughout the first three quarters of 20X1

20X1	Notes Receivable	3,390,300	
	Cash	376,700	
	Sales Contra (estimated uncollectible sales)	339,030	
	Sales		3,767,000
	Allowance for Uncollectible Notes Receivable		339,030
20X1	Cost of Sales	860,046	
	Inventory		860,046

Percentage-of-completion adjustments:

20X1	Sales	753,400	
	Sales Contra (estimated uncollectible sales)		67,806
	Delayed Revenue (20% of net sales)		685,594
	Delayed Cost of Sales (inventory account)	172,009	
	Cost of Sales (20% of 860,046)		172,009

Cost of Sales Calculation

Sales	$3,767,000
Estimated uncollectible sales	(339,030)
Net sales	3,427,970
COS %	25.09%
Cost of sales (before POC adj.)	$ 860,046

Ending Inventory Calculation

Inventory per books, 1/1/20X1	$2,000,000
Inventory sold in current period	(860,046)
POC adjustment in current period	172,009
Inventory per books, 9/30/20X1	1,311,963
Add: Estimated costs to complete	500,000
Less: POC adjustments to date	(172,009)
Inventory for next period COS % calculation purposes	$1,639,954

9/30/20X1	Ending inventory for calculation of Q4 20X1 COS percentage	$1,639,954	
	# of intervals defaulted in Q1-Q3 20X1	45	**(2)**
	# of intervals defaulted in Q1-Q3 20X1 that are recovered	45	**(2)**, **(3)**
	Remaining intervals available for sale	670	= 1,000 – 375 + 45

The net effect of the entries for the first three quarters of 20X1 is:

Selected Balance Sheet Accounts

Cash	$ 376,700
Notes Receivable	3,390,300
(collections not illustrated)	
Less: Allowance	(339,030)
Receivables, Net	$3,051,270
Inventory	1,311,963
(includes delayed COS of 172,009)	
Delayed Revenue	(685,594)
	$4,054,339

Selected Income Statement Accounts

Sales	$3,013,600
Estimated uncollectible sales	(271,224)
Net sales	2,742,376
Cost of Sales	688,037
	$2,054,339

(Note: Difference between $4,054,339 and $2,054,339 correctly equals the original $2,000,000 in Inventory at 1/1/20X1.)

Assume that during the 4th quarter of 20X1 and subsequent to the issuance of the 3rd quarter 20X1 financial statements, estimated defaults are re-estimated at 15%, versus the initial estimate of 10% based on an assessment of 20X1 experience to date and an economic downturn. Under the SOP's fully retrospective treatment of changes in estimate under the relative sales value method, a cumulative adjustment for January–September 20X1 is recorded in the 4th quarter of 20X1.

Redo the 20X1 COS %, using actual data for the first three quarters of 20X1 and estimates for the 4th quarter of 20X1. (Note: Sales of recovered intervals are assumed to increase as a result of the increase in estimated defaults.)

Estimated Sales Prices and Distribution

	20X1	*20X2*	*20X3*	*20X4 & Future*	*Total No. of Intervals*	*Sales Price*	*Expected Future Revenue*
Type X	250	250	100		600	$ 9,500	$5,700,000
Type Y	200	50	50		300	$10,000	3,000,000
Type Z	50	50			100	$13,000	1,300,000
	500	350	150		1,000		10,000,000
Sale of recovered intervals		15	60	75	150	$ 9,500	1,425,000
	500	365	210	75	1,150		11,425,000
Estimated sales discounts							—
Estimated uncollectible notes							(1,542,375)
Estimated future revenue							$9,882,625

COS percentage: 25.30% ($2,500,000 / $9,882,625)

Accounting entries for sales recorded throughout the first three quarters of 20X1 should have been recorded as

20X1	Notes Receivable	3,390,300	
	Cash	376,700	
	Sales Contra (estimated uncollectible sales)	508,545	
	Sales		3,767,000
	Allowance for Uncollectible Notes Receivable		508,545
20X1	Cost of Sales	824,289	
	Inventory		824,289

Percentage-of-completion adjustments:

20X1	Sales	753,400	
	Sales Contra (estimated uncollectible sales)		101,709
	Delayed Revenue (20% of net sales)		651,691
	Delayed Cost of Sales (inventory account)	164,858	
	Cost of Sales (20% of 824,289)		164,858

Cost of Sales Calculation

Sales	$3,767,000
Estimated uncollectible sales	(508,545)
Net sales	3,258,455
COS %	25.30%
Cost of sales (before POC adj.)	$ 824,289

Ending Inventory Calculation

Inventory per books, 1/1/20X1	$2,000,000
Inventory sold in current period	(824,289)
POC adjustment in current period	164,858
Inventory per books, 9/30/20X1	1,340,569
Add: Estimated costs to complete	500,000
Less: POC adjustments to date	(164,858)
Inventory for next period COS % calculation purposes	$1,675,711

9/30/20X1	Ending inventory for calculation of Q4 20X1 COS percentage	$1,675,711	
	# of intervals defaulted in Q1-Q3 20X1	45	**(2)**
	# of intervals defaulted in Q1-Q3 20X1 that are recovered	45	**(2)**, **(3)**
	Remaining intervals available for sale	670	= 1,000 – 375 + 45

Calculation of current-period cumulative adjustments for the first three quarters of 20X1, to be recorded in 20X1 4th quarter financial statements:

Estimated Sales Prices and Distribution

	Sales	*Sales Contra*	*Allowance*	*Cost of Sales*	*Delayed Revenue*	*Inventory*	*Delayed COS*
As redetermined	3,013,600	406,836	508,545	659,431	651,691	1,175,711	164,858
As orig. recorded	3,013,600	271,224	339,030	688,037	685,594	1,139,954	172,009
Retro adjustment	0	135,612	169,515	(28,606)	(33,903)	35,757	(7,151)

Accounting Entries

20X1	Sales Contra	135,612	
	Delayed Revenue	33,903	
	Allowance for Uncollectible Notes Receivable		169,515
20X1	Inventory	35,757	
	Delayed Cost of Sales (Inventory account)		7,151
	Cost of Sales		28,606

The net effect of the entries, including adjustment entries, for the first three quarters of 20X1 is:

Selected Balance Sheet Accounts		**Selected Income Statement Accounts**	
Cash	$ 376,700	Sales	$3,013,600
Notes Receivable	3,390,300	Estimated uncollectible sales	(406,836)
(collections not illustrated)			
Less: Allowance	(508,545)	Net sales	2,606,764
Receivables, Net	2,881,755		
Inventory	1,340,569	Cost of Sales	659,431
(includes delayed COS of 164,858)			
Delayed Revenue	(651,691)		
	$3,947,333		$1,947,333

(Note: Difference between $3,947,333 and $1,947,333 correctly equals the original $2,000,000 in Inventory at 1/1/20X1.)

Assumptions for 4th Quarter of 20X1:

Same as initial 20X1 assumptions except expected future revenue estimate is updated based on the increased estimated default rate of 15%.

Beginning Inventory Balance $1,675,711 including estimated costs to complete; excludes POC adjustments

Estimated Sales Prices and Distribution

	Q4 of 20X1	*20X2*	*20X3*	*20X4 & Future*	*Total No. of Intervals*	*Sales Price*	*Expected Future Revenue*
Type X	62	250	100		412	$ 9,500	$3,914,000
Type Y	50	50	50		150	$10,000	1,500,000
Type Z	13	50			63	$13,000	819,000
	125	350	150		625		6,233,000
Sale of recovered intervals		15	60	75	150	$9,500	1,425,000
	125	365	210	75	775		7,658,000
Estimated sales discounts							—
Estimated uncollectible notes							(1,033,830)
Estimated future revenue							$6,624,170

Sales for the 4th quarter of 20X1 are $1,258,000 (the 125 intervals from above at the respective sales prices shown above).

COS percentage: 25.30% ($1,675,711 / $6,624,170)

Accounting entries for sales recorded throughout Q4 of 20X1

20X1	Notes Receivable	1,132,200	
	Cash	125,800	
	Sales Contra (estimated uncollectible sales)	169,830	
	Sales		1,258,000
	Allowance for Uncollectible Notes Receivable		169,830
20X1	Cost of Sales	275,274	
	Inventory		275,274
Percentage-of-completion adjustments:			
20X1	Sales	251,600	
	Sales Contra (estimated uncollectible sales)		33,966
	Delayed Revenue (20% of net sales)		217,634
	Delayed Cost of Sales (inventory account)	55,055	
	Cost of Sales (20% of 275,274)		55,055

Cost of Sales Calculation

Sales	$1,258,000
Estimated uncollectible sales	(169,830)
Net sales	1,088,170
COS %	25.30%
Cost of sales (before POC adj.)	$ 275,274

Ending Inventory Calculation

Inventory per books, 9/30/20X1	$1,340,569
Inventory sold in current period	(275,274)
POC adjustment in current period	55,055
Inventory per books, 12/31/20X1	1,120,350
Add: Estimated costs to complete	500,000
Less: POC adjustments to date	(219,913)
Inventory for next period COS % calculation purposes	$1,400,437

9/30/20X1	Ending inventory for calculation of 20X2 COS percentage	$1,400,437	
	# of intervals defaulted in Q4 20X1	15	**(2)**
	# of intervals defaulted that are recovered in Q4 20X1	15	**(2)**, **(3)**
	Remaining intervals available for sale	560	= 670 - 125 + 15

The net effect of the entries for the full year of 20X1 is:

Selected Balance Sheet Accounts

Cash	$ 502,500
Notes Receivable	4,522,500
(collections not illustrated)	
Less: Allowance	(678,375)
Receivables, Net	3,844,125
Inventory	1,120,350
(includes delayed COS of 219,913)	
Delayed Revenue	(869,325)
	$4,597,650

Selected Income Statement Accounts

Sales	$4,020,000
Estimated Uncollectible sales	(542,700)
Net sales	3,477,300
Cost of Sales	879,650
	$2,597,650

(Note: Difference between $4,597,650 and $2,597,650 correctly equals the original $2,000,000 in Inventory at 1/1/20X1.)

Had the change in estimated defaults not occurred, in 20X1 the seller would have recorded income of $2,740,392 (see "As If" column below). Actual 20X1 income was $2,597,650 (see "Actual" column below), which is $142,742 lower than the "As If" income. In accordance with paragraph 41 of this SOP, the seller would disclose that the 20X1 4th quarter results include a $142,742 decrease in income in quarters 1 to 3 resulting from the change in estimated defaults in the relative sales value method. For simplicity, any related tax effects are ignored.

The amount to be disclosed is determined as follows:

	20X1—As If	20X1—Actual	Difference
Sales before POC adjustment	$5,025,000	$5,025,000	
Sales Contra	(452,250)	(678,375)	
Net Sales before POC adjustment	4,572,750	4,346,625	
POC adjustment (20%)	914,550	869,325	
Net Sales after POC adjustment	3,658,200	3,477,300	
Cost of Sales	917,808	879,650	
Income	$2,740,392	$2,597,650	($142,742)

Assumptions for 20X2:

Same assumptions as Q4 of 20X1, reflecting the increased estimated default rate of 15%.

Beginning Inventory Balance $1,400,437 including estimated costs to complete; excludes POC adjustments

Estimated Sales Prices and Distribution

	20X1	20X2	20X3	20X4 & Future	Total No. of Intervals	Sales Price	Expected Future Revenue
Type X		250	100		350	$ 9,500	$3,325,000
Type Y		50	50		100	$10,000	1,000,000
Type Z		50			50	$13,000	650,000
		350	150		500		4,975,000
Sale of recovered intervals		15	60	75	150	$ 9,500	1,425,000
		365	210	75	650		6,400,000
Estimated sales discounts							—
Estimated uncollectible notes							(864,000)
Estimated future revenue							$5,536,000

Sales for 20X2 are $3,667,500 (the 365 intervals from above at the respective sales prices shown above).

COS percentage: 25.30% ($1,400,437 / $5,536,000)

Accounting entries for sales recorded throughout 20X2

20X2	Notes Receivable	3,300,750	
	Cash	366,750	
	Sales Contra (estimated uncollectible sales)	495,113	
	Sales		3,667,500
	Allowance for Uncollectible Notes Receivable		495,113
20X2	Cost of Sales	802,516	
	Inventory		802,516

Cost of Sales Calculation

Sales	$3,667,500
Estimated uncollectible sales	(495,113)
Net sales	3,172,387
COS %	25.30%
Cost of sales (before POC adj.)	$ 802,516

The net effect of the entries for the full years 20X1 and 20X2, before any 20X2 POC adjustments, is:

Selected Balance Sheet Accounts		Selected Income Statement Accounts	
Cash	$ 869,250	Sales	$7,687,500
		Estimated Uncollectible Sales	(1,037,813)
Notes Receivable	7,823,250	Net sales	6,649,687
(collections not illustrated)			
Less: Allowance	(1,173,488)		
Receivables, Net	6,649,762		
Inventory	317,834	Cost of Sales	1,682,166
(includes delayed COS of 219,913)			
Delayed Revenue	(869,325)		
	$6,967,521		$4,967,521

(Note: Difference between $6,967,521 and $4,967,521 correctly equals the original $2,000,000 in Inventory at 1/1/20X1.)

Assume that during 20X2, the seller incurs $400,000 towards completion of the project but then estimates at 12/31/20X2 that $300,000 additional is needed to complete. Because the seller has been recording sales throughout 20X2, percentage-of-completion adjustments would have been recorded based on the original estimate total costs of $2,500,000 and POC of 96% ($2,400,000/ $2,500,000) at 12/31/20X2. For simplicity in illustrating the effect of the change in estimate, this example assumes that the $200,000 increase in estimated costs to complete occurs at the end of 20X2, at which time the seller recalculates the POC as 88.89% ($2,400,000 / $2,700,000). The seller then records a current-period adjustments to sales and cost of sales for the difference between total sales and costs of sales that would have been reorganized for the current and all prior years to date based on a percent complete of 88.89%, and total sales actually reorganized to date.

Recording of $400,000 costs incurred in 20X2 toward completion of the project:

20X2	Inventory	400,000	
	Cash		400,000

Recording of POC adjustments for 20X2, based on the original estimated costs to complete of $2,500,000:

Percent complete: 96.00% ($2,400,000 / $2,500,000)

20X2	Sales	146,700	
	Sales Contra (estimated uncollectible sales)		19,805
	Delayed Revenue (4% of net sales)		126,895
	Delayed Cost of Sales (Inventory account)	32,101	
	Cost of Sales (4% of 802,516)		32,101
	To adjust 20X2 results for percent complete of 96%.		
20X2	Sales Contra (estimated uncollectible sales)	108,540	
	Delayed Revenue	695,460	
	Sales		804,000
	Cost of sales	175,930	
	Delayed Cost of Sales (Inventory account)		175,930
	To adjust 20X1 results for increase in percent complete from 80% to 96%.		

The net effect of the above entries, before recording the effect of the change in estimated total costs to complete, is:

Selected Balance Sheet Accounts		Selected Income Statement Accounts	
Cash	$ 469,250	Sales	$8,344,800
		Estimated Uncollectible Sales	(1,126,548)
Notes Receivable	7,823,250	Net Sales	7,218,252
(collections not illustrated)			
Less: Allowance	(1,173,488)		
Receivables, Net	6,649,762		
Inventory	574,004	Cost of Sales	1,825,996
(includes delayed COS of 76,084)			
Delayed Revenue	(300,760)		
	$7,392,256		$5,392,256

(Note: Difference between $7,392,256 and $5,392,256 correctly equals the original $2,000,000 in Inventory at 1/1/20X1.)

Recording of current-period adjustments for increase to $2,700,000 of total estimated costs to complete:

COS percentage: 27.32% ($2,700,000 / $9,882,625)

(The denominator in this percentage is based on actual revenue to date plus estimated future revenue, excluding POC adjustments.)

Cost of Sales Calculation	20X1–20X2 (excluding POC adjustments)
Sales	$8,692,500
Estimated uncollectible sales	(1,173,488)
Net sales	7,519,012
COS %	27.32%
Cost of sales	$2,054,245

Percent complete—revised: 88.89% ($2,400,000 / $2,700,000)

As-if entries for 20X1–20X2 combined, based on $2,700,000 estimated total cost

Notes Receivable	7,823,250	
Cash	469,250	
Sales Contra (estimated uncollectible sales)	1,173,488	
Sales		8,692,500
Allowance for Uncollectible Notes Receivable		1,173,488
Cost of Sales	2,054,245	
Inventory		1,654,245
Percentage-of-completion adjustments:		
Sales	965,833	
Sales Contra (estimated uncollectible sales)		130,387
Delayed Revenue (11.11% of net sales)		835,446
Delayed Cost of Sales (Inventory account)	228,249	
Cost of Sales (11.11% of 2,054,245)		228,249

Cumulative adjustments for 20X1–20X2 to reflect change in estimated costs from $2,500,000 to $2,700,000 to be recorded in 20X2 financial statements:

	Sales	*Sales Contra*	*Cash*	*Cost of Sales*	*Delayed Revenue*	*Inventory*	*Delayed COS*
As redetermined	7,726,667	1,043,101	469,250	1,825,996	835,446	345,755	228,249
As orig. recorded	8,344,800	1,126,548	469,250	1,825,996	300,760	497,920	76,084
Retro adjustment	(618,133)	(83,447)	0	0	534,686	(152,165)	152,165

Accounting Entries

20X2	Sales	618,133	
	Delayed Cost of Sales (Inventory account)	152,165	
	Inventory		152,165
	Delayed Revenue		534,686
	Sales Contra		83,447

The net effect of all of the entries to date (12/31/20X2), including POC adjustments and effects of changes in estimate, is:

Selected Balance Sheet Accounts		**Selected Income Statement Accounts**	
Cash	$ 469,250	Sales	$7,726,667
		Estimated Uncollectible Sales	(1,043,101)
Notes Receivable	7,823,250	Net Sales	6,683,566
(collections not illustrated)			
Less: Allowance	(1,173,488)		
Receivables, Net	6,649,762		
Inventory	574,004	Cost of Sales	1,825,996
(included delayed COS of 228,249)			
Delayed Revenue	(835,446)		
(= 965,833 delayed Sales less 130,387 delayed Sales Contra)			
	$6,857,570		$4,857,570

(Note: Difference between $6,857,570 and $4,857,570 correctly equals the original $2,000,000 in Inventory at 1/1/20X1.)

In accordance with paragraph 41 of this SOP, the seller would disclose that the 20X2 results include a $534,686 decrease in income as a result of the change in the project's estimated percentage of completion due to the revised estimated total cost to complete ($534,686 = $618,133 decrease in Sales less $83,447 decrease in Sales Contra). For simplicity, any related tax effects are ignored.

Ending Inventory Calculation

Inventory per books, 1/1/20X1	$2,000,000	
Inventory costs incurred in 20X2	400,000	
Inventory sold in 20X1–20X2	(2,054,245)	
POC adjustments, 20X1–20X2	228,249	
Inventory per books, 12/31/20X2	574,004	
Add: Estimated costs to complete	300,000	
Less: POC adjustments to date	(228,249)	
Inventory for next period COS % calculation purposes	$ 645,755	
Ending inventory for calculation of 20X3 COS percentage	$ 645,755	
# of intervals defaulted	90	**(2)**
# of intervals defaulted that are recovered	90	**(2)**, **(3)**
Remaining intervals available for sale	285	= 560 – 365 + 90

Assumptions for 20X3:

No change in assumptions except expected future revenue estimate and percent complete are updated.

In January 20X3, the seller spends the estimated $300,000 to complete, and thereby completes the project construction.

Beginning Inventory Balance	$ 645,755	including estimated costs to complete; excludes POC adjustments

Estimated Sales Prices and Distribution

	20X1	*20X2*	*20X3*	*20X4 & Future*	*Total No. of Intervals*	*Sales Price*	*Expected Future Revenue*
Type X			100		100	$ 9,500	$ 950,000
Type Y			50		50	$10,000	500,000
Type Z						$13,000	
			150		150		1,450,000
Sale of recovered intervals			60	75	135	$ 9,500	1,282,500
			210	75	285		2,732,500
Estimated sales discounts							—
Estimated uncollectible notes							(368,888)
Estimated future revenue							$2,363,612

Sales for 20X3 are $2,020,000 (the 210 intervals from above at the respective sales prices shown above).

COS percentage: 27.32% ($645,755 / $2,363,612)

Accounting entries for sales recorded throughout 20X3

20X3	Notes Receivable	1,818,000	
	Cash	202,000	
	Sales Contra (estimated uncollectible sales)	272,700	
	Sales		2,020,000
	Allowance for Uncollectible Notes Receivable		272,700
20X3	Cost of Sales	477,374	
	Inventory		477,374

Cost of Sales Calculation

Sales	$2,020,000
Estimated uncollectible sales	(272,700)
Net sales	1,747,300
COS %	27.32%
Cost of sales	$ 477,374

Ending Inventory Calculation

Inventory per books, 1/1/20X3	$574,004
Inventory costs incurred in 20X3	300,000
Inventory sold in current period	(477,374)
POC adjustment in current period	—
Inventory per books, 12/31/20X3	396,630
Add: Estimated costs to complete	—
Less: POC adjustments to date	(228,249)
Inventory for next period COS% calculation purposes	$168,381

12/31/20X1	Ending inventory for calculation of COS percentage	$ 168,381	**(4)**
	# of intervals defaulted	—	**(2)**
	# of intervals defaulted that are recovered	—	**(2), (3)**
	Remaining intervals available for sale in 20X4 and future	75	= 285 – 210

Because the project construction is complete as of 12/31/20X3, the seller now recognizes any remaining Delayed Revenue and Delayed Cost of Sales that were delayed under the percentage-of-completion method:

Accounting Entries

20X3	Delayed Revenue	835,446	
	Sales Contra	130,387	
	Sales		965,833
	Cost of Sales	228,249	
	Delayed Cost of Sales (Inventory account)		228,249

The net effect of all of the entries to date (12/31/20X3) is:

Selected Balance Sheet Accounts		Selected Income Statement Accounts	
Cash	$ 371,250 (assumes cash paid for $700,000 construction)	Sales	$10,712,500
		Estimated Uncollectible Sales	(1,446,188)
		Net Sales	9,266,312
Notes Receivable	9,641,250 (collections not illustrated)		
Less: Allowance	(1,446,188)		
Receivables, Net	8,195,062		
Inventory	168,381	Cost of Sales	2,531,619
Delayed Revenue	0		
	$8,734,693		$6,734,693

(Note: Difference between $8,734,693 and $6,734,693 correctly equals the original $2,000,000 in Inventory at 1/1/20X1.)

FOOTNOTES

(1) For simplicity purposes only. It is likely that the seller may not be able to sell all remaining units, as some units will be undesirable or the sales effort will not be cost-effective.

(2) Amount is a given for this example and is not derived from any assumptions.

(3) For simplicity purposes only. Normally, not all interval sales that default will result in recovery of inventory by the seller, as a result of issues such as significant legal (foreclosure) costs and marketability of particular units. In determining estimated future revenue, the seller should take into account the effect of those intervals that would not be recovered versus the effect of those that would. To simplify the illustration, that effect has not been reflected.

(4) As part of its process of assessment of assets for impairment, the seller should evaluate ending inventory in view of the potentially prohibitive cost of marketing such a small quantity of units. Paragraph 34 of FASB Statement No. 144 would require that the inventory be measured, for purposes of determining a possible impairment, at the lower of carrying amount or fair value less cost to sell.

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Appendix C

Continuing Involvement

Below are scenarios related to a seller's continuing involvement discussed in paragraphs 25 through 43 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate*, and comments with respect to whether those scenarios typically apply or do not apply to a time-share seller.

Repurchase Option or Obligation (FASB Statement No. 66, paragraph 26)

The seller has an obligation to repurchase the property, or the terms of the transaction allow the buyer to compel the seller or give an option[1] to the seller to repurchase the property.

1. A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase.

Comments: Time-share contracts typically do not contain repurchase obligations or options for repurchase. Buyer upgrade programs should not be considered as options for repurchase because both buyer and seller must agree to an upgrade transaction. Neither has a unilateral right to compel the other.

Limited Partnership Arrangement (FASB Statement No. 66, paragraph 27)

The seller is a general partner in a limited partnership that acquires an interest in the property sold (or has an extended, noncancelable management contract requiring similar obligations) and holds a receivable from the buyer for a significant[2] part of the sales price.

2. For this purpose, a significant receivable is a receivable in excess of 15 percent of the maximum first-lien financing that could be obtained from an independent established lending institution for the property. It includes:

   a. A construction loan made or to be made by the seller to the extent that it exceeds the minimum funding commitment for permanent financing from a third party that the seller will not be liable for

   b. An all-inclusive or wraparound receivable held by the seller to the extent that it exceeds prior-lien financing for which the seller has no personal liability

   c. Other funds provided or to be provided directly or indirectly by the seller to the buyer

   d. The present value of a land lease when the seller is the lessor

Comments: A time-share developer typically does not partner on either a general or limited basis with the time-share interval purchaser. In many cases, the developer or an entity related to the developer provides management services to the third-party condominium/owners association (OA) for a fee. Time-share management contracts generally extend for three to ten years with renewals at the option of the OA. The management contracts generally contain various cancellation clauses that allow either the manager or the OA to cancel the contract under prescribed conditions. Under those contracts, the continuing involvement typically would not preclude profit recognition under FASB Statement No. 66.

Guaranteed Return on Investment (FASB Statement No. 66, paragraph 28)

The seller guarantees[3] the return of the buyer's investment or a return on that investment for a limited or extended period. For example, the seller guarantees cash flows, subsidies, or net tax benefits.

3. Guarantees by the seller may be limited to a specified period of time.

Comments: Time-share intervals typically are not sold with any stated or implied investment return and, accordingly, developers do not provide any such investment return guaranty for any period of time.

Seller Support of Operations (FASB Statement No. 66, paragraphs 29 and 30)

The seller is required to initiate or support operations or continue to operate the property at its own risk, or may be presumed to have such a risk, for an extended period, for a specified limited period, or until a specified level of operations has been obtained, for example, until rentals of a property are sufficient to cover operating expenses and debt service.

Comments: Time-share developers typically subsidize the operations of a phase during the development or during the initial period of operations. During the sales process, the quoted maintenance fee, which contractually may remain level or increase with inflation, represents the maintenance fee at completion. Typically, during the early stages of a phase, the phase operates at a deficit given the normal operational costs and the fact that the number of units registered with the OA may not yet have reached the break-even level. Therefore, the developer subsidy represents two items:

1. *Developer's payment of maintenance fees for intervals committed to (that is, enrolled in) the time-share plan, for which the developer retains title.* See paragraphs .49 through .52 of this SOP.

2. *Developer subsidy paid to the OA during the start-up period of operations.* In many cases, time-share developers will begin phase operations with a minimal number of units committed to the time-share plan; therefore, the developer has to subsidize the operations until a sufficient number of units has been committed.

Typically, the duration of both kinds of payments lasts through the sellout of the time-share phase. Developer payments typically diminish as intervals are sold.

However, if the subsidies extend past the sellout period or do not diminish as intervals are sold, this is an indication that the seller has not transferred substantially all the risks and rewards of ownership of real estate and that transactions occurring during the subsidy period are in substance **right-to-use** arrangements.

Seller-Provided Management Services (FASB Statement No. 66, paragraph 31)

. . . the sales contract requires the seller to provide management services relating to the property after the sale without compensation or at compensation less than prevailing market rates for the service required . . . or on terms not usual for the services to be rendered . . .

Comments: Management services typically are not required under time-sharing sales contracts. Developers often provide management services to OAs on a cost-plus-management-fee basis that is billed and collected separately from the sale of the time-share interval. As an indication of a reasonable fee, independent (nondeveloper) time-share management companies charge between 5 percent and 15 percent management fees (that is, between 5 percent and 15 percent of the underlying operating and other costs of management).

Sometimes a developer offers to pay an interval purchaser's OA maintenance fee for a fixed period of time as a sales incentive. Sometimes a developer operates an internal exchange program whereby a time-share buyer can exchange his or her interval for a given year for another unit or week (or both) in the developer's network of time-sharing properties. Under paragraph 31 of

FASB Statement No. 66, if the seller provides the exchange service at less than prevailing market rates for the service, compensation should be imputed when the sale is recognized and recognized as revenue as the exchange services are performed. The fees of independent time-sharing exchange companies should be considered in determining prevailing market rates, but it should be recognized that the services of an independent exchange company may be more complex than the services of an internal exchange program.

A developer may operate a vacation club or affinity program under which a time-share buyer can exchange his or her interval (for example, one week) for a given year for such items as cruises, hotel stays, airline tickets, or car rentals. Pursuant to the exchange, the developer gets back the unit-week and any associated income from rental of the unit for that week. The developer frequently has to purchase from independent third parties those items the buyer receives in exchange. Often, a seller reserves the right to change the rewards at any time, allowing the seller to match the rewards at a given time to the net rental income that can be generated from a particular interval. Thus, if a particular interval becomes less popular over time, for example, the seller can reduce the rewards that the purchaser of such interval could obtain in exchange for the interval. If the seller retains such flexibility, the seller is likely to assure that the value of the services the buyer receives does not exceed the rental income that can be generated from the interval. Conversely, if the seller does not have that flexibility, the seller likely will be unable to estimate the relationship between the value of the services the buyer receives and the rental income that can be generated from the interval.

Option to Purchase (FASB Statement No. 66, paragraph 32)

The transaction is merely an option to purchase the property. [*Next sentence paraphrased.*] For example, an interval may be sold under terms that call for a very small initial investment by the buyer and postponement of additional payments until contingencies specified in the sales agreement are satisfactorily resolved.

Comments: Once the **rescission** period has expired, contracts for the sales of time-share intervals are binding purchase contracts and not options.

Partial Sales (FASB Statement No. 66, paragraphs 33 and 34)

The seller has made a partial sale. A sale is a partial sale if the seller retains an equity interest in the property or has an equity interest in the buyer. [*Next sentence paraphrased.*] Additionally, the buyer may not be independent of the seller—for example, if the seller holds or acquires an equity interest in the buyer—or the seller may control the buyer.

Comments: Sales of time-sharing intervals are not partial sales, as the developer cannot record profit without a transfer of title (see paragraph .13 of this SOP). In the case in which the developer transfers title to a special-purpose entity (SPE) or trust in exchange for shares or beneficial interests, the developer should not recognize profit until the share or beneficial interest is sold to the end user (see paragraph .55 of this SOP).

Collection Not Reasonably Assured (FASB Statement No. 66, paragraph 35)

. . . collection of the sales price is not reasonably assured.

Comments: Paragraph 35 of FASB Statement No. 66 prescribes the cost recovery or installment method of recognizing profit if collection of the sales price is not reasonably assured.

Seller Support of Operations After the Sale (FASB Statement No. 66, paragraph 36)

> . . . the seller is required to support the operations of the property after the sale . . . For example, the seller may retain an interest in the property sold and the buyer may receive preferences as to profits, cash flows, return on investment, and so forth.
>
> *Comments:* Time-share developers typically are not obligated to support the time-share resorts after the sale except in the circumstances described above under the scenarios entitled "Seller Support of Operations" and "Seller-Provided Management Services."
>
> **Sale of Improvements, Lease of Land** (FASB Statement No. 66, paragraphs 38 and 39)
>
> The seller sells property improvements and leases the underlying land to the buyer of the improvements.
>
> *Comments:* See paragraph A-48 of this SOP.
>
> **Contractual Future Requirements of the Seller** (FASB Statement No. 66, paragraphs 41 and 42)
>
> The sales contract or an accompanying agreement requires the seller to develop the property in the future, to construct facilities on the land, or to provide off-site improvements or amenities. The seller is involved with future development or construction work if the buyer is unable [or not required] to pay amounts due for that work or has the right under the terms of the arrangement to defer payment until the work is done.
>
> *Comments:* In situations in which developers sell intervals prior to the completion of the facilities, improvements, or amenities, the sales do not qualify for the full accrual method of profit recognition under FASB Statement No. 66.
>
> **Seller Participation in Future Resale Profits** (FASB Statement No. 66, paragraph 43)
>
> The seller will participate in future profit from the property without risk of loss (such as participation in operating profits or residual values without further obligation).
>
> *Comments:* Developers typically do not participate in future profits from the resale of time-share intervals.

All of the preceding in this appendix discusses the time-sharing seller's continuing involvement arising from legal obligations. The seller also may have indicated a commitment, based on considerations such as business reputation, intercompany relationships, or credit standing, to provide financial support or other services to a time-share project beyond the seller's legal obligations. Such a commitment might be indicated by previous support provided by the seller to the same or other time-sharing projects or statements to third parties by the seller of its intention to provide support. If such a commitment exists, the seller should determine which kind(s) of continuing involvement it represents under the above scenarios, and record transactions based on the relevant paragraphs in FASB Statement No. 66. Often, such a commitment represents additional support to an OA that would fall under the scenario entitled "Seller Support of Operations" above.

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Appendix D

Illustration of Use of Historical Data on Uncollectibles, Including Related Disclosures

This illustration shows how a time-share entity may organize its historical data about uncollectibles in order to determine the charge to revenue for estimated uncollectibles on current-year (2006) sales, and to assess the adequacy of the allowance for uncollectibles as of the end of 2006. Related illustrative disclosures are included.

Historical Data

Table D1. Sales, Net of Down Payments, by Year

(For projects with characteristics similar to the entity's current project)

1996	$28,000	2002	$60,000
1997	$26,000	2003	$70,000
1998	$30,000	2004	$76,000
1999	$33,000	2005	$80,000
2000	$34,000	2006	$90,000
2001	$50,000		

Table D2 summarizes the uncollectibles experience for years 1996 through 2006 for projects similar to the entity's current time-share project. The uncollectibles are organized into columns based on the year of sale. Thus, the column "2001 Sales" shows that of the $50,000 of sales recorded in 2001, $1,100 in receivables were deemed uncollectible in 2001, $2,000 in 2002, $900 in 2003, and so on.[1] However, Table D2 also can be analyzed to show receivables deemed uncollectible in each fiscal year. For example, in 2006, as shown by the figures inside rectangles, there were $7,670 in total uncollectible receivables, specifically, $2,070 from 2006 sales, $2,600 from 2005 sales, $1,400 from 2004 sales, $800 from 2003 sales, $500 from 2002 sales, $200 from 2001 sales, and $100 from 2000 sales. The "Combined Experience" column is computed two ways—one using only those sales from 1996 through 2000, "1996-2000," for which the notes have been collected in full, and the other, "All Years," using the uncollectibility experience for all years. The combined experience is calculated as a simple average here for illustration purposes. A weighted average also would be appropriate.

Assessment of Historical Data

Fluctuations in collection experience from year to year can be explained by economic conditions; the economy was stronger in 2003 through 2006 than in prior years,[2] and uncollectibility rates declined modestly. As the year 2006 ends, the economy is softening. As a result, the entity concludes that the percentages from the "Combined Experience," "All Years" column in Table D2, which blends the strong economic conditions of recent years and the weaker conditions of earlier years, should be applied to compute the charge to revenue for estimated uncollectibles on current year (2006) sales and to assess the adequacy of the allowance for uncollectibles at the end of 2006.

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[1] That is, $1,100 of individually identified notes receivable were past due and there was no expectation of subsequent collectibility.

[2] Economic conditions discussed in this appendix are hypothetical and for illustrative purposes only. They are not intended to reflect actual economic conditions existing during the indicated years.

Table D2

	2006 Sales		2005 Sales		2004 Sales		2003 Sales		2002 Sales		2001 Sales	
	Uncol-lectible	*% of sales (net of down pmnts)*	*Uncol-lectible*	*% of sales (net of down pmnts)*	*Uncol-lectible*	*% of sales (net of down pmnts)*	*Uncol-lectible*	*% of sales (net of down pmnts)*	*Uncol-lectible*	*% of sales (net of down pmnts)*	*Uncol-lectible*	*% of sales (net of down pmnts)*
FY of Sale	$\boxed{\$2,070}$	2.3%	$1,800	2.3%	$1,400	1.8%	$1,300	1.9%	$1,300	2.2%	$1,100	2.2%
1 yr after FY of sale			$\boxed{2,600}$	3.3%	2,700	3.6%	2,200	3.1%	2,000	3.3%	2,000	4.0%
2 yrs after FY of sale					$\boxed{1,400}$	1.8%	1,300	1.9%	1,000	1.7%	900	1.8%
3 yrs after FY of sale							$\boxed{800}$	1.1%	900	1.5%	600	1.2%
4 yrs after FY of sale									$\boxed{500}$	0.8%	700	1.4%
5 yrs after FY of sale											$\boxed{200}$	0.4%
6 yrs after FY of sale												
Total uncol. sales as of Dec. 31, 2006	$2,070	2.3%	$4,400	5.6%	$5,500	7.2%	$5,600	8.0%	$5,700	9.5%	$5,500	11.0%

Table D2—(continued)

	2000 Sales		1999 Sales		1998 Sales		1997 Sales		1996 Sales		Combined Experience	
	Uncol-lectible	*% of sales (net of down pmnts)*	*Uncol-lectible*	*% of sales (net of down pmnts)*	*Uncol-lectible*	*% of sales (net of down pmnts)*	*Uncol-lectible*	*% of sales (net of down pmnts)*	*Uncol-lectible*	*% of sales (net of down pmnts)*	*1996-2000*	*All Years*
FY of Sale	$1,000	2.9%	$ 800	2.4%	$ 750	2.5%	$ 700	2.7%	$ 500	1.8%	2.5%	2.3%
1 yr after FY of sale	1,500	4.4%	1,400	4.2%	1,300	4.3%	1,000	3.8%	900	3.2%	4.0%	3.7%
2 yrs after FY of sale	900	2.6%	850	2.6%	700	2.3%	550	2.1%	450	1.6%	2.3%	2.0%
3 yrs after FY of sale	600	1.8%	700	2.1%	500	1.7%	400	1.5%	300	1.1%	1.6%	1.5%
4 yrs after FY of sale	300	0.9%	250	0.8%	250	0.8%	250	1.0%	150	0.5%	0.8%	0.9%
5 yrs after FY of sale	150	0.4%	250	0.8%	150	0.5%	100	0.4%	75	0.3%	0.5%	0.5%
6 yrs after FY of sale	$\boxed{100}$	0.3%	150	0.5%	100	0.3%	75	0.3%	100	0.4%	0.3%	0.3%
Total uncol. sales as of Dec. 31, 2006	$4,550	13.3%	$4,400	13.4%	$3,750	12.4%	$3,075	11.8%	$2,475	8.9%	12.0%	11.2%

Computation of Charge to Revenue for Estimated Uncollectibles on Current Year (2006) Sales, and Balance of Allowance at End of 2006

Tables D3 and D4 illustrate the computation of the charge to revenue for estimated uncollectibles on current-year (2006) sales and the computation of the required balance in the allowance for uncollectibles at the end of 2006. For simplicity, this illustration assumes that there is no evidence that the existing receivables are different from the receivables covered by the historical data above. As discussed in paragraph .37 of this Statement of Position (SOP), the allowance should consider such factors as the aging of the receivables, economic conditions, and recent collection history. This illustration uses the historical data for all years, rather than just the data for 1996 to 2000 sales, on the assumption that the more recent experience is relevant to the collectibility of existing receivables.

Table D3. Estimated Uncollectible by Year of Sale

Year Uncollectible	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
2007	0.3%	0.5%	0.9%	1.5%	2.0%	3.7%
2008		0.3%	0.5%	0.9%	1.5%	2.0%
2009			0.3%	0.5%	0.9%	1.5%
2010				0.3%	0.5%	0.9%
2011					0.3%	0.5%
2012						0.3%
Total expected future uncollectible (%)	0.3%	0.8%	1.7%	3.2%	5.2%	8.9%
Sales, net of down payments	$50,000	$60,000	$70,000	$76,000	$80,000	$90,000
Total expected future uncollectible ($)	$ 150	$ 480	$ 1,190	$ 2,432	$ 4,160	$ 8,010
Total allowance needed at December 31, 2006						$16,422

Table D4. Charge to Revenue for Current Year Sales

Sales net of down payments, 2006	$90,000
Uncollectible — estimated and actual (%)	11.2%
Total charge for 2006 sales	10,080
Less: Chargeoffs during 2006	2,070
Charge for Estimated Uncollectible Sales*	$ 8,010

* Year-end 2006 charge to revenue for estimated uncollectibles on 2006 sales.

Assume the following in addition to the above:

1. Seller finances substantially all sales with notes with a seven-year term and interest rates of 12 percent to 15 percent. The weighted-average interest rates were 13.5 percent at December 31, 2006, and 13.6 percent at December 31, 2005, respectively.
2. The receivables balances were $300,800 at December 31, 2006, and $267,700 at December 31, 2005, with weighted-average remaining lives of 3.2 years at both dates.

Illustrative Financial Statement Disclosures[3]

The entity in this illustration (the Company) finances substantially all sales of time-sharing intervals with seven-year mortgage notes. Buyers are required to make a down payment of at least 10 percent of the sales price, with the balance payable in level monthly installments including interest at 12 percent to 15 percent per year. All sales are recorded using the full accrual method of accounting, under which revenue, net of expected uncollectibles, and cost of sales are recorded at the date of the sale to the buyer. The maturities of the receivables are as follows:

	12/31/2006	*12/31/2005*
Due in 1 year	$ 61,400	$ 54,600
Due in 2 years	60,300	53,700
Due in 3 years	56,100	49,900
Due in 4 years	48,900	43,500
Due in 5 years	38,700	34,400
Due beyond 5 years	35,400	31,600
Total receivables	$300,800	$267,700
Total receivables per balance sheet	$300,800	$267,700
Weighted average interest rates	13.5%	13.6%

The activity in the allowance for uncollectibles was as follows:

Balance, beginning of year	$ 14,012	$ 13,552
Allowance for uncollectibles on current year sales	10,080	8,960
Write-offs of uncollectible receivables	(7,670)	(8,500)
Changes in estimate for prior years' sales	0	0
Balance, end of year	$ 16,422	$ 14,012

In June 2003, the Accounting Standards Executive Committee (AcSEC) issued an exposure draft of a proposed SOP, Allowance for Credit Losses. *The disclosures that follow do not include those that may be required under that proposed SOP. Readers should be alert to any final pronouncement.*

The Company assesses uncollectibles based on pools of receivables, because it holds large numbers of homogenous notes receivable. The Company estimates uncollectibles based on historical uncollectibles for similar time-share notes receivable over the past 10 years. The Company uses a technique referred to as static pool analysis, which tracks uncollectibles for each year's sales over the entire life of those notes. The Company considers whether the historical economic conditions are comparable to current economic conditions, with particular reference to unemployment rates. If current unemployment rates differ from the rates in effect when the historical experience was generated, the Company adjusts the allowance for uncollectibles to reflect the expected effects of current unemployment rates on uncollectibility. The Company currently groups all receivables in three pools for analytical purposes—Florida, California, and Hawaii. Although the Company's credit policies are identical in all locations, the customer demographics and historical uncollectibility have varied by state. Within states, customer demographics and historical uncollectibility for projects have been substantially the same.

[3] If the company had sold receivables with recourse, it would also disclose the activity on receivables sold in the allowance for uncollectible receivables.

The Company's accounting policy is to stop accruing interest income on individual notes when they become 60 days past due, and to charge off notes to the allowance for uncollectibles when they become 120 days past due and the Company has pursued most of its collection remedies.

Illustrative Relevant Sections of Financial Statements

Balance Sheet as of December 31, 2006

Gross notes receivable	$300,800
Allowance for uncollectible notes receivable	(16,422)
Net notes receivable	$284,378

Income Statement for the year ended December 31, 2006

Gross sales transactions*	$100,000
Estimated and actual uncollectible receivables	(10,080)
Revenue	89,920
Cost of sales	(22,000)
Gross profit	$ 67,920

* Includes down payments, or portions thereof, recognized as sales.

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Appendix E

Illustration of Determination of Sales Value of Time-Share Interval

Example 1

Assumptions

Stated sales price		$10,000
Buyer's down payment		$ 1,000
Face amount of note		$ 9,000
Stated interest rate on note		10%
Effective interest rate on note after loan origination fee		10.54%
Market interest rate on note		12%
Terms of note	84 equal monthly installments of	$149.41
Fees payable by buyer to seller at closing:		
Loan origination fee (charged only to buyers who receive seller financing)		$ 150
Document preparation fee (charged to all buyers)		$ 125
Incentives from seller to buyer at no additional cost to buyer: (Buyer must make six monthly payments to receive incentives)		
First year's fee to independent exchange company		$ 110
First year's owners association assessments		$ 300

Present-Value Computations

Present value of 84 monthly installments of $149.41 at market discount rate of 12%	$ 8,464
Fair value of incentives at date of sale:[1]	
First year's fee to independent exchange company	$ 104
First year's owners association assessments	$ 283

Note that if the market interest rate was lower than the stated interest rate on the note, the note would not be increased to an amount in excess of its carrying amount of $8,850.

Computation of Sales Value

Stated sales price	$10,000
Subtractions:	
Discount to state receivable at present value	(386)
Fair value of incentives in excess of amount paid by buyer:	
Exchange company fee	(104)
Owners association assessments	(283)
Additions:	
Document preparation fee	125
Sales value	$ 9,352

[1] The estimated fair value of an incentive at the date of sale equals the present value of the nominal amount discounted at the market interest rate on the note.

Computation of Buyer's Initial Investment

Down payment	$ 1,000
Loan origination fee	150
Document preparation fee	125
Buyer's initial investment	$ 1,275
Proof of buyer's initial investment:	
Sales value	$ 9,352
Plus: incentives	
Exchange company fee	104
Owners association assessments	283
Less: seller's net investment in note receivable	(8,464)
Buyer's initial investment	$ 1,275

Adequacy of Buyer's Initial Investment

The seller first considers whether the buyer's initial investment needs to be allocated between the interval and the incentives. In this case, the initial investment does not need to be allocated, because the buyer must make six monthly payments to receive the incentives. The six monthly payments total $896, which is more than enough to pay for the fair value of the incentives ($387) plus interest (see paragraph .25 of this SOP). Accordingly, the entire initial investment of $1,275 is allocated to the interval.

If the buyer did not need to make any monthly payments to receive the incentives, then the initial investment would be allocated first to the incentives ($387) and the remainder ($888) to the interval.

The adequacy of the buyer's initial investment would then be determined in accordance with paragraph 5(b) of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate*.

Note that, consistent with FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, the computation of sales value and buyer's initial investment is exactly the same as if the buyer provided the seller a note with a face amount of $8,850, requiring 84 monthly payments of $149.41 with an effective interest rate of 10.54 percent, a required down payment of $1,150, and no loan origination fee.

Illustrative Journal Entries

At date of sale:

Dr.	Cash	$1,275	
	Note receivable	8,464	
Cr.	Revenue from sale of interval		$9,352
	Liability for incentives		387

To record sale of interval and liability to provide incentives at end of six months.

Month 1:

Dr.	Cash	$149	
Cr.	Note receivable		$64
	Interest income		85
Dr.	Interest expense	4	
Cr.	Liability for incentives		4

To record accrual of interest income on note receivable, interest expense on liability for incentive, and collection on note receivable.

Months 2 through 6:

Dr.	Cash	$747	
Cr.	Note receivable		$334
	Interest income		413
Dr.	Interest expense	19	
Cr.	Liability for incentives		19

To record accruals of interest income on note receivable, interest expense on liability for incentive, and collections on note receivable.

End of Month 6:

Dr.	Liability for incentives	$410	
Cr.	Cash		$410

To record seller's payment of exchange company fee and owners association assessments.

Example 2

Assumptions

Same as Example 1 except that market interest rate on note is 9 percent.

Present-Value Computation

Present value of 84 monthly installments of $149.41 at market discount rate of 9%	$ 9,286

Because the market interest rate is lower than the effective interest rate on the note, the note is not increased to an amount in excess of the seller's carrying amount of $8,850.

Computation of Sales Value

Stated sales price	$10,000
Subtractions:	
Fair value of incentives in excess of amount paid by buyer:[2]	
Exchange company fee	(105)
Owners association assessments	(287)
Additions:	
Document preparation fee	125
Sales value	$ 9,733

Computation of Buyer's Initial Investment

Down payment	$ 1,000
Loan origination fee	150
Document preparation fee	125
Buyer's initial investment	$ 1,275
Proof of buyer's initial investment:	
Sales value	$ 9,733
Plus: incentives	
Exchange company fee	105
Owners association assessments	287
Less: carrying amount of seller's note receivable	(8,850)
Buyer's initial investment	$ 1,275

[2] The estimated fair value of an incentive at the date of sale equals the present value of the nominal amount discounted at the market interest rate on the note.

Adequacy of Buyer's Initial Investment

The seller first considers whether the buyer's initial investment needs to be allocated between the interval and the incentives. In this case, the initial investment does not need to be allocated, because the buyer must make six monthly payments to receive the incentives. The six monthly payments total $896, which is more than enough to pay for the fair value of the incentives ($392) plus interest (see paragraph .25 of this SOP). Accordingly, the entire initial investment of $1,275 is allocated to the interval.

If the buyer did not need to make any monthly payments to receive the incentives, then the initial investment would be allocated first to the incentives ($392) and the remainder ($883) to the interval.

The adequacy of the buyer's initial investment would then be determined in accordance with paragraph 5(b) of FASB Statement No. 66.

Note that, consistent with FASB Statement No. 91, the computation of sales value and buyer's initial investment is exactly the same as if the buyer provided the seller a note with a face amount of $8,850, requiring 84 monthly payments of $149.41 with an effective interest rate of 10.54 percent, a required down payment of $1,150, and no loan origination fee.

Example 3

Assumptions

Same as Example 2 except that seller does not charge a document preparation fee.

Present-Value Computation

Present value of 84 monthly installments of $149.41 at market discount rate of 9%	$ 9,286

Because the market interest rate is lower than the effective interest rate on the note, the note is not increased to an amount in excess of the seller's carrying amount of $8,850.

Computation of Sales Value

Stated sales price	$10,000
Subtractions:	
Fair value of incentives in excess of amount paid by buyer:[3]	
Exchange company fee	(105)
Owners association assessments	(287)
Sales value	$ 9,608

Computation of Buyer's Initial Investment

Down payment	$1,000
Loan origination fee	150
Buyer's initial investment	$1,150
Proof of buyer's initial investment:	
Sales value	$9,608
Plus: incentives	
Exchange company fee	105
Owners association assessments	287
Less: carrying amount of seller's note receivable	(8,850)
Buyer's initial investment	$1,150

[3] The estimated fair value of an incentive at the date of sale equals the present value of the nominal amount discounted at the market interest rate on the note.

Adequacy of Buyer's Initial Investment

The seller first considers whether the buyer's initial investment needs to be allocated between the interval and the incentives. In this case, the initial investment does not need to be allocated, because the buyer must make six monthly payments to receive the incentives. The six monthly payments total $896, which is more than enough to pay for the fair value of the incentives ($392) plus interest (see paragraph .25 of this SOP). Accordingly, the entire initial investment of $1,150 is allocated to the interval.

If the buyer did not need to make any monthly payments to receive the incentives, then the initial investment would be allocated first to the incentives ($392) and the remainder ($758) to the interval.

The adequacy of the buyer's initial investment would then be determined in accordance with paragraph 5(b) of FASB Statement No. 66.

Note that, consistent with FASB Statement No. 91, the computation of sales value and buyer's initial investment is exactly the same as if the buyer provided the seller a note with a face amount of $8,850, requiring 84 monthly payments of $149.41 with an effective interest rate of 10.54 percent, a required down payment of $1,150, and no loan origination fee.

Example 4

Assumptions

Same as Example 2 except that seller charges no loan origination fee. Therefore, effective interest rate on note equals the stated rate of 10 percent.

Present-Value Computation

Present value of 84 monthly installments of $149.41 at market discount rate of 9%	$9,286

Because the market interest rate is lower than the effective interest rate on the note, the note is not increased to an amount in excess of the seller's carrying amount of $9,000.

Computation of Sales Value

Stated sales price	$10,000
Subtractions:	
Fair value of incentives in excess of amount paid by buyer:[4]	
Exchange company fee	(105)
Owners association assessments	(287)
Additions:	
Document preparation fee	125
Sales value	$ 9,733

[4] The estimated fair value of an incentive at the date of sale equals the present value of the nominal amount discounted at the market interest rate on the note.

Computation of Buyer's Initial Investment

Down payment	$1,000
Document preparation fee	125
Buyer's initial investment	$1,125
Proof of buyer's initial investment:	
Sales value	$9,733
Plus: incentives	
Exchange company fee	105
Owners association assessments	287
Less: carrying amount of seller's note receivable	(9,000)
Buyer's initial investment	$1,125

Adequacy of Buyer's Initial Investment

The seller first considers whether the buyer's initial investment needs to be allocated between the interval and the incentives. In this case, the initial investment does not need to be allocated, because the buyer must make six monthly payments to receive the incentives. The six monthly payments total $896, which is more than enough to pay for the fair value of the incentives ($392) plus interest (see paragraph .25 of this SOP). Accordingly, the entire initial investment of $1,125 is allocated to the interval.

If the buyer did not need to make any monthly payments to receive the incentives, then the initial investment would be allocated first to the incentives ($392) and the remainder ($733) to the interval.

The adequacy of the buyer's initial investment would then be determined in accordance with paragraph 5(b) of FASB Statement No. 66.

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Glossary

Affinity Program. See *vacation club*.

Amenities. Features that enhance the attractiveness or perceived value of a time-sharing interval. Examples of amenities include golf courses, clubhouses, swimming pools, tennis courts, indoor recreational facilities, and parking facilities. See also *planned amenities* and *promised amenities*.

Assumption. The substitution of one debtor for another, whereby the second debtor agrees to assume the debt obligation of the original debtor.

Common Costs. Costs that relate to two or more phases within a time-sharing project.

Continuing Investments. The sum of the buyer's payments to date (down payment, fees retained by the seller, and principal payments subsequent to the down payment) towards the purchase of a time-sharing interval. Payments of interest are excluded.

Continuing Involvement. A situation in which the seller has not transferred substantially all of the benefits and risks incident to the ownership of real estate. Benefits include but are not limited to the right to occupy the property, the transferability of the time-sharing interval without restrictions from the seller, the right to insurance proceeds and condemnation awards, the right to participate in making decisions regarding management of the property, the control over rental of the time-sharing interval, and the right to any increase in the value of the time-sharing interval. Risks include but are not limited to the responsibility for payment of applicable taxes, repairs, utilities, maintenance, insurance, and improvements; the responsibility for management of the property; legal liabilities; setting aside of replacement reserves; casualty losses; and exposure to any decrease in the value of the time-sharing interval. In time-sharing transactions, it is common for certain of the benefits and risks to be transferred to an owners association or similar entity that acts on behalf of the owners of time-sharing intervals. See Appendix C, "Continuing Involvement" [paragraph .69] of this Statement of Position.

Contract-for-Deed. A purchase contract by which the seller agrees at some future point, when the purchaser has paid a specified portion of the price of the time-sharing interval, to convey title to the purchaser. The transfer of title may not be dependent on other factors or contingencies.

Deferment. The postponement of some or all of a debtor's payment obligations.

Deposit Method. A method of accounting for time-sharing transactions under which cash received from the buyer is reported as a deposit and shown as a liability in the seller's balance sheet.

Downgrade. A transaction under which, as a result of credit concerns, the holder of a time-sharing interval returns the interval to the seller in exchange for a lower-valued interval (and a corresponding reduction in contractual payment obligation). The determination of whether the value is lower is based on a comparison of the sales value of the new interval with the original sales value of the original interval.

Exchange. The trading, by a purchaser of a time-sharing interval, of that time-sharing interval for a given year for another time interval, another location, or another kind of privilege of ownership. Such trading is often effected through the buyer's membership in an exchange company. Many developers also offer an internal exchange program. Buyers typically pay a fee for exchange privileges.

Fixed Time. A time-sharing arrangement in which ownership is passed through a deed and the buyer purchases a specific period (generally, a specific week) during the year.

Floating Time. A time-sharing arrangement in which ownership is passed through a deed but the buyer is not limited to a specific period (generally, a specific week) during the year.

Fractional Interest. A partial ownership interest in real estate that typically includes larger blocks of time on an annual basis (for example, three weeks or more).

Full Accrual Method. A method of recognizing profit for time-sharing transactions under which profit is recognized in full provided the applicable criteria in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate*, are met. Those conditions may be met at the time a time-share is sold or at some later date.

Holding Period. The period during which a time-sharing interval is held for sale. Sellers may offer time-sharing units for rent during such holding periods.

Incentive. A product or service that the seller of a time-sharing interval provides to the buyer for stated compensation (often, for no compensation) that is less than the fair value of that product or service. See also *inducement*.

Incidental Operations. Revenue-producing activities, such as rentals, engaged in during the holding or development period to reduce the cost of holding or developing the property for use as time-sharing units, as distinguished from activities designed to generate a profit or return from the use of the property.

Independent Third Party. A party unrelated to the seller of a time-sharing interval.

Inducement. A product or service that a time-share seller provides to a potential buyer for stated compensation (often, no compensation) that is less than the fair value of that product or service. A typical example of an inducement is a complementary stay at a time-share resort in exchange for the potential buyer's agreement to take a guided tour of the resort. The difference between an *inducement* and an *incentive* is the conditions for receipt and the timing of the offer. An inducement is offered to potential buyers regardless of whether a consummated sale occurs, whereas an incentive is typically offered at the point of sale and is provided only to buyers of time-sharing intervals.

Interval. The specific period (generally, a specific week) during the year that a time-sharing unit is specified by agreement to be available for occupancy by a particular customer. Also denoted *time-sharing interest* or *time-share*.

Mini-Vacation. A marketing program under which a time-share developer offers, for a fee, a short (typically, two to three days) visit to a destination where the developer operates a project. The developer typically subsidizes the fee to the customer for the mini-vacation in exchange for the customer attending a sales presentation at the project. The mini-vacation may include room accommodations, entertainment tickets, and similar items of value. The customer typically accepts the offer of the fee subsidy in exchange for his or her attending the sales presentation.

Modification. A change in the terms of the financing agreement between buyer and seller, typically to accommodate a situation in which the buyer is unable to meet his or her original contractual payment obligations.

Other Than Retail Land Sales (OTRLS). Refers to other-than-retail-land-sales transactions as discussed in FASB Statement No. 66.

Owners Association (OA). A body of owners formed to administer the rules and regulations of a time-sharing project. Also denoted *homeowners association* (HOA), *interval owners association* (IOA), *property owners association* (POA), or *vacation owners association* (VOA).

Percentage-of-Completion Method. A method of recognizing profit for time-sharing transactions under which the amount of revenue recognized (based on the sales value) at the time a sale is recognized is measured by the relationship of costs already incurred to the total of costs already incurred and future costs expected to be incurred.

Phase. A contractually or physically distinguishable portion of a time-sharing project. That portion is distinguishable from other portions based on shared characteristics such as (1) units a developer has declared or legally registered to be for sale, (2) units linked to an owners association, (3) units to be constructed during a particular time period, or (4) how a developer plans to build the time-sharing project.

Planned Amenities. Amenities that a developer is planning to construct but is not obligated to construct under the terms of time-sharing contracts with purchasers. See also *amenities* and *promised amenities*.

Points. Purchased vacation credits that a buyer may redeem for occupancy at various sites. The number of points redeemed depends on such factors as unit type and size, site location, and season.

Project. A time-sharing development; some projects may be completed in a single phase, such as a single, one-story building containing several time-sharing units. Other projects may be completed in several phases, for example (1) a hotel that is being converted to time-sharing units one floor at a time while the unconverted units continue to be rented or (2) a number of buildings, each containing several time-sharing units, being built on a piece of property over an extended period of time.

Promised Amenities. Amenities that a developer is obligated to construct under the terms of time-sharing contracts with purchasers. See also *amenities* and *planned amenities*.

Real Estate Time-Sharing. See *time-sharing*.

Recourse. The right of a transferee of receivables to receive payment from the transferor of those receivables for (1) failure of debtors to pay when due, (2) the effects of prepayments, or (3) adjustments resulting from defects in the eligibility of the transferred receivables.

Relative Sales Value Method. A method of allocating inventory cost and determining cost of sales in conjunction with a time-sharing sale. Cost of sales is calculated as a percentage of net sales by applying a cost-of-sales percentage, determined as the ratio of inventory cost to total remaining estimated time-sharing revenue to be collected from sales of the inventory. The inventory balance reported in the balance sheet is considered to be a pool of costs that will be charged against future revenue.

Reload. A time-sharing transaction whereby a customer obtains a second time-sharing interval from the same seller but does not relinquish the right to the first—for example, obtaining an additional unit, an additional interval, or additional points (see *vacation club*).

Rescission. Statutory right of the buyer to cancel a sales contract within a certain defined time period and obtain a return of all consideration paid to the seller.

Right-to-Use (RTU). A time-sharing arrangement in which the ownership of the real estate remains with the seller.

Sales Value. A calculated amount that approximates the amount at which a time-sharing interval would be sold in an all-cash sale, without financing or incentives. Sales value is determined by adjusting the stated sales price to add or subtract the following amounts:

1. Subtracting from the stated sales price a discount to reduce the receivable to its present value using an appropriate interest rate not less than the rate stated in the note. The objective is to value the note at an amount not greater than the amount at which it could be sold without recourse by the seller at the date of the sales contract.

2. Adding to the stated sales price any fees paid by the buyer to the seller that are unrelated to financing—for example, sales document preparation fees—to consummate a sales transaction.

3. Subtracting from the stated sales price the excess of the fair value of incentives provided to the buyer over the stated amount the buyer pays for the incentives.

4. Subtracting from the stated sales price the excess of the fair value of services provided by the seller over the stated amount the buyer pays for the services. If similar services are provided by entities other than the seller, the fair value of the services should be determined as the prevailing market rates for such services.

Sampler Program. A marketing program under which a time-share developer offers a customer, who has previously toured one of the developer's projects, a stay at one of the projects at a reduced rate. In exchange, the customer agrees to take another, subsequent tour of the project selected under the sampler program during the customer's stay at that project. If the subsequent tour results in a sale, the developer may allow the customer to apply some or all of the amount paid for the sampler toward the purchase of a time-share, as a part of the down payment. Also referred to as *exit program*.

Seller Subsidy. An amount that a seller pays to an owners association to cover net losses that may be incurred by the association.

Special-Purpose Entity. See *time-sharing special-purpose entity*.

Tenancy-for-Years. A time-sharing arrangement in which a customer has a qualified right to possession and use of a time-sharing interval for a certain number of years, after which it reverts to the seller or a third party. Also known as *estate-for-years* or *term-for-years*.

Time-Share. See *interval*.

Time-Sharing. An arrangement in which a seller sells or conveys the right to occupy a dwelling unit for specified periods in the future. Forms of time-sharing arrangements covered by this SOP include but are not limited to fixed and floating time, interval ownership, **undivided interests**, points programs, vacation clubs, right-to-use arrangements such as **tenancy-for-years** arrangements, and arrangements involving special-purpose entities.

Time-Sharing Interest. See *interval*.

Time-Sharing Special-Purpose Entity (SPE). An entity, typically a corporation or a trust, to which a seller transfers time-sharing real estate in exchange for the entity's stock, membership interests, or beneficial interests.

Uncollectibility. A situation in which, as a result of credit issues, (1) the time-share seller is unable to collect all amounts due (both principal and interest) according to the contractual terms of a note receivable from a buyer, or (2) a time-share receivable has not been written off but facts and circumstances indicate that it is probable[1] that the seller will not collect all contractual payments. Any sale that, as a result of credit issues, is canceled or modified subsequent to being recorded as a sale is considered *uncollectible*.

Undivided Interest (UDI). A time-sharing arrangement that involves a tenant-in-common interest in a condominium unit or entire improved property, and in which the interest holder is assigned a specific period (generally, a specific week). The interest holder is also assigned a specific unit if the undivided interest is in the entire improved property.

Unit. The physical space in a time-sharing project that a customer is specified by agreement to occupy for a specific time interval (generally, a specific week) during the year.

Upgrade. A time-sharing transaction whereby a customer relinquishes the right to a currently held time-sharing interval and obtains a higher-priced time-sharing interval from the same seller.

Vacation Club. A time-sharing arrangement whereby a buyer receives the right to use accommodations at all resorts belonging to the club. Membership may include a priority reservation right to the member's home resort. Other typical attributes include finite term of membership; use of points to obtain accommodations or other benefits; the privilege of being able to use different kinds of lodging, such as time-sharing units, condominiums, hotels, and campgrounds; the privilege of being able to exchange one's yearly interval for cruises, hotel stays, airline tickets, or car rentals; and benefits other than lodging, such as travel services, hotel discounts, golf packages, or health club memberships. May also be termed *affinity program*.

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[1] *Probable* is defined in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, as "likely to occur" and is used in the same sense in this definition.

Accounting Standards Executive Committee (2002-2003)

AICPA Staff

Time-Sharing Task Force

The Time-Sharing Task Force and staff gratefully acknowledge the contributions made to the development of this Statement of Position by Paul Andrews, Matthew E. Avril, James H. Brant, Carl W. Daugherty, Maria K. Davis, Nancy L. Hennessey, and Jack A. Kramer.

[The next page is 81,371.]

Section 10,920

Statement of Position 05-1 Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts

September 19, 2005

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, as amended, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*:

- The SOP defines an internal replacement as a modification in product benefits, features, rights, or coverages that occurs by the exchange of a contract for a new contract, or by amendment, endorsement, or rider to a contract, or by the election of a feature or coverage within a contract. Modifications that result from the election by the contract holder of a benefit, feature, right, or coverage that was within the original contract are not internal replacements subject to this guidance as long as all of the conditions listed in paragraph .09 of this SOP are met.

- The SOP introduces the terms **integrated** and **nonintegrated contract features** and specifies that nonintegrated features do not change the base contract and are to be accounted for in a manner similar to a separately issued contract. Integrated features are evaluated in conjunction with the base contract.
- Contract modifications meeting all of the conditions in paragraph .15 of this SOP result in a replacement contract that is substantially unchanged from the replaced contract and should be accounted for as a continuation of the replaced contract.
- An internal replacement that is determined to result in a replacement contract that is substantially changed from the replaced contract should be accounted for as an extinguishment of the replaced contract. Unamortized deferred acquisition costs, unearned revenue liabilities, and deferred sales inducement assets from the replaced contract in an internal replacement transaction that results in a substantially changed contract should not be deferred in connection with the replacement contract.
- Unamortized deferred acquisition costs and the present value of future profits[1] continue to be subject to premium deficiency testing in accordance with the provisions of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended.
- The notes to the financial statements should describe the accounting policy applied to internal replacements, including whether or not the company has availed itself of the alternative application guidance outlined in paragraphs .18 and .19 of this SOP and, if so, for which kinds of internal replacement transactions.

This SOP is effective for internal replacements occurring in fiscal years beginning after December 15, 2006, with earlier adoption encouraged. Retrospective application of this SOP to previously issued financial statements is not permitted. Initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date, all prior interim periods of the year of adoption should be restated).

Disclosure of the effect of the change on retained earnings as of the date of adoption is required. If the financial statements of the year of adoption are presented separately or included in comparative financial statements, the notes to the financial statements should disclose (*a*) the fact that this SOP has been adopted and the effective date of adoption, and (*b*) the nature of any differences in accounting principles or financial statement presentation applicable to the financial statements presented that resulted from adoption of this SOP.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public

[1] The *present value of future profits* is as discussed in EITF Issue No. 92-9, "Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company."

board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least 10 of AcSEC's 15 members, and (3) a proposed final document that has been approved by at least 10 of AcSEC's 15 members. The document is cleared if at least four of the seven FASB members do not object to AcSEC undertaking the project,[2] issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Introduction and Background

.01 Insurance enterprises may offer existing contract holders new products or modifications to **existing contracts**[1] for various reasons, such as increasing administrative efficiency and improving the competitive position of the contract to enhance contract holder satisfaction and retention. For example, at the time universal life-type contracts became popular, they were often purchased as replacements for traditional life insurance contracts issued by the same enterprise. In those cases, the contract holder generally used the cash surrender value of the previous contract to make an initial premium deposit for the new, universal life-type contract. Further, contract holders often request insurance enterprises to make changes to their existing contracts.

.02 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, refers to the replacement by an insurance enterprise of one of its traditional life insurance contracts by a universal life-type contract as an **internal replacement**. FASB Statement No. 97 specifies that unamortized deferred acquisition costs related to traditional life insurance contracts replaced with universal life-type contracts issued by the same insurance enterprise shall not be deferred in connection with the **replacement contract**.

.03 Diversity in practice exists in accounting for internal replacements other than those specified in FASB Statement No. 97, which discusses internal replacements of traditional life insurance contracts with universal life-type contracts only and does not address the accounting for other internal replacements (such as traditional life with traditional life, universal life with universal

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[2] At the time AcSEC undertook the project, at least five of the seven FASB members were required to not object to AcSEC undertaking this project.

[1] Terms defined in the "Glossary" [paragraph .37] are set in **boldface** type the first time they appear in the text.

life, annuity with annuity). AICPA Practice Bulletin No. 8, *Application of FASB Statement No. 97 to Insurance Enterprises* [section 12,080], issued in November 1990, clarifies that the accounting specified by FASB Statement No. 97 for internal replacement transactions applies only to the replacement of traditional insurance contracts with universal life-type contracts. Practice Bulletin 8 paragraphs 18 and 19 [section 12,080.18 and .19] state:

> .18 *Question 7*: Does the accounting specified by FASB Statement No. 97, paragraph 26, for internal replacement transactions apply only to the replacement of traditional insurance contracts by universal life-type contracts?
>
> .19 *Answer 7*: Yes, FASB Statement No. 97 addresses only replacements of traditional insurance contracts by universal life-type contracts. The accounting for other internal replacements should be based on the circumstances of the transaction. Paragraphs 70 to 72 of FASB Statement No. 97 discuss the Board's rationale for requiring recognition of loss on the termination of the replaced contract.

.04 The basis for conclusions of FASB Statement No. 97 discusses alternative views of accounting for internal replacements. Paragraph 71 of the Statement discusses two alternative views rejected by the FASB:

a. Continued deferral of costs related to replacement contracts is appropriate based on the continuation of the customer relationship:

> The replacement of a traditional life insurance contract with a universal life-type contract typically results in the need to account for an amount equal to the sum of (*a*) the unamortized acquisition costs associated with the replaced contract and (*b*) the difference between the cash surrender value and the previously recorded liability for policy benefits related to the replaced contract. The AICPA Issues Paper suggested that this net amount should be deferred and amortized as part of the capitalized acquisition costs of the new book of universal life-type contracts. The Issues Paper took the position that the universal life-type replacement contract represented a continuing relationship between the insurer and the policyholder, and maintained that the new contract represented only a change in the form of the insurance protection.

b. Continued deferral of costs related to replaced contracts more closely equates the cost of replacement contracts and contracts issued to new customers:

> Some respondents also suggested that the incremental costs of replacement transactions are usually less than the costs of sales to new policyholders. In their view, the continued deferral of net amounts related to replaced contracts more nearly equates the costs of contracts issued to different classes of policyholders.

.05 As stated in paragraph 72 of FASB Statement No. 97:

> The Board rejected those proposals. The Board recognizes that an insurance enterprise that conducts an internal replacement program may be motivated by a desire to retain its customer base and that the alternative to replacement may be loss of that base. That objective is not, however, different from the objectives of similar transactions undertaken by insurance enterprises and other enterprises for which continued deferral of costs is not permitted, including the refunding of debt.

Applicability and Scope

.06 This Statement of Position (SOP) applies to all entities to which FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended, applies, hereinafter referred to as *insurance enterprises*,[2, 3] and is applicable to modifications and replacements made to contracts defined by FASB Statement No. 60 as short-duration and long-duration contracts, including those contracts defined by FASB Statement No. 97 as investment contracts.

Conclusions

.07 If an internal replacement (as described in paragraphs .08 through .10 of this SOP) occurs and the rights and obligations of the parties to the contract are substantially unchanged (based on an evaluation of the conditions specified in paragraph .15 of this SOP) from those under the **replaced contract**, the replacement contract should be accounted for as a continuation of the replaced contract in accordance with the guidance in paragraphs .16 through .24 of this SOP. If the internal replacement occurs and results in a replacement contract that is substantially changed from the replaced contract, the replaced contract should be accounted for as extinguished in accordance with the guidance in paragraph .25 of this SOP.

Internal Replacements

.08 An internal replacement is a modification in product benefits, features, rights, or **coverages** that occurs by the legal extinguishment of one contract and the issuance of another contract (a **contract exchange**), or by amendment, endorsement, or rider to a contract, or by the election of a benefit, feature, right, or coverage within a contract.

.09 Modifications (other than partial withdrawals, surrenders or reductions in coverage that are addressed in paragraph .10 of this SOP) that result from the election by the contract holder of a benefit, feature, right, or coverage that was within the **original contract** are not internal replacements subject to this guidance as long as all of the following conditions are met:

a. The election is made in accordance with terms fixed or specified within narrow ranges in the original contract.

b. The election of the benefit, feature, right, or coverage is not subject to any underwriting.

c. The insurance enterprise cannot decline to provide the coverage or adjust the pricing of the benefit, feature, right, or coverage.

d. The benefit, feature, right, or coverage had been accounted for since the inception of the contract, for example, the option to elect the feature is an embedded option within the contract that is required to be accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, (or

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[2] FASB Statement No. 60, as amended, applies to life insurance enterprises, property and liability insurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, assessment enterprises, and fraternal benefit societies. Modifications and exchanges of debt issued by insurance enterprises should follow the guidance in Emerging Issues Task Force (EITF) Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments."

[3] Other relevant accounting guidance, for instance FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, governs the determination of the implications of modifications to insurance and reinsurance contracts on risk transfer assessment and the classification of short-duration contracts as either retroactive or prospective.

would have been accounted for under FASB Statement No. 133 if the "grandfathering" provisions of the Statement, for embedded derivatives, had not been elected) or the existence of the option to elect a feature was assessed in the classification of and accounting for of the contract, such as the classification of the contract as an insurance contract under SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts* [section 10,870].

The annuitization phase of a contract is separate and distinct from and cannot be accounted for as a continuation of the accumulation phase, even if annuitization is in accordance with terms fixed in the original contract.

.10 Partial withdrawals, surrenders, or reductions in coverage (for example, reduced face amount on a life insurance contract or higher deductibles on a property casualty contract), as allowed by terms that are fixed and specified at contract inception either in the contract or other information available to the contract holder or, if required by state law or regulation, at terms in effect when the reduction is made for that benefit, feature, right, or coverage, whether or not **surrender charges** or other termination charges are assessed, are not internal replacements subject to this guidance, as long as there are no **reunderwriting** or other modifications to the contract, at that time, that would require evaluation under paragraph .15 of this SOP.

Integrated and Nonintegrated Contract Features

.11 For long-duration contracts, **integrated contract features** are those for which the benefits provided by the feature can be determined only in conjunction with the account value or other contract holder balances related to the **base contract**, and **nonintegrated contract features** are those for which the determination of benefits provided by the feature is not related to or dependent on the account value or other contract holder balances of the base contract. Underwriting and pricing for nonintegrated contract features typically are executed separately from other components of the contract, and it is inherent in this concept that the premium charged is not in excess of an amount that is commensurate with the incremental insurance coverage provided.

.12 For short-duration contracts, nonintegrated contract features are those that provide coverage that is underwritten and priced only for that incremental insurance coverage, and do not result in the explicit or implicit reunderwriting or repricing of other components of the contract. It is inherent in this concept that the premium charged is not in excess of an amount that is commensurate with the incremental insurance coverage provided. Additional coverage provided by a nonintegrated contract feature would be considered nonintegrated even though the entire coverage provided by the short-duration contract may be subject to only one deductible or limit in the event of an insured loss. For short-duration contracts, integrated contract features are those where there is explicit or implicit reunderwriting or repricing of existing components of the base contract.

Contract Modifications Involving Nonintegrated Contract Features

.13 If a contract feature or coverage is nonintegrated, the addition or election of that feature or coverage, in and of itself, does not change the existing base contract and, as a result, further evaluation of the base contract under paragraph .15 of this SOP is not required. The nonintegrated contract feature or coverage should be accounted for in a manner similar to a separately issued contract. Subsequent modifications made only to the nonintegrated contract feature or coverage should be evaluated under paragraphs .09 through .15 of this SOP separately from the base contract, and any deferred acquisition costs related to the nonintegrated contract feature or coverage accounted for accordingly. Subsequent termination of a nonintegrated contract feature or coverage should be accounted for as an extinguishment of only the balances related to the nonintegrated contract feature or coverage.

Contract Modifications Involving Integrated Contract Features

.14 For contract modifications involving integrated contract features or coverages (other than those contract modifications described in paragraphs .09 and .10 of this SOP), the insurance enterprise should review the conditions set forth in paragraph .15 of this SOP to determine whether the contract has changed substantially as a result of the modification. A contract modification meeting all of the conditions in paragraph .15 of this SOP results in a replacement contract that is substantially unchanged from the replaced contract, and should be accounted for as a continuation of the replaced contract in accordance with paragraphs .16 through .24 of this SOP. A contract modification that fails any of the conditions in paragraph .15 of this SOP results in a replacement contract that is substantially changed from the replaced contract, and should be accounted for as an extinguishment of the replaced contract in accordance with paragraph .25 of this SOP.

Determining Substantial Changes

.15 An internal replacement (other than those not subject to the SOP as described in paragraphs .09 and .10 of this SOP) is determined to involve contracts that are substantially unchanged only if all the following conditions exist:

a. The insured event, risk, or period of coverage of the contract has not changed, as noted by no significant changes in the kind and degree of mortality risk, morbidity risk, or other insurance risk, if any.

b. The nature of the investment return rights (for example, whether amounts are determined by formulae specified by the contract, pass through of actual performance of referenced investments, or at the discretion of the insurer), if any, between the insurance enterprise and the contract holder has not changed.

c. No additional deposit, premium, or charge relating to the original benefit or coverage, in excess of amounts specified or allowed in the original contract, is required to effect the transaction; or if there is a reduction in the original benefit or coverage, the deposit, premiums, or charges are reduced by an amount at least equal to the corresponding reduction in benefits or coverage.

d. Other than distributions to the contract holder or contract designee or charges related to newly purchased or elected benefits or coverages, there is no net reduction in the contract holder's account value or, for contracts not having an explicit or implicit account value, the cash surrender value, if any.

e. There is no change in the participation or dividend features of the contract, if any.

f. There is no change to the amortization method or revenue classification of the contract.

If any of the conditions above are not met, an internal replacement is determined to involve a replacement contract that is substantially changed from the replaced contract.

Accounting for Contracts That Are Substantially Unchanged

.16 An internal replacement that is determined to result in a replacement contract that is substantially unchanged from the replaced contract should be accounted for as a continuation of the replaced contract.[4] Unamortized deferred acquisition costs,[5] unearned revenue liabilities, and deferred sales inducement assets associated with the replaced contract should continue to be deferred and amortized or earned in connection with the replacement contract. Other balances associated with the replaced contract, such as any liability for minimum guaranteed death benefits (MGDBs) or guaranteed minimum income benefits (GMIBs), should be accounted for in a similar manner, that is, as if the replacement contract is a continuation of the replaced contract.

Accounting for FASB Statements No. 91, No. 97, and No. 120 Contracts—General

.17 For contracts accounted for under FASB Statements No. 97 and No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, the estimated gross profits of the replacement contract are treated as revisions to the estimated gross profits or margins of the replaced contract in the determination of the amortization of deferred acquisition costs and deferred sales inducement assets and the recognition of unearned revenues. For contracts to which the FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, interest method amortization methodology is applied, the replacement contract represents revisions to the cash flows of the replaced contract, and unamortized deferred acquisition costs and deferred sales inducement assets are adjusted accordingly. Other balances that are determined based on activity over the life of the contract, such as a liability for MGDBs (which, under the provisions of SOP 03-1 [section 10,870], is determined based on assessments and benefit costs) should be calculated considering the entire revised life of the contract, including activity during the term of the replaced contract.

Accounting for FASB Statements No. 91, No. 97, and No. 120 Contracts—Practicability Considerations

.18 If it is not reasonably practicable for an insurance enterprise to account for, in the manner described in paragraph .17 of this SOP, a contract

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[4] However, even if both accumulation and annuitization phase contracts are investment contracts involving no life contingencies, the annuitization phase of a contract is separate and distinct from and cannot be accounted for as a continuation of the accumulation phase of the contract. For a short-duration contract, renewal results in a separate and distinct contract that cannot be accounted for as a continuation of the previous contract.

[5] If the replaced contract was acquired in a purchase business combination, any present value of future profits established in accordance with EITF Issue No. 92-9, "Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company," should be accounted for in a similar manner. Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141 (revised 2007), *Business Combinations*, should be applied and accounted for under the acquisition method. FASB Statement No. 141(R) nullifies EITF Issue No. 92-9. If the replaced contract was acquired in a business combination, any present value of future profits should be accounted for in a similar manner. [Footnote revised, May 2008, due to the issuance of FASB Statement No. 141(R).]

exchange that has resulted in a replacement contract that is substantially unchanged from the replaced contract, the insurance enterprise should determine the balance of unamortized deferred acquisition costs related to the replaced contract to carry forward to the replacement contract and utilize estimated gross profits only of the replacement contract to determine future amortization. The total balance of unamortized deferred acquisition costs prior to the internal replacement should be allocated between replaced contracts and contracts remaining in the original book of business based on a reasonable and systematic allocation process. Appendix D [paragraph .36], "Illustration of Deferred Acquisition Costs and Unearned Revenue Liability Amortization for a FASB Statement No. 97 Internal Replacement That Is Determined to Result in a Substantially Unchanged Contract," of this SOP illustrates one such allocation approach.

.19 In conjunction with the guidance in paragraph .18 of this SOP, the balance of unamortized deferred acquisition costs and other contract-related balances should be updated based on the most current assumptions at the time of the internal replacement. All related accounting balances that use estimated gross profits or assessments as a base for amortization or recognition should be handled in a similar manner.

Accounting for FASB Statement No. 60 Long-Duration Contracts

.20 For long-duration contracts accounted for under FASB Statement No. 60, the replacement contract generally should be viewed as a *prospective revision* of the replaced contract with future amortization of unamortized deferred acquisition costs adjusted, accordingly, on a prospective basis. Under the prospective revision methodology, the unamortized deferred acquisition costs and benefit liability balances at the time of replacement are unchanged. Future increases and decreases to the unamortized deferred acquisition costs and benefit reserve balances should reflect the revised revenue expected from the replacement contract at the time of replacement. This approach preserves the "lock-in" principle and is consistent with the treatment of other premium changes on indeterminate premium life insurance and guaranteed renewable health insurance contracts accounted for under the provisions of FASB Statement No. 60. The prospective revision methodology should be applied consistently for liabilities for policy benefits and unamortized deferred acquisition costs. Where the modification is a reduction in benefits with a directly proportionate reduction in premiums, the modification should result in an immediate proportionate reduction in unamortized deferred acquisition costs rather than a prospective revision.

Accounting for FASB Statement No. 60 Short-Duration Contracts

.21 Similar to long-duration contracts accounted for under FASB Statement No. 60, a revision to a short-duration contract generally is viewed as a prospective revision with future recognition of unearned premium and amortization of unamortized deferred acquisition costs adjusted, accordingly, on a prospective basis. Consistent with the guidance in paragraphs 13 and 29 of FASB Statement No. 60, unearned premium is recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided, amortization of deferred acquisition costs continues to be recognized in proportion to the premium recognized, and the revised amortization ratio is used prospectively. Where the modification is a reduction in benefits with a directly proportionate reduction in premiums, the modification should result in an immediate proportionate reduction in unamortized deferred acquisition costs rather than a prospective revision.

Costs Related to Internal Replacements That Are Substantially Unchanged

.22 Costs incurred in connection with an internal replacement that results in a replacement contract that is substantially unchanged from the replaced contract should be accounted for as policy maintenance costs and charged to expense as incurred. The portion of renewal commissions paid on the replacement contract that meets the criteria for deferral in accordance with the provisions of FASB Statements No. 60 and No. 97, as appropriate, limited to the amount of the future deferrable renewal commissions on the replaced contract that would have met the deferral criteria, continues to be deferrable under the provisions of FASB Statements No. 60 and No. 97.

Sales Inducements to Contract Holders Offered With Internal Replacements of Long-Duration Contracts That Are Substantially Unchanged

.23 In certain situations, an insurance enterprise may assess a surrender charge on the replaced contract that is offset by an immediate **sales inducement to a contract holder** on the replacement contract. In this situation, the insurance enterprise should offset any surrender charges assessed against the contract holder's account balance under the replaced contract against any stated immediate sales inducement to determine whether there has been a net reduction in the contract holder's account value in accordance with paragraph .15*d* of this SOP.

.24 The liability for a sales inducement to a contract holder offered in conjunction with an internal replacement of a long-duration contract that is determined to result in a replacement contract that is substantially unchanged from the replaced contract should be accounted for from the date of its addition to the replacement contract in accordance with the guidance in paragraph 36 of SOP 03-1 [section 10,870.36]:

> Sales inducements provided to the contract holder, whether for investment or universal life-type contracts, should be recognized as part of the liability for policy benefits over the period in which the contract must remain in force for the contract holder to qualify for the inducement or at the crediting date, if earlier, in accordance with paragraph .20 of this SOP. No adjustments should be made to reduce the liability related to the sales inducements for anticipated surrender charges, persistency, or early withdrawal contractual features.

The criteria in paragraph 37 of SOP 03-1 [section 10,870.37] for recognition of a related sales inducement asset cannot be satisfied in these circumstances because the sales inducement was not specifically identified in the original contract.

Accounting for Contracts That Are Substantially Changed

.25 An internal replacement that is determined to result in a replacement contract that is substantially changed from the replaced contract should be accounted for as an extinguishment of the replaced contract. Unamortized deferred acquisition costs,[6] unearned revenue liabilities, and deferred sales

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[6] If the replaced contract was acquired in a purchase business combination, any present value of future profits established in accordance with EITF Issue No. 92-9, "Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company," should be accounted for in a similar manner.

inducement assets from the replaced contract in an internalreplacement transaction that results in a substantially changed contract should not be deferred in connection with the replacement contract. Other balances associated with the replaced contract, such as any liability for MGDBs or GMIBs, should be accounted for in a similar manner; that is, accounted for based on an extinguishment of the replaced contract and issuance of a new contract. Acquisition costs related to the replacement contract should be evaluated for deferral in accordance with the provisions of FASB Statements No. 60 and No. 97, as appropriate.

Contract Assessments Related to Internal Replacements of Long-Duration Contracts

.26 Front-end fees assessed in connection with an internal replacement of a long-duration contract should be evaluated for deferral in accordance with existing authoritative accounting literature. For contracts accounted for under FASB Statements No. 91, No. 97, and No. 120, both new and existing front-end fees on an internal replacement that results in a replacement contract that is substantially unchanged from the replaced contract should be adjusted to reflect the revisions to the estimated gross profits.

Recoverability

.27 Unamortized deferred acquisition costs and the present value of future profits continue to be subject to premium deficiency testing in accordance with the provisions of FASB Statement No. 60.

Disclosures

.28 The notes to the financial statements should describe the accounting policy applied to internal replacements, including whether or not the company has availed itself of the alternative application guidance outlined in paragraphs .18 and .19 of this SOP and, if so, for which types of internal replacement transactions.

Effective Date and Transition

.29 The provisions of this SOP are effective for internal replacements occurring in fiscal years beginning after December 15, 2006, with earlier adoption encouraged. Retrospective application of this SOP to previously issued financial statements is not permitted. Initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date, all prior interim periods of the year of adoption should be restated).

Internal Replacements Occurring Prior to the Year of Adoption

.30 Unamortized deferred acquisition costs and other balances, such as unearned revenue on front-end fees and unamortized deferred sales inducements, related to internal replacement transactions occurring prior to the year of adoption of this SOP should not be adjusted to the amounts that would have been reported had this SOP been in effect when the internal replacements occurred.

Internal Replacements Occurring After the Date of Adoption

.31 Prior to the adoption of the SOP, an enterprise's accounting policy would have treated certain internal replacements as continuations of the replaced contract, while others may have been treated as extinguishments. Under the provisions of this SOP, the enterprise's accounting policy may change for certain internal replacements. Changes in unamortized deferred acquisition costs,[7] unearned revenue liabilities, and deferred sales inducement assets that result from the impact on estimated gross profits of changes in accounting policy due solely to the adoption of this SOP, as applied to previously anticipated future internal replacements, and any related income tax effects, should be reported in a manner similar to the cumulative effect of a change in accounting principle with offsetting adjustments to the opening balance of retained earnings as of the date of adoption.

Disclosures

.32 Disclosure of the effect of the change on retained earnings as of the date of adoption is required. If the financial statements of the year of adoption are presented separately or included in comparative financial statements, the notes to the financial statements should disclose (*a*) the fact that this SOP has been adopted and the effective date of adoption, and (*b*) the nature of any differences in accounting principles or financial statement presentation applicable to the financial statements presented that resulted from adoption of this SOP. Disclosure of the pro forma effects of retrospective application (or, prior to the adoption of FASB Statement No. 154, retroactive application as discussed in paragraph 21 of Accounting Principles Board Opinion [APB] No. 20, *Accounting Changes*) or the pro forma effect on the year of adoption is not required.

The provisions of this Statement need not be applied to immaterial items.

[7] If the replaced contract was acquired in a purchase business combination, any present value of future profits established in accordance with Emerging Issues Task Force (EITF) Issue No. 92-9, "Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company," should be accounted for in a similar manner.

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Appendix A

Background and Basis for Conclusions

A-1. This section discusses considerations that were deemed significant by the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position (SOP). In March 2003, AcSEC issued for public comment an exposure draft of a proposed SOP, *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Specifically Described in FASB Statement No. 97*. During the 60-day comment period, AcSEC received 10 comment letters. In November 2004, after further deliberation and revisions to certain significant conclusions proposed in the March 2003 exposure draft, AcSEC issued for public comment a second exposure draft of a proposed SOP, *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements*. During the 40-day comment period, AcSEC received 10 comment letters.

Background

A-2. In 1999, the Insurance Companies Committee of the American Institute of Certified Public Accountants (AICPA) issued a discussion paper, *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Covered by FASB Statement No. 97*, for informal public comment. Eleven comment letters were received with differing responses to the accounting alternatives presented.

A-3. The discussion paper included three alternative accounting views to be considered:

a. The accounting guidance provided in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, for internal replacements of traditional life products with universal life-type products should be extended by analogy to all types of internal replacement transactions.

b. Internal replacement transactions represent a continuation of a contractual relationship and, therefore, the unamortized deferred acquisition costs relating to the original contract and any new deferred acquisition costs should be capitalized and amortized over the life of the new contract assuming appropriate recoverability tests are met.

c. Internal replacements of one insurance or investment contract with another insurance or investment contract with substantially different terms should be accounted for similar to an extinguishment of debt.

Basis for Conclusions

Internal Replacements

A-4. AcSEC concluded that, for purposes of this SOP, an *internal replacement* is defined as a modification in product benefits, features, rights, or coverages that occurs by the legal extinguishment of one contract and the issuance of another contract (a contract exchange) or by amendment, endorsement, or by rider to a contract, or the election of a benefit, feature, right, or coverage within the contract. Modifications to contract terms can be achieved through a variety of different legal structures and the form of the modification may be a result of company preference and convenience or regulatory constraints. AcSEC believes that, in concept, the legal form of a modification should not determine the accounting applicable to the transaction and the accounting should be based on the substance of the transaction, regardless of whether it takes the form of an amendment, endorsement, or rider to the contract or the issuance of a new contract in a contract exchange.

A-5. Many respondents to the March 2003 and November 2004 exposure drafts expressed the view that the proposed definition of internal replacements was overly broad. Those respondents believe that the exercise of features or riders contained in the existing contract should not result in a requirement to evaluate the contract under the provisions of this SOP. Many long-duration contracts, particularly those accounted for under FASB Statement No. 97, contain features that are flexible and discretionary and, in general, current practice does not view the utilization of those elections by the contract holder as an internal replacement. AcSEC was concerned that, given the flexibility of many insurance contract designs, benefit, coverage, and feature elections could be designed such that the execution of these elections could substantially change the replaced contract. AcSEC reaffirmed that the form of the transaction should not determine the accounting.

A-6. After review of the comments received and further discussion, AcSEC concluded that the election of a benefit, feature, right, or coverage, made in accordance with terms (including price) established in the original contract, for which the insurance enterprise is required to provide the benefit or coverage and it is not subject to underwriting, does not represent a new negotiation between the contract holder and the insurance enterprise if the existence of the feature was accounted for at the inception of the contract. AcSEC concluded that, in these circumstances, the insurance enterprise has essentially written an option providing for the feature, coverage, or rider election. This written option should be evaluated at contract inception as a possible derivative requiring recognition under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended,[1] or if not a derivative under FASB Statement No. 133, for accounting recognition under other applicable literature, for example, as an annuitization guarantee under SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts* [section 10,870]. For instance, if the contract holder can elect to add a guaranteed minimum withdrawal benefit (GMWB) rider, the terms and the charges for which are fixed in the original contract, the option to add the GMWB may constitute an embedded derivative requiring bifurcation under FASB Statement No. 133. The written option also may have implications for contract classification, for example, the right to subsequently elect to add to an annuity contract a minimum guaranteed death benefit (MGDB) rider, with terms that are fixed in the original contract, may result in the contract being classified as an insurance contract from inception of the contract. If the existence of the feature is assessed in the contract classification at contract inception, election of the feature at a later time generally would not be expected to result in a change in the accounting model applicable to the contract. Several respondents to the November 2004

[1] Election by an insurance enterprise of the "grandfathering" provision of FASB Statement No. 133 for embedded derivatives is considered to have satisfied the requirement in paragraph .09*d* of this SOP to account for the option from the inception of the contract.

exposure draft commented that paragraph 9(b) was not a criterion but rather the accounting implication of the other criteria of paragraph 9. After discussion of these comments, AcSEC concluded it was appropriate to retain the guidance in paragraph 9(b) of the exposure draft (paragraph .09*d* of this SOP). AcSEC noted that paragraph 7 of FASB Statement No. 97 supports the conclusion that the annuitization phase of a contract is separate and distinct from and cannot be accounted for as a continuation of the accumulation phase of the contract, and that the establishment of a liability for an annuitization guarantee does not change that conclusion.

A-7. AcSEC also noted that the contractual elections not subject to the guidance of this SOP are only those explicitly stated in the original contract, with terms that are fixed and determinable and specific enough that the contract holder is able to evaluate whether to elect the feature in current and future market conditions. Certain terms of the contract may be specified as a range, however, such a range should be narrow enough to provide a meaningful guarantee to the contract holder. Contractual provisions that allow the contract holder to elect to add future coverage at then-current rates, subject to a stated minimum and maximum, generally are not specific enough to satisfy this requirement unless the range between the current rates at contract inception and maximum is narrow.

A-8. At times, insurance enterprises will amend contracts by making available additional features to a group or series of contracts through unilateral endorsements. One type of endorsement represents an offer to add additional features. This is not considered a contract modification, and does not require evaluation under the guidance in this SOP, at the point of availability, if it requires the acceptance of the offer and benefit by the contract holder. In this situation, it is the election of the offered benefit feature or coverage by the contract holder that would constitute acceptance of the offer and trigger a contract modification that would require evaluation under the guidance in this SOP. If the insurance enterprise can legally withdraw a contract feature that has not yet been elected by the contract holder, the feature represents an offer. Election of such feature by the contract holder is considered an internal replacement and would require evaluation under the guidance of this SOP. Withdrawal of such a feature by the insurance enterprise prior to acceptance by the contract holder is not considered a contract modification as it represents the withdrawal of an offer, and does not require evaluation under the guidance of this SOP. Another type of endorsement adds a benefit feature or coverage that is effective without contract holder election. This contract modification should be evaluated under the guidance of this SOP at the date of endorsement because the benefits or coverages provided by the contract have changed.

A-9. Also in response to comments received on the March 2003 exposure draft, AcSEC acknowledged the potential administrative complexities involved with the additional tracking required for all contract modifications and, to alleviate some potential system modifications, agreed that insurance enterprises should classify contract modifications as integrated contract modifications or nonintegrated contract modifications.

Integrated and Nonintegrated Contract Features

A-10. AcSEC understands that it is common industry practice for insurance enterprises to account for nonintegrated riders, benefit features, endorsements, and coverages as separate contracts apart from the existing contract within their administrative systems. AcSEC concluded that it is appropriate for insurance enterprises to account for nonintegrated riders, benefit features, endorsements, and coverages as separate contracts as these features are not related or involved with the existing base contract. AcSEC believes that this change from the March 2003 exposure draft to allow insurance enterprises to continue to account for nonintegrated riders and benefit features as separate contracts and to evaluate modifications to nonintegrated benefit features on a stand-alone basis should alleviate some of the potential system modifications that some companies believed may otherwise have been necessary.

A-11. Internal replacements may involve contract features, benefits, or coverages that are either integrated or nonintegrated with the base contract. Several respondents to the November 2004 exposure draft indicated that the definitions of integrated and nonintegrated contract features were unclear, especially with regards to application to short-duration contracts. In response to these comments, AcSEC redeliberated and concluded that it would be clearer to describe the criteria for determining whether a contract feature should be considered integrated or nonintegrated separately for long-duration and short-duration contracts as a result of the inherent differences in the types of products.

A-12. For long-duration contracts, AcSEC concluded that a contract feature is considered integrated if the determination of the benefit resulting from the feature can only be made in conjunction with the account value or other contract holder balances related to the base or replacement contract. Examples of integrated contract features for long-duration contracts include minimum guaranteed death benefits (MGDBs), guaranteed minimum accumulation benefits (GMABs), and guaranteed minimum income benefits (GMIBs); in all cases for these features, the benefit provided cannot be determined independently of the annuity contracts. For short-duration contracts, integrated contract features are those in which there is explicit or implicit reunderwriting or repricing of other components of the base or replaced contract. An example of an integrated contract feature for a short-duration contract is an experience refund provision in a worker's compensation insurance contract.

A-13. AcSEC also concluded that nonintegrated contract features for long-duration contracts are those for which the determination of benefits provided by the feature is not related or dependent on the account value or other contract holder balances of the base contract. Underwriting and pricing for nonintegrated contract features typically are executed separately from other components of the contract and it is inherent in this concept that the premium charged is not in excess of an amount that is commensurate with the incremental insurance coverage provided. For short-duration contracts, nonintegrated contract features are those that provide coverage that is underwritten and priced only for that incremental insurance coverage, such that the additional premium charged for that incremental insurance coverage is not in excess of an amount that is commensurate with the incremental insurance coverage provided and does not result in the explicit or implicit reunderwriting or repricing of other components of the contract. AcSEC concluded that for short-duration contracts, additional coverage provided by a nonintegrated contract feature would be considered nonintegrated even though the entire coverage provided by the short-duration contract may be subject to only one deductible in the event of an insured loss. Examples of nonintegrated contract features include a long-term care (LTC) rider added to an annuity or disability contract, a term life rider added to an annuity contract, paid up additions to a life insurance contract, a newly acquired automobile added to an existing personal automobile contract, and a personal articles floater added to a homeowner's contract. In these examples, the benefit provided can be determined independently of the base contract. AcSEC noted that many of the common modifications to property and casualty contracts, as described in Appendix B [paragraph .34], "Application of Statement of Position Product and Product Feature Examples," of this SOP, involve nonintegrated contract features.

A-14. AcSEC also noted that some contract features can be either integrated or nonintegrated depending on the contract terms. One example of this concept is a waiver of premium benefit, which provides that a contract holder who is disabled retains coverage under the contract without having to pay premiums or cost of insurance charges, depending on the contract. A waiver of premium feature that provides for the waiver of a contractually specified premium amount would be considered a nonintegrated contract feature as the determination of the amount to be waived was set at contract inception and is not related to current contract account balances. However, a waiver of premium feature that waives the cost of insurance charges is a function of the contract account value at the time the benefit is utilized, and would be considered an integrated contract feature.

A-15. AcSEC concluded that the addition or election of nonintegrated contract features is in substance equivalent to the issuance of an additional contract, as the new contract features are not interrelated with or dependent on the balances of the replaced contract. AcSEC concluded that for a contract modification involving several added or elected contract features or coverages, the insurance enterprise should separately evaluate whether the individual contract features or coverages are integrated or nonintegrated with the base contract. AcSEC also concluded that in a contract exchange that involves a replaced or replacement contract with a nonintegrated contract feature, the contract and the nonintegrated feature should be accounted for as separate contracts under the guidance in paragraph .13 of this SOP, and the insurance enterprise should review the guidance in paragraphs .09 through .15 of this SOP separately for modifications to the base contract and modifications to the nonintegrated feature to determine the appropriate accounting.

Applicability of Guidance

A-16. Some respondents to the March 2003 exposure draft questioned if the guidance in this SOP applies to the present value of future profits (PVP), a contract-related intangible asset recognized in a purchase business combination. AcSEC noted that issues related to purchase accounting are not within the scope of this SOP. Emerging Issues Task Force (EITF) Issue No. 92-9, "Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company", notes that PVP is similar in nature to deferred acquisition costs and is amortized and evaluated for impairment in the same manner as deferred acquisition costs. AcSEC concluded that for an internal replacement transaction that involves a contract for which there is a contract-related intangible asset accounted for under EITF Issue No. 92-9, the guidance in this SOP would be applicable to determine whether the contract was a continuation and the accounting implication of that determination. A respondent to the November 2004 exposure draft requested that the SOP specifically address the accounting implications when the contract is substantially changed and the Value of Business Acquired (VOBA) is viewed as part of the contract holder liability. AcSEC noted that paragraphs .16 and .25 of this SOP provide guidance on accounting for other balances associated with the replaced contract.

A-17. Some respondents to the March 2003 exposure draft also questioned whether this SOP should be applied to reinsurance contracts. AcSEC concluded that the reinsurer has a contract with the ceding company, and that is the contract that the reinsurer should evaluate for modifications. AcSEC also concluded that while the criteria in this SOP may not be directly applicable to reinsurance contracts, based on the specific facts and circumstances of a transaction, the concepts are useful in evaluating the implications on deferred acquisition costs of modifications to reinsurance contracts or the underlying reinsured contracts. AcSEC noted that other relevant accounting guidance, for instance FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, governs the determination of the implications of modifications to insurance and reinsurance contracts on risk transfer assessment and the classification of short-duration contracts as either retroactive or prospective.

A-18. Some respondents to the March 2003 and November 2004 exposure drafts commented as to whether the concepts in this SOP are applicable to internal replacements occurring between affiliated companies and how the concepts should be applied. AcSEC observed that other existing accounting literature may be applicable in accounting at the individual company level; for instance, whether the internal replacement is a transaction in the normal course of business or a transfer under common control. For purposes of consolidated financial statements, the guidance of this SOP should be applied at the consolidated level. AcSEC also noted that there may be circumstances under which the accounting at the individual company level may be different than at the consolidated level. That is, an internal replacement occurring between affiliated companies may result in an extinguishment of a contract at the subsidiary level being reported in the separate company financial statements of that subsidiary but, on a consolidated basis, the replacement meets the conditions to be accounted for as a continuation of the replaced contract.

Substantial Changes

A-19. In general, life insurance and annuity products are financial instruments. The insurance enterprise has a contractual obligation to deliver cash, and the customer has a contractual right to receive cash. Paragraph 15 of FASB Statement No. 97 requires that investment contracts issued by an insurance enterprise be accounted for in a manner consistent with the accounting for interest-bearing instruments. Paragraph 72 of FASB Statement No. 97 refers to APB Opinion No. 26, *Early Extinguishment of Debt*, as amended by FASB Statement No. 76, *Extinguishment of Debt*, and as subsequently amended by FASB Statements No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, as the governing literature, which requires the write-off of unamortized costs associated with extinguished debt if the extinguished debt is replaced by a new liability to the same party. EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," interpreted the guidance in FASB Statement No. 125 and concluded that certain debt exchanges do not represent substantive modifications to existing debt, resulting in the deferral of both unamortized amounts related to the old debt and new fees related to the new debt, amortization of those deferred amounts over the life of the new debt, and the expensing of costs incurred with third parties. FASB Statement No. 125 was superseded by FASB Statement No. 140, but the guidance in FASB Statement No. 125 that was interpreted by EITF Issue No. 96-19 was carried forward to FASB Statement No. 140 without reconsideration.

A-20. AcSEC believes instruments issued by financial institutions should be accounted for consistently, as noted in FASB Statement No. 97, paragraph 39:

While many investment contracts are issued primarily by insurance enterprises, the Board believes that similar financial instruments should be accorded similar treatment regardless of the nature of the issuing enterprise.

A-21. In EITF Issue No. 96-19, the EITF reached a consensus that an exchange of debt instruments with substantially different terms should be accounted for and reported in the same manner as an extinguishment. The EITF observed that a debtor could achieve the same economic effect by making a substantial modification of the terms of an existing debt instrument. Accordingly, the EITF reached a consensus that a substantive modification of terms should be accounted for and reported in the same manner as an extinguishment. Substantive modifications of debt terms materially affect the present value of future cash flows on the debt, necessitating the abandonment of the existing amortization with "fresh-start" measurements.

A-22. EITF Issue No. 96-19 provided quantitative guidance and noted that debt instruments are substantially different if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument. AcSEC considered a 10-percent test similar to that adopted by the EITF. AcSEC ultimately concluded that such analysis would not be reliable in reaching a conclusion concerning contract similarity because of the potential subjectivity of assumptions and complex nature of many insurance and investment contracts. Rather, AcSEC adopted a qualitative analysis to be used in determining whether the replacement or modification of an insurance or investment contract results in the contract being considered substantially unchanged. AcSEC believes that the use of a qualitative analysis will result in an improvement in practice by providing a framework to evaluate internal replacements. AcSEC believes that framework will significantly narrow the circumstances that will result in costs associated with the replaced contract continuing to be deferred with the replacement contract.

A-23. A number of respondents to the March 2003 exposure draft expressed a view that the proposed guidance was inconsistent with EITF Issue No. 96-19, and should be revised to eliminate qualitative criteria and to include similar quantitative analysis. AcSEC reaffirmed its belief that applying solely quantitative analysis to the internal replacement of an insurance or investment contract to determine whether the contract was substantially unchanged is not appropriate. Instead, AcSEC decided to strengthen the qualitative conditions included in the framework, which also contain quantitative components. The format used in the SOP of the conditions, to determine whether an internal replacement involves contracts that are substantially unchanged, was revised from the March 2003 exposure draft, as some of the factors had been combined together in the concept of "inherent nature" in the March 2003 exposure draft. The condition in paragraph .15*a*, change in the insured event, is essentially the same concept included in the discussion of inherent nature in the March 2003 exposure draft. In an effort to make the guidance in the SOP simpler to apply, AcSEC revised how insurance enterprises determine whether an internal replacement involves contracts that are substantially changed or unchanged, but kept the same basic concepts. The concept of primary benefits that existed in the March 2003 exposure draft was replaced with the concepts of integrated and nonintegrated benefit features.

Conditions for Determining Whether a Contract Is Substantially Unchanged

A-24. AcSEC concluded that changes to certain contract features are always indicative of substantial changes to the substance of the replaced contract, and that it would be appropriate to conclude that these types of changes would always result in a substantially changed contract for financial reporting purposes. Therefore, AcSEC concluded that the determination of whether a contract has changed substantially should be based on a qualitative evaluation of the existence of certain key components in the internal replacement transaction.

A-25. AcSEC also concluded that certain changes would always result in an internal replacement with a substantially unchanged replacement contract if evaluated under the conditions of paragraph .15 of this SOP. Examples of these types of changes would include:

a. Changes in the allocation of the contract holder's account balance among investment alternatives provided for in the contract, even if reallocated 100 percent to a specific investment alternative

b. Additional investment allocation alternatives added to a contract with multiple investment alternatives

AcSEC observed that changes in the cost of insurance charges, interest-crediting rates, or similar provisions within ranges outlined in the contract, without any other change in benefits or coverages, are not modifications to the contract and are not internal replacements. AcSEC also observed that partial withdrawals or surrenders or reductions in coverage (for example, reduced face amount on a life insurance contract or higher deductibles on a property casualty contract), as allowed by the terms of the contract, whether or not surrender charges or termination fees are assessed, are not internal replacements subject to the guidance of this SOP as long as there are no other modifications to the contract, at that time, that would require evaluation under paragraph .15 of this SOP. Under certain contracts, for example, employee group health contracts and worker's compensation contracts, the insured population is regularly adjusted as employees are hired and terminated. These changes and the associated charges are made in accordance with terms specified in the contract and are not internal replacements for purposes of this guidance. Another example of a similar insurance contract in which the insured population typically is adjusted in accordance with contractual terms, is a commercial automobile contract providing coverage for a fleet of cars.

A-26. Some respondents to the March 2003 exposure draft expressed a view that the fundamental nature of the transaction and the economics of the transaction should also be reviewed to determine the appropriate accounting. In their view, criteria should include:

a. Is the transaction fundamentally the surrender of the replaced contract and a new issue or is it a modification to an existing coverage?

b. Is the transaction expected to preserve or improve the insurer's future margins associated with the contract?

AcSEC reaffirmed that the scope of this SOP includes modifications to contracts, not just contract exchanges, and, therefore, concluded that the first question was not a defining criterion. AcSEC did, however, acknowledge that, for many companies, permitting different approaches to modifications and contract exchanges could mitigate administrative complexity and related costs. As for the second suggested criterion, AcSEC reaffirmed its conclusion that it is the substance of the contract between the insurance enterprise and the contract holder that is to be evaluated and not just the economics to the insurance enterprise that is critical to determining whether an internal replacement results in a substantially changed contract.

Mortality, Morbidity, or Other Insurance Risk

A-27. AcSEC concluded that significant changes in the kind or degree of mortality, morbidity, or other insurance risks would result in a replacement contract that is substantially changed from the replaced contract, as these risks are defining components of the substance and classification of a contract. An example of a significant change in the degree of mortality risk would be an internal replacement of a variable annuity with a minimal death benefit to a variable annuity with a "rich" death benefit, which would result in a replacement contract that is substantially changed from the replaced contract. AcSEC concluded that an exchange of a contract with one type of death benefit for a contract with another type of death benefit requires review of the terms to determine whether the degree of mortality is similar. An example of an insignificant change in the degree of mortality risk would be an internal replacement of a variable annuity with a **roll-up death benefit** to a variable annuity with a **ratchet death benefit** of similar relative expected cost, which would not result in a substantial change to the mortality benefit, as both variable annuities contained significant and similar levels of mortality risk related to premature death. An example of a significant change in the type of mortality risk would be an exchange of a life insurance contract for a solely life-contingent payout annuity. AcSEC noted that, in determining whether a change in the degree and kind of risks of a contract is significant, the focus should be on the substance of the risks of the contract, and not the form of the contract. Factors to consider in determining whether there are significant changes in insurance risks may include changes in actuarially estimated costs for that benefit feature or the SOP 03-1 [section 10,870] benefit ratio related to that benefit feature. Reunderwriting the entire contract generally would indicate a substantial change resulting from a change in the kind or degree of mortality, morbidity, or other insurance risk.

A-28. Some respondents to the March 2003 exposure draft questioned whether the guidance in this SOP is applicable to short-duration contracts. AcSEC noted that the guidance in this SOP applies to all entities to which FASB Statement No. 60 applies, which includes both short-duration and long-duration contracts, but believed that it would be beneficial to solicit additional comments from preparers and auditors in the November 2004 exposure draft as to whether the guidance is clear and operational for short-duration contracts. Some respondents to the November 2004 exposure draft commented that it was unclear how to apply the definition of nonintegrated and integrated contract features to short-duration contracts. AcSEC concluded that it would be clearer to discuss the definitions of nonintegrated and integrated contract features separately for short-duration and long-duration contracts as a result of inherent differences in the products.

A-29. Some respondents to the March 2003 exposure draft also questioned whether the guidance in this SOP is applicable to group life insurance. AcSEC noted that evaluation of all the related facts and circumstances of a group contract is required to determine whether a contract should be analyzed at the group contract level or individual certificate (under the group contract) level for purposes of applying the guidance in this SOP. AcSEC again stated that the form of the transaction should not determine the accounting. For example, a traditional group life contract that covers all full-time employees at a base amount (for example, coverage at a fixed amount per life or at one-times-salary) with no underwriting required, should be viewed at the aggregate group contract level when applying the guidance in this SOP, as the individuals covered are not significant in determining the insured event. In contrast, a group key-man life insurance contract that covers a company's top management with individual underwriting for each employee covered should be viewed at the individual certificate level when applying the guidance in this SOP, as each employee is separately underwritten and each life should be considered a separate contract for purposes of applying the guidance of this SOP.

Investment Reward Rights

A-30. In the March 2003 exposure draft, AcSEC concluded that the nature of investment reward rights was a significant component in the contractual relationship between the contract holder and the insurance enterprise. Therefore, for contracts that pass through the performance of a pool of assets (for example, variable contracts), the existence of a minimum return guarantee, such as a GMAB, did not change the nature of the investment reward rights (pass through of actual investment performance of the referenced assets); instead, such minimum return guarantees on those contracts were viewed as being in the nature of a separate "put" that operated independent of the "basic" investment reward provisions of the contract. Some respondents to the March 2003 exposure draft commented that changes in the nature of the investment return rights and provisions (for example, changing from a contract with a fixed crediting rate to a crediting rate based on the performance of a specified pool of assets) should not drive the release of deferred acquisition costs, particularly if that change does not materially affect future expected contract margins in reasonably possible scenarios. Other respondents commented that they did not believe that the proposed guidance was operational, as preparers could reach different conclusions. After a review of comments received and further discussion, AcSEC concluded that a change in the nature of the investment return rights (for example, between discretionary and formulaic or pass-through) is always significant, and changes in minimum guarantees for contracts subject to periodic discretionary declaration may be significant, depending on facts and circumstances. AcSEC also concluded that for pass-through contracts, the adding of a floor or a capping of the returns, such that actual returns (net of fees and charges) are not passed through to the policyholder, fundamentally changes the nature of the investment return rights and therefore is a significant change in the contract.

Additional Deposit, Premium, or Charge

A-31. AcSEC believes that the requirement of an additional deposit, premium, or charge relating to the benefit or coverage provided under the replaced contract, in excess of amounts contemplated in the replaced contract, whether explicit or implicit, indicates that the replacement contract is not a continuation of the replaced contract because of the change of the underlying economics of the replaced contract as a result of the internal replacement. For example, an increase in premiums in excess of the amount that is commensurate with an increase in the contractual benefits or coverages is an implicit additional premium for the original benefit or coverage.

Net Decrease in Balance Available to the Contract Holder

A-32. AcSEC concluded that a net decrease to the balance available to the contract holder would effectively be a surrender charge and, therefore, would be indicative of a change in the substance of the contract between the contract holder and the insurance enterprise, rather than the continuation of the replaced contract. In certain situations, an insurance enterprise may assess a surrender charge on the replaced contract that is offset by an immediate sales inducement on the replacement contract that is equal to or greater than the surrender charge. In these situations, the insurance enterprise should offset any immediate sales inducements against any surrender charges assessed against the contract holder's account balance under the replaced contract to determine whether there has been a net reduction in the contract holder's account balance. If the surrender charge is greater than the immediate sales inducement, the condition in paragraph .15*d* of this SOP would not be met and the internal replacement would result in substantially changed contracts. For example, if the account balance of a FASB Statement No. 97 universal life contract prior to surrender charges is $100 and a $5 surrender charge is imposed, the resulting $95 credited to the replacement contract (prior to the consideration of any new surrender charges) results in a substantial change to the contract. However, if an immediate bonus of $5 or more was credited to the replacement contract as well, there would be no net decrease to the balance available to the contract holder and the internal replacement results in a contract that is substantially unchanged, provided the other conditions of paragraph .15 are satisfied.

Change in Participation or Dividend Features

A-33. AcSEC concluded that a change in the participation, including experience refund, or dividend features of a contract indicates a substantial change to the replaced contract. For example, the addition of an experience refund rider to a LTC contract is an integrated benefit and results in a substantially changed contract. AcSEC also noted that the substance of the contract, not just its legal classification, must also be evaluated.

Change in Amortization Method or Revenue Classification

A-34. AcSEC also concluded that a modification resulting in a change to the amortization method or revenue classification of the contract indicates a substantive change in the contract because a change in amortization method or revenue classification means that the contracts should be accounted for under different accounting models. Multiple accounting models exist to address the different kinds of products issued by insurance enterprises. Because "insurance-specific" accounting models are prescriptive, not elective, the use of a different accounting model implies a substantially different kind of contract. An analogy can be made to FASB Statement No. 13, *Accounting for Leases*. Paragraph 9 of FASB Statement No. 13 requires a lease agreement, whose terms have been modified, to be accounted for as a new agreement if the original classification of the lease would have been different under the modification. For example, a modification that results in either a change from amortization of deferred acquisition costs in proportion to premium revenue to amortization based on the emergence of estimated gross profits or a change in revenue classification from reporting premium as revenue to reporting deposits results in contracts that are substantially changed.

Accounting for Contracts That Are Substantially Unchanged

A-35. Paragraph 15 of FASB Statement No. 97 requires that investment contracts issued by insurance enterprises be accounted for in a manner consistent with interest-bearing instruments. EITF Issue No. 96-19 interpreted the guidance in FASB Statement No. 125, as amended by FASB Statement No. 140, to conclude that certain debt exchanges do not represent substantive modifications to existing debt. The EITF explicitly acknowledged that an exchange or modification in terms that is not substantially different does not result in an extinguishment.

A-36. AcSEC concluded that an internal replacement that is determined to result in a replacement contract that is substantially unchanged from the replaced contract should be accounted for as a continuation of the replaced contract. As such, the unamortized deferred acquisition costs, unearned revenue liabilities, and deferred sales inducement assets associated with the replaced contract should continue to be deferred. Other balances associated with the replaced contract, such as any liability for MGDBs, or GMIBs, should be handled in a similar manner, that is, as if the replacement contract is a continuation of the replaced contract.

Accounting for FASB Statements No. 91, No. 97, and No. 120 Contracts

A-37. FASB Statements No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*; No. 97; and No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, specify the treatment of revisions to the estimated cash flows and estimated gross profits of contracts accounted for under these Statements. AcSEC concluded that it would be appropriate to follow the existing authoritative accounting guidance that specifies the treatment of revisions to the estimated cash flows and estimated gross profits.

A-38. A number of respondents to the March 2003 exposure draft commented that the proposed guidance for accounting for FASB Statements No. 97 and No. 120 contracts involved in an internal replacement that is determined to result in a replacement contract that is substantially unchanged from the replaced contract, would create significant implementation and administration difficulties, as most companies would require substantial administrative system modifications to comply. In response to these concerns, AcSEC concluded that if the accounting approach described in paragraph .17 of this SOP (account for the replacement contract as a continuation of the replaced contract through revisions to future estimated gross profits) is not reasonably practicable for a contract exchange, an insurance enterprise may determine an appropriate balance of unamortized deferred acquisition costs related to the replaced contract to carry forward to the replacement contract to be treated as day-one deferrable acquisition costs and amortized prospectively using estimated gross profits only of the replacement contract. Other contract-related balances that are determined based on activity over the life of the contract, such as a liability for MGDBs and deferred sales inducement assets, would be handled in a similar manner. AcSEC did note that it is expected that future administrative systems would be structured to capture the required information and accommodate the approach described in paragraph .17 of this SOP.

Accounting for FASB Statement No. 60 Long-Duration Contracts

A-39. For long-duration contracts accounted for under FASB Statement No. 60, the continuation of the contract after an internal replacement transaction is not unlike a prospective adjustment of premiums on indeterminate premium life insurance. Although not specifically addressed in existing authoritative accounting literature, actuarial literature and practice have emerged to address that situation. Actuarial Standard of Practice No. 10 *Methods and Assumptions for Use in Life Insurance Company Financial Statements Prepared* *in Accordance with GAAP*, addresses the accounting for indeterminate premium policies as follows:

> *Indeterminate Premium Policies.* Provided the policy is not, in substance, a [universal life]-type policy, [FASB Statement] No. 60 is applicable to indeterminate premium policies. The premium flexibility associated with these policies may affect the application of [FASB Statement] No. 60, such as the use of a smaller provision for the risk of adverse deviation. The ability and willingness of the insurer to change premiums may be anticipated in performing loss recognition. Assumptions may be "unlocked" at gross premium change dates. If assumptions are adjusted, it should be done prospectively, without a change in the liability as of the valuation date.

In such cases, deferred acquisition costs factors also are adjusted prospectively, and there is no discontinuity in the balance of unamortized deferred acquisition costs. Such a prospective revision in this and similar situations involving guaranteed renewable health insurance products, on which premiums may be adjusted prospectively, does not violate the FASB Statement No. 60 "lock-in" concept.

Sales Inducements to Contract Holders

A-40. In the March 2003 exposure draft, AcSEC concluded that sales inducements to contract holders offered in conjunction with an internal replacement of long-duration contracts, determined to result in a replacement contract that is substantially unchanged from the replaced contract and otherwise meeting the conditions of SOP 03-1 [section 10,870], should be accounted for as if the sales inducement had been present and explicitly identified at the inception of the original contract, with a cumulative adjustment recognized as amortization in the current period to reflect accumulated amortization since inception. Several respondents to the March 2003 exposure draft noted concerns with the proposed guidance for sales inducements and perceived inconsistencies with the sales inducement guidance in SOP 03-1 [section 10,870]. The respondents were concerned that sales inducements that did not meet the conditions included in SOP 03-1 [section 10,870], namely, explicit identification at the inception of the contract, could be added as a sales inducement and labeled an internal replacement to receive preferential accounting treatment. After review of the comments received and further discussion, AcSEC concluded that a sales inducement to a contract holder offered in conjunction with an internal replacement of a long-duration contract that is determined to result in a replacement contract that is substantially unchanged from the replaced contract should be accounted for from the date of its addition to the replacement contract under the guidance of SOP 03-1 [section 10,870], and should not be accounted for as if it had been present in the original contract at the inception of the contract.

Accounting for Contracts That Are Substantially Changed

A-41. AcSEC concluded that an internal replacement transaction that is determined to result in a replacement contract that is substantially changed from the replaced contract should be accounted for as the extinguishment of the replaced contract and the issuance of a new contract. This conclusion is consistent with the analogy to guidance in EITF Issue No. 96-19 and the guidance in FASB Statement No. 97 relative to the internal replacement of a traditional life insurance contract with a universal life-type contract. AcSEC also concluded there was no compelling reason to propose any modification to the accounting results that follow from the application of current accounting guidance applicable to the termination of the replaced contract and the issuance of a new contract.

Costs Related to Internal Replacements

A-42. AcSEC concluded that an internal replacement that is determined to result in a replacement contract that is substantially unchanged from the replaced contract is, in substance, a continuation of the replaced contract; and, in the March 2003 exposure draft, concluded that any costs should be evaluated for deferral under the provisions of FASB Statements No. 60 and No. 97 applicable for nonfirst-year or renewal acquisition costs. Accordingly, in the March 2003 exposure draft, AcSEC concluded that these costs should be capitalized to the extent that they meet the criteria for deferral as renewal acquisition costs under the provisions of FASB Statements No. 60 and No. 97, in accordance with what AcSEC believed to be industry practice.

A-43. Based on discussion with the FASB concerning the intention of the guidance in FASB Statements No. 60 and No. 97, AcSEC concluded that since the contract was determined to be unchanged, the purpose of the related costs would be more in the nature of contract maintenance than acquisition and should be accounted for as policy maintenance costs and charged to expense as incurred. It was also noted that one comment letter specifically made the point that it was inconsistent to analogize costs incurred in connection with an internal replacement that is in substance a continuation of the replaced contract with acquisition costs incurred in connection with contract renewals that are in substance new contracts. Some respondents to the November 2004 exposure draft questioned how renewal commissions on a replaced contract that is determined to be substantially unchanged should be accounted for in conjunction with the guidance of this SOP. AcSEC concluded that the portion of renewal commissions paid on the replacement contract that meets the criteria for deferral in accordance with the provisions of FASB Statements No. 60 and No. 97, as appropriate, limited to the amount of the future deferrable renewal commissions on the replaced contract that would have met the deferral criteria, continues to be deferrable under the provisions of FASB Statements No. 60 and No. 97.

Recoverability

A-44. AcSEC concluded there was no reason to modify the existing guidance contained in FASB Statement No. 60 as it relates to determining the recoverability of unamortized deferred acquisition costs and the present value of future profits. AcSEC did note that the separate contracts resulting from internal replacements with nonintegrated contract features should be examined independently for the recoverability of related unamortized deferred acquisition costs and the present value of future profits.

Disclosures

A-45. AcSEC concluded that existing disclosure requirements relative to the financial statement balances affected by internal replacements, such as deferred acquisition costs, unearned revenues, sales inducements, benefit liabilities, and account balances, provide adequate disclosure of information that is useful and informative to financial statement users.

Effective Date and Transition

A-46. Several respondents to the March 2003 exposure draft commented that the proposed effective date of January 1, 2004, was not reasonable. The majority of respondents to the November 2004 exposure draft also commented that the revised proposed effective date of January 1, 2006, was not reasonable given the combination of extensive time and systems modifications associated with implementation of this guidance and other guidance that insurance enterprises are currently adopting. AcSEC concluded that additional time should be allowed and, even though revisions to the proposed guidance should help alleviate some of the potential implementation issues, decided to require this SOP to be effective for internal replacements occurring in fiscal years beginning after December 15, 2006. AcSEC believed this effective date will provide insurance enterprises sufficient time to implement this SOP. AcSEC also concluded that it would allow companies the alternative of early adoption.

A-47. Upon the issuance of FASB Statement No. 154, *Accounting Changes and Error Corrections: a replacement of APB Opinion No. 20 and FASB Statement No. 3*, AcSEC evaluated the guidance in FASB Statement No. 154 and concluded that the SOP should be applied prospectively for internal replacements occurring after adoption. AcSEC concluded that it would be impracticable to apply the effects of the change in accounting principle resulting from the adoption of this SOP retrospectively because enterprises would not have accumulated the information at the level required by this new guidance to enable the companies to identify deferred acquisition costs specific to prior internal replacements.

A-48. As a result of adopting the guidance in this SOP, an insurance enterprise may need to revise lapse, surrender, or other assumptions used in the development of estimated gross profits, for previously anticipated future internal replacements. In some instances, these revisions will be necessary solely to reflect any impact of adopting the accounting guidance in this SOP. That is, the internal replacement was previously assumed to occur and the impact was already provided for in the estimated gross profits, however, the treatment of the internal replacement as either a termination or continuation of the existing contract will be different under the provisions of the SOP. Anticipated future internal replacements that, prior to the adoption of this SOP, would have been accounted for as continuations of the replaced contracts may be required to be accounted for as extinguishments of the replaced contracts, and internal replacements that, prior to the adoption of this SOP, would have been accounted for as extinguishments of the replaced contracts may be required to be accounted for as continuations of the replaced contracts. AcSEC concluded that adjustments to unamortized deferred acquisition costs, present value of future profits, unearned revenue liabilities, deferred sales inducements, and similar balances that are determined based on estimated gross profits that result from revising the lapse, surrender, or other assumptions for anticipated future internal replacements, solely as a result of changes in accounting policy to comply with this SOP and any related income tax effects, should be reported in a manner similar to a cumulative effect of a change in accounting principle with offsetting adjustments to the opening balance of retained earnings as of the date of adoption. Changes in assumptions used in determining prospective estimated gross profits that are related to changes in the estimate of the volume or trends in contract holder behavior are changes in accounting estimates and would not be included in the cumulative effect adjustment of a change in accounting principle. Changes in assumptions used in determining prospective estimated gross profits that cannot be substantiated as solely the result of a change in accounting policy due to adoption of this SOP should be reported as a change in accounting estimate.

A-49. AcSEC recognizes the benefits of comparable financial statements but believes that because insurance enterprises are unlikely to have accumulated the information at the level required by this new guidance to enable them to identify deferred acquisition costs specific to prior internal replacements, retrospective application of this SOP in the year of adoption is not permitted and pro forma disclosures in the year of adoption are not required.

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Appendix B

Application of Statement of Position Product and Product Feature Examples

The following are examples of contract modifications and the application of the guidance in this Statement of Position (SOP) for evaluating whether the internal replacements are substantially changed from the replaced contracts. The conclusions reached in the following examples are based on the specific facts and circumstances of the examples; the same conclusions may not be reached for other modifications because of differing facts or circumstances.

The following examples of contract modifications are included in this Appendix:

Increasing Death Benefit Coverage on a Life Contract

B-1. There are several ways in which a contract holder can increase death benefit coverage on a traditional whole life insurance contract.

Option to Purchase Additional Insurance Rider

B-2. An option to purchase additional insurance (OPA) rider gives the contract holder the right to purchase additional insurance coverage with no additional underwriting. That is, the contract holder can increase the face value of the policy for the same type of insurance coverage and in the same form as that provided by the original contract. The additional premium charged is not in excess of an amount that would be commensurate with the additional insurance coverage obtained. The rider could be included in the original contract or added subsequently to its issuance.

B-3. This is an example of a nonintegrated contract feature. Once purchased, the benefit under the OPA rider generally is accounted for as a separate contract.

Issuance of a Second Life Insurance Policy for an Incremental Face Amount

B-4. The contract holder obtains a second life insurance policy for an incremental face amount, with underwriting required on the new policy only. The original contract remains in force without change.

B-5. This transaction does not fall within the definition of an internal replacement in paragraph .08 of this SOP. The accounting for the original contract remains unchanged and the new contract is accounted for independently of the original contract. Any deferrable acquisition costs associated with the new contract are deferred and amortized according to the revenue or margin stream of the new contract, as applicable.

Contract Modification to Increase the Face Amount of a Traditional Life Insurance Contract

B-6. The increased face amount (death benefit) of a traditional life insurance contract effectuated through an amendment or rider to the original contract is considered a nonintegrated feature that should be accounted for separately from the existing life insurance contract, provided that the additional premium charged for that incremental insurance coverage is not in excess of an amount that is commensurate with the incremental insurance coverage and does not result in the explicit or implicit reunderwriting or repricing of other components of the contract.

Increase in Face Amount of Universal Life-Type Contract

B-7. As noted in FASB Statement No. 97, universal life-type contracts are long-duration contracts, that can provide either death or annuity benefits and are characterized by one of the following features:

a. One or more of the amounts assessed by the insurer against the policyholder are not fixed and guaranteed by the terms of the contract.

b. Amounts that accrue to the benefit of the policyholder are not fixed and guaranteed by the terms of the contract.

c. Premiums may be varied by the policyholder within contract limits without the consent of the insurer.

B-8. The increase in face amount of a universal life-type contract through an amendment to the original contract is considered an integrated feature as the death benefit under a universal life-type contract is equal to the excess of face amount over contract account value. In this example, only the additional face amount has been underwritten during the contract amendment and the additional premium charged is not in excess of an amount that would be commensurate with the additional insurance coverage obtained. This contract amendment to increase the face amount of a universal life-type contract results in the replacement contract being substantially unchanged from the replaced contract due to the following:

a. The modification does not result in a change in the insured event, as there is no significant change in the kind and degree of mortality risk. Although the face amount of the contract has increased, it is appropriate in this example to analyze the change in degree of mortality risk by comparing the relationship of the expected cost of the benefit to charges assessed for that benefit, and there was no significant change in this relationship.

b. There is no change in the nature of the investment return rights from the replaced contract.

c. There are no changes in the charges related to the original benefits; also, the additional cost of insurance is not in excess of an amount commensurate with the additional insurance coverage obtained.

d. There is no net decrease in the balance available to the contract holder, except to pay the cost of insurance charge for the increased coverage.

e. There is no change in the participation or dividend feature of the replaced contract.

f. The modification does not result in a change to either the amortization method or revenue classification of the contract.

Universal Life-Type Contract to Universal Life-Type Contract With a No-Lapse Guarantee

B-9. A universal-life type contract may contain a no-lapse guarantee feature that provides for continuing coverage of the contract even if the account value drops to a level that cannot cover the contract charges. The contract exchange of a universal life-type contract for a universal life-type contract that contains a no-lapse guarantee results in the replacement contract being substantially changed from the replaced contract because the addition of the no-lapse guarantee changes both the period of coverage of the contract as well as introducing a combination of mortality and investment risk. The analysis would be the same if the change had been achieved through the addition of a no-lapse guarantee rider, as it would be considered an integrated benefit (the benefit is a function of the contract account value) and would need to meet the conditions in paragraph .15 if this SOP. If, however, the contract holder had elected to add a no-lapse guarantee feature that was included in the original contract (and met the specifications in paragraph .09 of this SOP), the modification would not be considered an internal replacement subject to the guidance of this SOP.

Universal Life-Type Contract to Universal Life-Type Contract With a Second-to-Die Feature

B-10. A second-to-die feature incorporates multiple mortality events within a single contract, as payment to the beneficiary is made, assuming the contract remains in force, only after both insured individuals die. The contract exchange of a universal life-type contract for a universal life-type contract that contains a second-to-die provision results in the replacement contract being substantially changed from the replaced contract because the addition of the second-to-die feature changes the insured event, as now two mortality events must occur for the beneficiary to obtain the proceeds. If the modification were achieved through amendment, endorsement, or rider rather than through a contract exchange, the analysis and conclusion would be the same as for the contract exchange because the second-to-die provision is an integrated feature.

Addition of a New Car to an Automobile Contract

B-11. An automobile insurance contract is a short-duration contract that generally provides coverage for personal injury and automobile damage sustained by the insured and liability to third parties for losses caused by the insured. A newly purchased car being added to an existing automobile policy with no change in the other vehicles covered or the premium related to the other vehicles under the contract results in additional nonintegrated contract coverage that should be accounted for separately from the existing automobile contract coverage, assuming the underwriting and price for coverage of the new car is determined separately and there is no change, explicit or implicit, in the pricing of the base contract.

Deletion of a Car From an Automobile Contract

B-12. If one of the existing automobiles under the contract described in paragraph B-11 of this SOP is removed from the automobile contract, it is considered the extinguishment of nonintegrated contract coverage and should be accounted for as an extinguishment of only the balances related to that nonintegrated coverage. The amount refunded to the contract holder from the change in the coverage is determined in accordance with terms that are fixed in the contract or applicable state law or regulation and no reunderwriting is required for other coverage. The amount refunded to the contract holder reduces the related unearned revenue liability and unamortized deferred acquisition costs related to the extinguished nonintegrated contract coverage is eliminated.

Change of Car in an Automobile Contract

B-13. Assume the automobile insurance contract described in paragraph B-11 of this SOP contains one car and one driver, the existing car is sold and replaced with another car, and coverage is changed through a contract endorsement. For accounting purposes, the original automobile contract is extinguished and coverage for a new automobile contract is established for the driver and the new car. The modification is not a reduction in coverage under paragraph .10 of this SOP, as it is a termination of all coverage in the contract, not a partial termination of coverage as described in paragraph .10. It is common practice to net settle the premium and commission adjustments resulting from this contract modification. For accounting purposes, there are in substance two transactions: the extinguishment of one contract, which is accounted for as a contract extinguishment under paragraph .25 of this SOP, and establishment of a new contract.

Addition of a New Driver to an Automobile Contract

B-14. The addition of a new driver to an existing automobile contract with no other changes in the contract results in additional nonintegrated contract coverage that should be accounted for separately from the existing automobile contract coverage, as the underwriting and price for coverage for the new driver is determined separately.

Deletion of a Driver From an Automobile Contract

B-15. If one of the existing drivers under the contract described in paragraph B-14 of this SOP is removed from the automobile contract, it is the extinguishment of nonintegrated contract coverage and should be accounted for as an extinguishment of only the balances related to that nonintegrated coverage. The amount refunded to the contract holder from the change in the coverage is determined in accordance with terms that are fixed in the contract or applicable state law or regulation and no reunderwriting is required for other coverage. The amount refunded to the contract holder reduces the related unearned revenue liability and the balance of the unamortized deferred acquisition costs related to the extinguished nonintegrated contract coverage is eliminated.

Change in Coverage of an Automobile Contract

B-16. An increase in the collision deductible of an automobile contract is, in effect, a reduction in the coverage provided. It is not an internal replacement, but a reduction in coverage under paragraph .10 of this SOP, providing that all the terms that determine the amount refunded from the change in coverage are fixed in the original contract or by applicable state law or regulation and no reunderwriting is required for the continuing coverage. Contractual provisions that allow the contract holder to elect to decrease existing coverage at then-current rates (other than when required by state law or regulation), subject to a stated minimum and maximum, generally are not specific enough to satisfy this requirement.

B-17. A decrease in the collision deductible of an automobile contract is, in effect, an increase in the coverage provided. It is not an internal replacement, but an election by the contract holder of coverage that was within the original contract as noted in paragraph .09 of this SOP, providing that all the terms that determine the amount of the premium related to the additional coverage are fixed in the original contract or by applicable state law or regulation and no reunderwriting is required of the original coverage. Contractual provisions that allow the contract holder to elect to add future coverage at then-current rates (other than when required by state law or regulation), subject to a stated minimum and maximum, generally are not specific enough to satisfy this requirement.

Addition of a Personal Articles Floater to a Homeowner's Contract

B-18. A homeowner's contract is a short-duration contract that generally provides coverage for loss or damage of property and personal injury occurring on the insured's property. A personal articles floater provides coverage for losses on personal property not covered under the terms of the homeowner's contract. If multiple pieces of jewelry are added to a personal articles floater, this SOP views each separately identified and priced item to constitute a nonintegrated contract feature. Thus, the addition of a personal articles floater providing coverage for several new pieces of jewelry to an existing homeowner's contract, with no other changes in the contract, results in additional nonintegrated contract coverage that should be accounted for separately from the existing homeowner's contract, as the underwriting and price for coverage for the jewelry is determined separately from the homeowner's contract and does not result in the reunderwriting of the existing coverages provided by the contracts. This is true even though the items covered by the personal articles floater and the homeowner's contract share a deductible and limit in the event of a common loss. The sharing of a common deductible and limit in the event of loss does not determine whether the contract feature or coverage is integrated, as the deductible is a definition of the terms of coverage resulting from a single loss event.

Increase in Coverage to Homeowner's Contract

B-19. A contract holder increases the coverage of a homeowner's contract, which insures a house valued at $350,000 with $300,000 of insurance coverage, to $400,000 to include a recently completed addition to the house worth $100,000. The additional layer of coverage results in a nonintegrated contract feature that should be accounted for separately from the existing homeowner's contract, provided that the additional premium charged for that incremental insurance coverage is not in excess of an amount that is commensurate with the incremental insurance coverage and does not result in the explicit or implicit reunderwriting or repricing of other components of the contract. If, however, there was substantive underwriting of the entire contract, including the original coverage, the contract would be considered to be substantially changed because substantive reunderwriting of existing contract coverage is an indicator that the insurance risk has changed significantly, and would probably also result in the repricing of the entire contract, which would result in failure to satisfy the criteria in paragraph .15*c* of this SOP. Additional coverage provided by a nonintegrated contract feature is considered nonintegrated even though the entire coverage provided by the contract is subject to a common deductible and limit in the event of an insured loss.

Increase in Limits for an Umbrella Contract

B-20. A contract holder currently has an umbrella contract from the same insurance enterprise as his or her homeowner's contract that provides for liability coverage with a limit of $1 million. The contract holder requests to increase the limit on the umbrella contract to $2 million. This additional layer of coverage results in additional nonintegrated contract coverage that should be accounted for separately from the existing umbrella contract, as the additional premium charged is not in excess of an amount that would be commensurate with the additional insurance coverage obtained ($1 million in excess of $1 million with no additional deductible), and there was no reunderwriting of the original coverage. If, however, there was substantive underwriting of the entire contract, including the original coverage, the contract would be considered to be substantially changed because substantive reunderwriting of existing contract coverage is an indicator that the insurance risk has changed significantly.

Increase in Premiums Versus Reduced Coverage

B-21. A long-term care (LTC) product provides for a specified payment while the insured qualifies for benefits under the contract. For example, while in a long-term care facility or when receiving care at home. If the LTC product had an authorized rate increase, the insurance enterprise may offer the contract holder the option of reducing coverage instead of paying additional premiums (i.e., maintain the current premium rate). For example, if the original contract provided benefit coverage of $100 a day for a $2,000 annual premium and there was an authorized increase of premiums to $2,500, the contract holder could elect to pay the increased premium or, if allowed by the insurance contract, retain annual premiums of $2,000 with reduced benefit coverage of $80 a day. In this example, the increase in premiums from $2,000 to $2,500 is related to a change in the cost of the insurance that is within ranges outlined in the contract and approved by the insurance regulator, and by itself the premium increase is not considered a modification to the contract. The contract holder election of a reduction in benefits is not an internal replacement, but rather a reduction in coverage under paragraph .10 of this SOP, if all the terms for a change in coverage are fixed in the original contract or by applicable state law or regulation and no reunderwriting of the continuing coverage is required.

B-22. If the contract holder elected a reduction in benefits under which the terms related to a change in coverage were not fixed in the original contract, the contract modification results in the replacement contract being substantially unchanged from the replaced contract as a result of the following:

a. The insured event has not changed from the replaced contract.

b. The exchange does not change the nature of the contract holder's investment return rights.

c. No additional deposit or premium is required and there are no changes in the charges related to the original benefits in excess of the amounts specified or allowed in the original contract, as the reduction in benefits is not in excess of the corresponding reduction in premiums. (The original contract provided for benefits of $100 a day for $2,000 annual premium, the reduction in benefits to $80 a day is commensurate with the 20-percent reduction in premiums from the increased rate of $2,500 to $2,000.)

d. There is no net decrease in the balance available to the contract holder.

e. There is no change in the participation or dividend features of the replaced contract.

f. There is no change in the amortization method or revenue classification of the replaced contract.

Single Premium Deferred Annuity to Market Value Adjusted Annuity

B-23. A single premium deferred annuity (SPDA) is a **general account** fixed deferred annuity with a single premium and guaranteed minimum crediting rate. The crediting rate on an SPDA may vary above the minimum guaranteed rate at the discretion of the insurance enterprise and typically is declared in advance and set for a defined period (for example, one year or three years), often as a result of a selection made by the contract holder. SPDAs typically are classified as investment contracts under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*.

B-24. A market value adjusted (MVA) SPDA provides for return of principal and guaranteed interest if held until a specified date or a calculated market adjusted value if surrendered at an earlier date. The current interest rate guarantee period of the MVA annuity typically does not encompass substantially all of the expected life of the contract. At the end of an interest rate declaration period, a new crediting rate is declared by the insurance enterprise and may vary above the minimum guaranteed rate. The length of the initial and subsequent interest rate guarantee periods generally is selected by the contract holder. MVA annuities typically are classified as FASB Statement No. 97 investment contracts.

B-25. In this example, there is no significant difference in the declared interest crediting rate (further, the change in interest rates is consistent with the change in declaration period), no change in the guaranteed minimum interest rate, no additional deposit or premium is required, and there are no surrender charges or front-end fees associated with the internal replacement. The contract exchange of an SPDA contract for an MVA contract results in the replacement contract being substantially unchanged from the replaced contract as a result of the following:

a. The insured event has not changed from the replaced contract.

b. The exchange does not change the nature of the contract holder's investment return rights (crediting rate declared by insurance enterprise, subject to guaranteed minimum crediting rate). The SPDA and the MVA are both contracts for which the interest rate is periodically reset by the insurer subject to a minimum interest rate guaranteed by the contract and, in this example, the current declared interest period does not represent substantially all of the expected life of the contract. The difference between the SPDA and the MVA annuity results from the manner in which the amount available to the contract holder is determined in the event the contract is terminated prematurely, not the contractual rights and provisions for the determination of the contract holder's investment return in the absence of a premature termination of the contract.

c. No additional deposit or premium is required, and there are no changes in the charges related to the original benefits.

d. There is no net decrease in the balance available to the contract holder.

e. There is no change in the participation or dividend features of the replaced contract.

f. There is no change in the amortization method or revenue classification of the replaced contract.

The SPDA and the MVA are both contracts for which the interest rate is periodically reset by the insurer subject to a minimum interest rate guaranteed by the contract; the only significant substantive difference between these two contracts is the manner in which amounts are determined in the event of a premature surrender. If the declared interest rate period of the MVA annuity constituted substantially all of the expected life of the contract, the change from a contract for which interest is set at the discretion of the insurer to one for which the rate is set by contract would result in a substantially changed contract.

Single Premium Deferred Annuity to Equity-Indexed Annuity

B-26. An SPDA has a crediting rate that is set at the discretion of the insurance enterprise. An equity-indexed annuity is a deferred fixed annuity contract with a guaranteed minimum crediting rate plus a contingent return based on a contractually specified internal or external equity index. Equity-indexed annuities typically are classified as FASB Statement No. 97 investment contracts with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, embedded derivatives that are required to be bifurcated from the contract and accounted for separately.

B-27. The contract exchange of an SPDA contract for an equity-indexed annuity results in the replacement contract being substantially changed from the replaced contract because the nature of the contract holder's investment return rights differs significantly between the two contracts. The crediting rate of the SPDA contract is declared at the discretion of the insurance enterprise, while the crediting rate on the equity-indexed annuity is contractually determined by reference to a pool of assets, an index, or other specified formula.

Single Premium Deferred Annuity to Multi-Bucket Annuity

B-28. An SPDA has a crediting rate that is set at the discretion of the insurance enterprise. A multi-bucket annuity is a general account deferred annuity for which, subject to a contractually specified minimum crediting rate, the interest rate to be credited on the contract holder's account balance is determined based on the returns achieved on a specified category of investments or investment strategy selected by the contract holder. The contract specifies the rights and provisions for the determination of investment return to the contract holder.

B-29. The contract exchange of an SPDA contract for a multi-bucket annuity results in the replacement contract being substantially changed from the replaced contract because the nature of the investment return rights are different between the two contracts. In the case of the typical SPDA, the interest rate is declared at the discretion of the insurance enterprise whereas, in the case of the multi-bucket annuity, the interest rate is determined by reference to a specific category of assets or investment strategy selected by the contract holder as defined in the contract.

Fixed-Interest Rate Guaranteed Investment Contract to a Variable-Interest Rate Guaranteed Investment Contract

B-30. A fixed-interest rate guaranteed investment contract (GIC) has a stated fixed crediting rate guaranteed for a specified period. An example of a variable-interest rate GIC is a contract with a credited interest rate defined as

London Inter Bank Offered Rate (LIBOR) plus a specified spread. Both types of GIC contracts are classified as FASB Statement No. 97 investment contracts.

B-31. The contract exchange of a fixed-rate GIC for a variable-rate GIC results in the replacement contract being substantially changed from the replaced contract because the investment return rights for the determination of the contract holder's investment return are different between the two contracts. In the case of the fixed-rate GIC, the interest rate is fixed and guaranteed whereas, in the case of the variable-interest rate GIC, the investment return to the contract holder is contractually specified to be determined based on the returns achieved on a specified category of investments or tied to a specific index.

Variable Annuity With Return of Premium Death Benefit Guarantee to Variable Annuity With Ratchet Death Benefit Guarantee

B-32. A variable annuity is a product offered by an insurance enterprise in which the contract holder's payments are used to purchase units of a **separate account**. The contract holder directs the allocation of the account value among various investment allocation alternatives and bears the investment risk. The units may be surrendered for their current value in cash (often less a surrender change) or applied to purchase annuity income contracts. The insurance enterprise periodically deducts mortality and expense charges from the account. A common feature in variable annuities is a minimum guaranteed death benefit (MGDB), with some MGDB designs providing more extensive benefits than others.

B-33. The contract exchange of a variable annuity with a return of premium death benefit guarantee, that in this example is determined to have a minimal degree of mortality risk (although sufficient to result in classification as an insurance contract under SOP 03-1 [section 10,870]), for a variable annuity that contains a ratchet death benefit guarantee, that in this example is determined to be a "rich" death benefit, results in the replacement contract being substantially changed from the replaced contract as the change in death benefits substantively changes the degree of mortality risk. The nature of a MGDB provision is essentially a combination of mortality and investment events. Although the actual mortality event itself is the same in the return of premium and ratchet GMDBs (death of the contract holder), the risk has changed because of the combined effects of mortality and investment events. In this instance, the preparer analyzed and concluded that a significant change in the SOP 03-1 [section 10,870] benefit ratio, as well as in the actuarially determined expected mortality costs, were indicative of a significant change in the degree of mortality risk. It should be noted that other methods and approaches could have been used to evaluate the change in degree of mortality.

Variable Annuity With Rollup Death Benefit Guarantee to Variable Annuity With Ratchet Death Benefit Guarantee

B-34. In this example, it is assumed that both the variable annuity with the rollup death benefit guarantee and the variable annuity with the ratchet death benefit guarantee offered as an internal replacement are determined to have similar degrees of mortality risk. In this instance, the preparer compared actuarially determined expected mortality costs, and since the costs were similar, it was indicative that the degree of mortality risk was also similar. It should be noted that other methods and approaches could have been used to evaluate the change in degree of mortality. It is also assumed that there is no reunderwriting required for the transaction, no additional deposit required to effect the transaction, and no net decrease in the balance available to the contract holder prior to surrender charges. In this example, the replacement results in additional mortality and expense charges due to the enhanced death benefit guarantee not in excess of an amount commensurate with the added benefit. A contract exchange of a variable annuity contract that contains an MGDB that is determined to have significant mortality risk with a variable annuity contract that contains another kind of MGDB that is determined to have a comparable degree of mortality risk, results in the replacement contract being substantially unchanged from the replaced contract as a result of the following:

a. The exchange does not result in a significant change in the kind and degree of mortality risk.

b. The exchange does not change the nature of the contract holder's investment return rights.

c. No additional deposit or premium is required relating to the variable annuity (the original benefit) and the additional charges for the ratchet death benefit guarantee are not in excess of an amount commensurate with the benefit.

d. There is no net decrease in the balance available to the contract holder.

e. There is no change in the participation or dividend features of the contracts.

f. There is no change to the amortization method or revenue classification of the replaced contract.

If the modification were achieved through amendment, endorsement, or rider rather than through a contract exchange, the analysis and conclusion would be the same as for the contract exchange because the MGDB is an integrated feature.

Variable Annuity to a Variable Annuity with Long-Term Care Benefit

B-35. A long-term care (LTC) rider provides that in the event the insured enters a LTC facility, the feature will provide a specified fixed payment while the insured is being treated at a LTC facility.

B-36. In this example, the contract holder exchanges the original variable annuity contract for a new variable annuity contract that contains an LTC rider. This is a contract exchange in which the replacement contract contains a nonintegrated contract feature, as the LTC rider is not related to the provisions of the replacement variable annuity contract. This contract exchange results in the base annuity contract being substantially unchanged from the replaced contract as a result of the following:

a. The modification does not result in a change in the insured event, as there is no significant change in the kind and degree of mortality risk from the replaced contract.

b. There is no change in the nature of the investment return rights from the replaced contract.

c. There are no changes in the charges related to the variable annuity (the original benefit), and the additional premium for the long-term care benefit is not in excess of an amount commensurate with the additional insurance coverage obtained.

d. There is no net decrease in the balance available to the contract holder.

e. There is no change in the participation or dividend features of the replaced contract.

f. The modification does not result in a change to either the amortization method or revenue classification of the contract.

The LTC rider should be accounted for as a separate contract, as it is a nonintegrated contract feature. This accounting would be the same if the modification had been achieved through the addition of a LTC rider to the original annuity contract rather than through an exchange.

Variable Annuity With New Investment Alternatives Added and Elections of Fixed Allocation Alternatives

B-37. Variable annuities generally have a number of investment allocation alternatives from which the contract holder may select. In the normal course of business, companies modify these elections for a number of reasons, including competition and changes in investment management and distribution relationships. Throughout the life of the contract, the contract holder has the option to select new allocations for the investment of his or her annuity account balance. Generally, the addition of new investment allocation alternatives to variable life insurance or annuity contracts does not result in a substantive change to the original contract because the contractual rights and provisions for the determination of the contract holder's investment return have not changed.

B-38. It is possible that one of the investment allocation alternatives added or elected could be a fixed return option. As long as the contract remains a variable annuity contract and the contract holder retains the right to reallocate amounts to other investment alternatives, neither the addition of the investment alternative nor the contract holder's utilization of that investment alternative would constitute an internal replacement that results in a substantially changed contract. If, however, the contract holder's election of a fixed allocation alternative results in a conversion or partial conversion to a fixed annuity contract or the contract remains a variable annuity contract but the transfer is effectively a conversion or partial conversion because there are substantive restrictions on the contract holder's ability to reallocate amounts to other investment alternatives, the modification would result in a substantially changed contract to the extent of the conversion or substantially restricted balance.

Variable Annuity to Variable Annuity With Guaranteed Minimum Accumulation Benefit

B-39. A variable annuity contract is replaced with a variable annuity contract that also provides a guaranteed minimum accumulation benefit (GMAB); in this example, a 5-percent annual rollup of contract value in 10 years. The contract exchange of a variable annuity for a variable annuity that contains a GMAB results in the replacement contract being substantially changed from the replaced contract because the addition of a GMAB, an integrated benefit feature, changes the investment return rights of the contract holder by providing a minimum investment return guarantee. The analysis would be the same if the change had been achieved through the addition of a

GMAB rider. If, however, the contract holder had elected to add a GMAB feature that was included in the original contract (and met the specifications in paragraph .09 of this SOP), the modification would not be considered an internal replacement subject to the guidance in this SOP.

Variable Annuity to Variable Annuity With Guaranteed Minimum Income Benefit

B-40. A variable annuity contract is replaced with a variable annuity contract that also provides a guaranteed minimum income benefit (GMIB); in this example, a 5-percent annual rollup of contract value. A GMIB, an integrated contract feature, specifies a manner in which an annuitization benefit is determined if the contract holder elects to annuitize. The GMIB benefit cannot be withdrawn or net settled. The contract exchange of a variable annuity for a variable annuity that contains a GMIB results in the replacement contract being substantially changed from the replaced contract because the addition of a GMIB changes the investment return rights of the contract holder, as a minimum investment return provision, via the guaranteed amount for annuitization, has been added to the variable annuity. The analysis would be the same if the change had been achieved through the addition of a GMIB rider. If, however, the contract holder had elected to add a GMIB feature that was included in the original contract (and met the specifications in paragraph .09 of this SOP), the modification would not be considered an internal replacement subject to the guidance in this SOP.

Variable Annuity to Variable Annuity With Guaranteed Minimum Withdrawal Benefit

B-41. A guaranteed minimum withdrawal benefit (GMWB) provides a contract holder a guarantee that a minimum amount (usually stated as a percentage of premiums) will be available for withdrawal over a specific period. Regardless of the contract value, the contract holder is guaranteed the right to periodic withdrawals from the contract until the amount of premiums deposited into the contract is withdrawn. The insurance enterprise either replaces deferred annuity contracts with annuity contracts that contain the GMWB feature or the insurance enterprise adds a GMWB rider to existing inforce business (that is, deferred annuity contracts).

B-42. A variable annuity with a GMWB is classified as an FASB Statement No. 97 investment contract with an embedded derivative. The contract exchange of a variable annuity for a variable annuity that contains a GMWB results in the replacement contract being substantially changed from the replaced contract because the addition of a GMWB, an integrated contract feature, changes the investment return rights of the contract holder, as a minimum investment return provision, via the guaranteed withdrawal amount, to the variable annuity. The analysis would be the same if the change had been achieved through the addition of a GMWB rider. If, however, the contract holder had elected to add a GMWB feature that was included in the original contract (and met the specifications in paragraph .09 of this SOP), the modification would not be considered an internal replacement subject to the guidance in this SOP.

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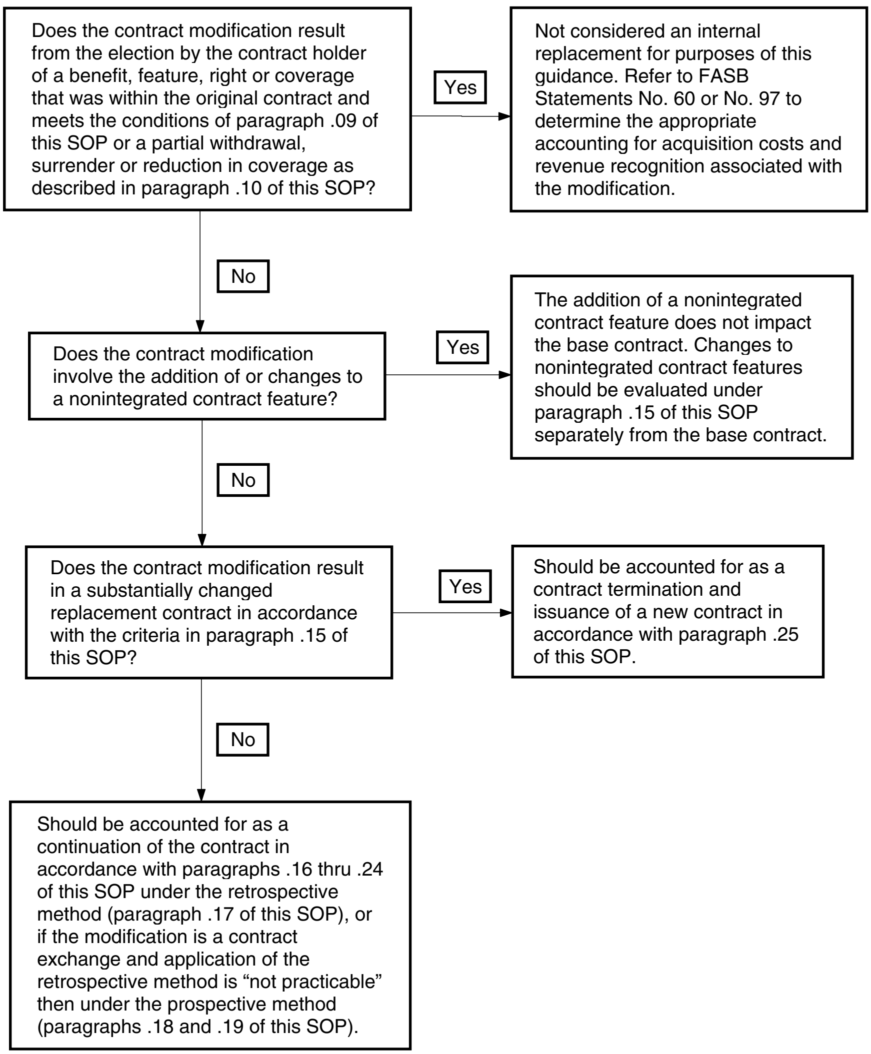
Appendix C

Flowchart—Application of SOP 05-1 Accounting Model



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Appendix D

Illustration of Deferred Acquisition Costs and Unearned Revenue Liability Amortization for a FASB Statement No. 97 Internal Replacement That Is Determined to Result in a Substantially Unchanged Contract

D-1. The schedules in Illustrations D-1 and D-2 that follow are based on the same example and use the same assumptions. In the illustrative examples, an insurance enterprise is offering to replace its general account single premium deferred annuity (SPDA) contracts with newer general account SPDA contracts, and assumes that 50 percent of the existing contract holders choose the internal replacement at the end of year 5. No surrender charges from the original contract will be imposed on contract holders who elect to have their contracts replaced. The contract holder who elects the new contract will receive a higher interest crediting rate than under the older contract but must accept a new surrender charge period. The insurance enterprise expects that persistency rates will improve under the replacement contracts as a result of the new surrender charge period and the higher credited interest.

D-2. The exchange of an SPDA contract for a newer SPDA contract in this example results in the replacement contract being substantially unchanged from the replaced contract, due to the following:

- *a.* The insured event or risk, type, or period of coverage of the contract has not changed, as noted by no significant changes in the kind and degree of mortality risk, morbidity risk, or other insurance risk, if any.
- *b.* The nature of the investment return rights, if any, have not changed.
- *c.* No additional deposit, premium, or charge relating to the original benefit, in excess of amounts contemplated in the original contract, is required to effect the transaction.
- *d.* Other than distributions to the contract holder or contract designee, there is no net reduction in the contract holder's account value or, for contracts not having an explicit or implicit account value, the cash surrender value, if any.
- *e.* There is no change in the participation or dividend features of the contract, if any.
- *f.* There is no change to the amortization method or revenue classification of the contract.

D-3. Illustration D-1 presents an example of the application of the guidance in paragraph .17 of this Statement of Position (SOP), whereby the estimated gross profits (EGPs) of the replacement contract are accounted for as revisions to the EGPs of the replaced contract in the determination of the amortization of deferred acquisition costs and deferred sales inducement assets and the recognition of unearned revenues.

D-4. An alternative allocation approach may be used if it is not reasonably practicable for an insurance enterprise to account for, in the manner described in paragraph .17 of this SOP, a contract exchange that has resulted in a replacement contract that is substantially unchanged from the replaced contract. The insurance enterprise may then determine an appropriate balance of unamortized deferred acquisition costs related to the replaced contract to carry forward to the replacement contract, and utilize only EGPs of the replacement contract to determine future amortization. Illustration D-2 is an example of such an alternative allocation approach.

D-5. In the illustrations, the insurance enterprise's accounting policy is to let the discount rate fluctuate with changes in interest crediting rates.[1]

Illustration D-1

D-6. Illustration D-1, which follows, presents an example of the guidance in paragraph .17 of this SOP, whereby the EGPs or margins of the replacement contract are accounted for as revisions to the EGPs or margins of the replaced contract in the determination of the amortization of DAC and deferred sales inducement assets and the recognition of unearned revenues.

D-7. The following schedules are included in Illustration D-1:

- Schedule 1, "Original Contracts Deferred Acquisition Costs and URL Amortization Before Replacement"
- Schedule 2, "Account Value and EGPs, of Replacement Contracts" (This schedule illustrates the account balances for contracts that have elected to participate in the internal replacement transaction at the end of year 5.)
- Schedule 3, "Account Value and Crediting Rates of Original and Replacement Contracts" (This schedule illustrates the account balances and interest crediting rates for both the replacement contracts and the contracts not electing to participate in the internal replacement transaction.)
- Schedule 4, "Combined EGPs, Deferred Acquisition Costs, and URL" (This schedule summarizes the EGPs, deferred acquisition costs, and front-end fees for both the replacement contracts and the contracts not electing to participate in the internal replacement transaction.)
- Schedule 5, "Revised Amortization of Deferred Acquisition Costs and URL After Replacement" (This schedule illustrates the determination of the revised deferred acquisition costs and URL balances for the combination of both replacement contracts and the contracts not electing to participate in the internal replacement transaction.)
- Schedule 6, "Summary of Deferred Acquisition Costs and URL as a Result of Internal Replacement That Is Not Substantially Different"

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[1] In accordance with the guidance in paragraph 25 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*.

D-1: Schedule 1: Original Contracts Deferred Acquisition Costs and URL Amortization Before Replacement

Contract Year	*Discount Rate*	*Account Value End of Year*	*Deposits*	*Acquisition Costs*	*Front-End Fees*	*EGPs*	*Deferred Acquisition Costs Balance End of Year*	*URL Balance End of Year*
	(a)	*(b)*	*(c)*	*(d)*	*(e)*	*(f)*	*(g)*	*(h)*
1 (Act.)	6.00%	$30,694,950	$30,000,000	$1,925,000	$300,000	$ 302,094	$1,775,253	$276,663
2 (Act.)	7.00	31,201,417	—	—	—	356,730	1,586,302	247,216
3 (Act.)	7.50	28,510,294	—	—	—	517,263	1,251,103	194,977
4 (Act.)	6.50	22,772,598	—	—	—	549,372	850,060	132,477
5 (Act.)	5.50	16,817,563	—	—	—	414,428	532,934	83,055
6 (Proj.)	5.50	12,419,771	—	—	—	253,964	339,258	52,871
7 (Proj.)	5.50	9,172,001	—	—	—	149,039	227,057	35,385
8 (Proj.)	5.50	6,773,522	—	—	—	81,593	167,904	26,167
9 (Proj.)	5.50	5,002,246	—	—	—	60,646	123,889	19,307
10 (Proj.)	5.50	3,694,159	—	—	—	45,060	91,139	14,203
11 (Proj.)	5.50	2,728,136	—	—	—	33,468	66,765	10,405
12 (Proj.)	5.50	2,014,729	—	—	—	24,850	48,619	7,577
13 (Proj.)	5.50	1,487,877	—	—	—	18,445	35,097	5,470
14 (Proj.)	5.50	1,098,797	—	—	—	13,687	25,010	3,898
15 (Proj.)	5.50	811,462	—	—	—	10,154	17,470	2,723
16 (Proj.)	5.50	599,265	—	—	—	7,531	11,818	1,842
17 (Proj.)	5.50	442,557	—	—	—	5,584	7,565	1,179
18 (Proj.)	5.50	326,828	—	—	—	4,140	4,347	677
19 (Proj.)	5.50	241,363	—	—	—	3,068	1,892	295
20 (Proj.)	5.50	—	—	—	—	2,273	0	0
Present values				1,925,000	300,000	2,192,412		
k factor			0.87803	0.87803	0.13684			

(continued)

D-1: Schedule 1: Original Contracts Deferred Acquisition Costs and URL Amortization Before Replacement—*continued*

Explanation of columns:

(*a*) Discount rate for FASB Statement No. 97 product, which is the rate that accrues to contract holder balances.
(*b*) Prior year-end account value plus interest credited less fees less withdrawals.
(*c*) Premium deposits at beginning of contract year.
(*d*) Deferrable acquisition costs as defined in FASB Statement No. 60, assumed to be incurred as of the beginning of the year.
(*e*) Front-end fees charged to contract holders at beginning of year for services to be provided over life of contract.
(*f*) EGPs as defined in FASB Statement No. 97.
(*g*) Ending deferred acquisition costs balance as defined in FASB Statement No. 97 using EGPs as basis for amortization.
EOY DAC = BOY DAC + Acquisition Costs + Interest – Amortization (f * 0.87803).
(*h*) Ending URL as defined in FASB Statement No. 97 using EGPs as basis for amortization.
EOY URL = BOY URL + Front-End Fees + Interest – Amortization (f * 0.13684).

D-1: Schedule 2: Account Value and EGPs of Replacement Contracts

Contract Year	*Account Value End of Year*	*EGPs*	*Discount Rate*
	(*a*)	(*b*)	(*c*)
At Replacement	$8,408,782		
6 (Proj.)	8,669,979	$ 5,228	5.75%
7 (Proj.)	8,710,078	82,455	5.75%
8 (Proj.)	8,520,090	90,295	5.75%
9 (Proj.)	8,108,995	91,087	5.75%
10 (Proj.)	7,503,355	85,007	5.75%
11 (Proj.)	6,744,578	73,107	5.75%
12 (Proj.)	5,884,223	57,140	5.75%
13 (Proj.)	4,978,052	39,242	5.75%
14 (Proj.)	4,211,432	33,424	5.75%
15 (Proj.)	3,562,872	28,457	5.75%
16 (Proj.)	3,014,190	24,218	5.75%
17 (Proj.)	2,550,004	20,604	5.75%
18 (Proj.)	2,157,304	17,523	5.75%
19 (Proj.)	1,825,079	14,898	5.75%
20 (Proj.)	0	12,663	5.75%

Explanation of columns:

(*a*) 50 percent of original contracts account value at replacement; thereafter, prior year-end account value plus interest credited less fees less withdrawals.

(*b*) Estimated gross profits as defined in FASB Statement No. 97. EGP in year 6 reflects commissions of 0.75 percent of account value paid at time of replacement that is not deferrable under the SOP.

(*c*) Discount rate for FASB Statement No. 97 product, which is the rate at which contract holder's funds accumulate.

D-1: Schedule 3: Account Value and Crediting Rates of Original and Replacement Contracts

50 Percent of Original Contracts' Account Value Replaced With New Contracts

Contract Year	*Account Value End of Year Original Contracts*	*Account Value End of Year Replacement Contracts*	*Interest Crediting Rate Original Contracts*	*Interest Crediting Rate Replacement Contracts*	*Interest Crediting Rate Weighted Average*
	(*a*)	(*b*)	(*c*)	(*d*)	(*e*)
At Issue	$29,700,000	—	6.00%	—	6.00%
1	30,694,950	—	7.00	—	7.00
2	31,201,417	—	7.50	—	7.50
3	28,510,294	—	6.50	—	6.50
4	22,772,598	—	5.50	—	5.50
5	16,817,563				
At Replacement	8,408,782	$8,408,782	5.50	5.75%	5.63
6	6,209,885	8,669,979	5.50	5.75	5.65
7	4,586,000	8,710,078	5.50	5.75	5.66
8	3,386,761	8,520,090	5.50	5.75	5.68
9	2,501,123	8,108,995	5.50	5.75	5.69
10	1,847,079	7,503,355	5.50	5.75	5.70
11	1,364,068	6,744,578	5.50	5.75	5.71
12	1,007,364	5,884,223	5.50	5.75	5.71
13	743,939	4,978,052	5.50	5.75	5.72
14	549,399	4,211,432	5.50	5.75	5.72
15	405,731	3,562,872	5.50	5.75	5.72
16	299,632	3,014,190	5.50	5.75	5.73
17	221,278	2,550,004	5.50	5.75	5.73
18	163,414	2,157,304	5.50	5.75	5.73
19	120,681	1,825,079	5.50	5.75	5.73
20	—	—	—	—	—

Explanation of columns:

(*a*) Account value at the end of the contract year for original contracts (beginning in year 6, this represents account value related to those contracts not electing the replacement).

(*b*) Account value at the end of the contract year for replacement contracts (per Schedule 2 Column a).

(*c*) Interest crediting rate on original contracts; beginning in year 6 this represents the interest crediting rate on those contracts not electing the replacement.

(*d*) Interest crediting rate on replacement contracts.

(*e*) Interest crediting rate weighted by account value.

D-1: Schedule 4: Combined EGPs, Deferred Acquisition Costs, and URL (Contracts that have not elected the replacement plus contracts that have elected the replacement)

50 Percent of Original Contracts' Account Value Replaced With New Policies

Contract Year	*EGPs Original Contracts*	*EGPs Replacement Contracts*	*Combined EGPs*	*Deferred Acquisition Costs*	*Front-End Fees*
	(*a*)	(*b*)	(*c*)	(*d*)	(*e*)
1 (Act.)	$302,094	—	$302,094	$1,925,000	$300,000
2 (Act.)	356,730	—	356,730	—	—
3 (Act.)	517,263	—	517,263	—	—
4 (Act.)	549,372	—	549,372	—	—
5 (Act.)	414,428	—	414,428	—	—
6 (Proj.)	126,982	5,228	132,210	—	—
7 (Proj.)	74,520	82,455	156,975	—	—
8 (Proj.)	40,797	90,295	131,092	—	—
9 (Proj.)	30,323	91,087	121,410	—	—
10 (Proj.)	22,530	85,007	107,537	—	—
11 (Proj.)	16,734	73,107	89,841	—	—
12 (Proj.)	12,425	57,140	69,565	—	—
13 (Proj.)	9,223	39,242	48,465	—	—
14 (Proj.)	6,844	33,424	40,268	—	—
15 (Proj.)	5,077	28,457	33,534	—	—
16 (Proj.)	3,765	24,218	27,984	—	—
17 (Proj.)	2,792	20,604	23,396	—	—
18 (Proj.)	2,070	17,523	19,593	—	—
19 (Proj.)	1,534	14,898	16,432	—	—
20 (Proj.)	1,137	12,663	13,799	—	—
Present values				$1,925,000	$300,000
			2,328,377		00
k factor				0.8267561	0.1288451

Explanation of columns:

(*a*) EGPs from original policies (beginning in year 6, this represents EGPs related to those contracts not electing the replacement).

(*b*) EGPs from replacement policies.

(*c*) Combined EGPs.

(*d*) Deferrable acquisition costs from original policies.

(*e*) Front-end fees from original policies.

D-1: Schedule 5: Revised Amortization of Deferred Acquisition Costs and URL After Replacement

	Deferred Acquisition Cost Amortization				Unearned Revenue Amortization			
Contract Year	*Acquisition Costs*	*Interest Added*	*Amortization*	*DAC (End of Year)*	*Front-End Fees*	*Interest Added*	*Amortization*	*URL (End of Year)*
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
1 (Act.)	$1,925,000	$ 115,500	$ (249,758)	$1,790,742	$300,000	$ 18,000	$ (38,923)	$ 279,077
2 (Act.)	—	125,352	(294,929)	1,621,165	—	19,535	(45,963)	252,649
3 (Act.)	—	121,587	(427,650)	1,315,102	—	18,949	(66,647)	204,951
4 (Act.)	—	85,482	(454,197)	946,387	—	13,322	(70,784)	147,489
5 (Act.)	—	52,052	(342,631)	655,808	—	8,112	(53,397)	102,204
6 (Proj.)	—	36,889	(109,305)	583,392	—	5,749	(17,035)	90,918
7 (Proj.)	—	32,936	(129,780)	486,548	—	5,133	(20,225)	75,826
8 (Proj.)	—	27,557	(108,381)	405,724	—	4,295	(16,891)	63,230
9 (Proj.)	—	23,041	(100,377)	328,388	—	3,590	(15,643)	51,177
10 (Proj.)	—	18,689	(88,907)	258,170	—	2,913	(13,856)	40,234
11 (Proj.)	—	14,717	(74,277)	198,610	—	2,294	(11,576)	30,952
12 (Proj.)	—	11,337	(57,513)	152,434	—	1,767	(8,963)	23,756
13 (Proj.)	—	8,710	(40,069)	121,075	—	1,357	(6,244)	18,869
14 (Proj.)	—	6,923	(33,292)	94,706	—	1,079	(5,188)	14,760
15 (Proj.)	—	5,418	(27,724)	72,400	—	844	(4,321)	11,283
16 (Proj.)	—	4,144	(23,136)	53,408	—	646	(3,606)	8,323
17 (Proj.)	—	3,059	(19,343)	37,124	—	477	(3,014)	5,786
18 (Proj.)	—	2,127	(16,198)	23,053	—	331	(2,524)	3,593
19 (Proj.)	—	1,322	(13,585)	10,790	—	206	(2,117)	1,682
20 (Proj.)	—	619	(11,409)	0	—	96	(1,778)	(0)

(continued)

D-1: Schedule 5: Revised Amortization of Deferred Acquisition Costs and URL After Replacement—*continued*

Explanation of columns:

(*a*) Total deferrable acquisition costs from original policies.

(*b*) Interest on deferred acquisition costs.

(*c*) Deferred acquisition cost amortization (k-factor per Schedule 4, column d* total revised EGP per Schedule 4, column c).

(*d*) Ending DAC = BOY DAC + (a) + (b) +(c).

(*e*) Total front-end fees from original policies.

(*f*) Interest on URL.

(*g*) URL amortization (k-factor per Schedule 4, column e* total revised EGP per Schedule 4, column c).

(*h*) Ending URL = BOY URL + (e) + (f) + (g).

D-1: Schedule 6: Summary of Deferred Acquisition Cost and URL As a Result of Internal Replacement That Is Not Substantially Different

	Deferred Acquisition Costs	*URL*
Original contracts before replacement (year 5 balances, per Schedule 1, columns g and h)	$532,934	$ 83,055
Combined contracts after replacement (year 5 balances, per Schedule 5, columns d and h)	655,808	102,204
	(122,874)	(19,149)

Summary of Accounting Entries

Deferred acquisition costs	$122,874	
Amortization		$122,874
Change in Unearned Revenue	$ 19,149	
URL		$ 19,149

Illustration D-2

D-8. An alternative allocation approach may be used if it is not reasonably practicable for an insurance enterprise to account for, in the manner described in paragraph .17 of this SOP, a contract exchange that has resulted in a replacement contract that is substantially unchanged from the replaced contract. The insurance enterprise may then determine the balance of unamortized deferred acquisition costs related to the replaced contract to carry forward to the replacement contract, and utilize estimated gross profits or margins only of the replacement contract to determine future amortization. Illustration D-2 is an example of such an alternative allocation approach.

D-9. The following schedules are included in Illustration D-2:

- Schedule 1, "Original Contracts Deferred Acquisition Costs and URL Amortization Before Replacement"
- Schedule 2, "Original Contracts Deferred Acquisition Costs and URL Amortization After Replacement" (This schedule calculates the revised balances for deferred acquisition costs and URL for contracts not electing to participate in the internal replacement transaction. Account value and balances on EGPs related to replacement contracts are eliminated prospectively from the end of year 5, when contracts are assumed to be replaced for purposes of this illustration. The differences in the balances for deferred acquisition costs and URL are allocated to replacement contracts and treated as if they were deferrable acquisition costs and front-end fees, respectively, incurred at the inception of the replacement contracts.)
- Schedule 3, "Calculation of Carryover Amounts" (This schedule calculates the balances for deferred acquisition costs and URL to be allocated to the replacement contracts.)
- Schedule 4, "Account Value, Deferred Acquisition Costs, Front-End Fees, and EGPs of Replacement Contracts" (This schedule calculates the account value, deferred acquisition costs, front-end fees, and EGPs of contracts that have elected the internal replacement transaction at the end of year 5.)
- Schedule 5, "Deferred Acquisition Costs and URL Amortization for Replacement Contracts" (This schedule calculates the deferred acquisition costs and URL amortization of contracts that have elected the internal replacement transaction at the end of year 5.)
- Schedule 6, "Combined Deferred Acquisition Costs and URL After the Internal Replacement Transaction" (This schedule calculates the total deferred acquisition costs and URL balances for contracts that have not elected the internal replacement transaction and replacement contracts.)
- Schedule 7 "Summary of Deferred Acquisition Costs and URL as a Result of an Internal Replacement That Is Not Substantially Different"

D-2: Schedule 1: Original Contracts Deferred Acquisition Costs and URL Amortization Before Replacement

Contract Year	*Discount Rate*	*Account Value End of Year*	*Deposits*	*Acquisition Costs*	*Front-End Fees*	*EGPs*	*Deferred Acquisition Costs Balance End of Year*	*URL Balance End of Year*
	(a)	*(b)*	*(c)*	*(d)*	*(e)*	*(f)*	*(g)*	*(h)*
1 (Act.)	6.00%	$30,694,950	$30,000,000	$1,925,000	$300,000	$ 302,094	$1,775,253	$276,663
2 (Act.)	7.00%	31,201,417	—	—	—	356,730	1,586,302	247,216
3 (Act.)	7.50%	28,510,294	—	—	—	517,263	1,251,103	194,977
4 (Act.)	6.50%	22,772,598	—	—	—	549,372	850,060	132,477
5 (Act.)	5.50%	16,817,563	—	—	—	414,428	532,934	83,055
6 (Proj.)	5.50%	12,419,771	—	—	—	253,964	339,258	52,871
7 (Proj.)	5.50%	9,172,001	—	—	—	149,039	227,057	35,385
8 (Proj.)	5.50%	6,773,522	—	—	—	81,593	167,904	26,167
9 (Proj.)	5.50%	5,002,246	—	—	—	60,646	123,889	19,307
10 (Proj.)	5.50%	3,694,159	—	—	—	45,060	91,139	14,203
11 (Proj.)	5.50%	2,728,136	—	—	—	33,468	66,765	10,405
12 (Proj.)	5.50%	2,014,729	—	—	—	24,850	48,619	7,577
13 (Proj.)	5.50%	1,487,877	—	—	—	18,445	35,097	5,470
14 (Proj.)	5.50%	1,098,797	—	—	—	13,687	25,010	3,898
15 (Proj.)	5.50%	811,462	—	—	—	10,154	17,470	2,723
16 (Proj.)	5.50%	599,265	—	—	—	7,531	11,818	1,842
17 (Proj.)	5.50%	442,557	—	—	—	5,584	7,565	1,179
18 (Proj.)	5.50%	326,828	—	—	—	4,140	4,347	677
19 (Proj.)	5.50%	241,363	—	—	—	3,068	1,892	295
20 (Proj.)	5.50%	—	—	—	—	2,273	0	0
Present Values				$1,925,000	$300,000	$2,192,412		
k-factor				0.87803	0.13684			

(continued)

D-2: Schedule 1: Original Contracts Deferred Acquisition Costs and URL Amortization Before Replacement—*continued*

Explanation of columns:

(*a*) Discount rate for FASB Statement No. 97 product, which is the rate that accrues to contract holder balances.
(*b*) Prior year-end account value plus premiums plus interest credited less fees less withdrawals.
(*c*) Premium deposits at beginning of contract year.
(*d*) DAC as defined in FASB Statement No. 60, assumed to be incurred as of the beginning of the year.
(*e*) Front-end fees charged to contract holders at beginning of year for services to be provided over life of contract.
(*f*) EGPs as defined in FASB Statement No. 97.
(*g*) Ending deferred acquisition costs balance as defined in FASB Statement No. 97 using EGPs as basis for amortization.
EOY DAC = BOY DAC + Acquisition Costs + Interest – Amortization (f * 0.87803).
(*h*) Ending URL balance as defined in FASB Statement No. 97 using EGPs as basis for amortization.
EOY URL = BOY URL + Front-End Fees + Interest – Amortization (f * 0.13684).

D-2: Schedule 2: Original Contracts Deferred Acquisition Costs and URL Amortization After Replacement

Contract Year	*Discount Rate*	*Account Value End of Year*	*Deposits*	*Acquisition Costs*	*Front-End Fees*	*EGPs*	*Deferred Acquisition Costs Balance End of Year*	*URL Balance End of Year*
	(*a*)	(*b*)	(*c*)	(*d*)	(*e*)	(*f*)	(*g*)	(*h*)
1 (Act.)	6.00%	$30,694,950	$30,000,000	$1,925,000	$300,000	$ 302,094	$1,745,439	$272,016
2 (Act.)	7.00%	31,201,417	—	—	—	356,730	1,519,194	236,757
3 (Act.)	7.50%	28,510,294	—	—	—	517,263	1,127,912	175,778
4 (Act.)	6.50%	22,772,598	—	—	—	549,372	664,643	103,581
5 (Act.)	5.50%	8,408,782	—	—	—	414,428	296,419	46,195
6 (Proj.)	5.50%	6,209,885	—	—	—	126,982	188,696	29,407
7 (Proj.)	5.50%	4,586,000	—	—	—	74,520	126,289	19,681
8 (Proj.)	5.50%	3,386,761	—	—	—	40,797	93,388	14,554
9 (Proj.)	5.50%	2,501,123	—	—	—	30,323	68,907	10,739
10 (Proj.)	5.50%	1,847,079	—	—	—	22,530	50,691	7,900
11 (Proj.)	5.50%	1,364,068	—	—	—	16,734	37,135	5,787
12 (Proj.)	5.50%	1,007,364	—	—	—	12,425	27,042	4,214
13 (Proj.)	5.50%	743,939	—	—	—	9,223	19,521	3,042
14 (Proj.)	5.50%	549,399	—	—	—	6,844	13,910	2,168
15 (Proj.)	5.50%	405,731	—	—	—	5,077	9,717	1,514
16 (Proj.)	5.50%	299,632	—	—	—	3,765	6,573	1,024
17 (Proj.)	5.50%	221,278	—	—	—	2,792	4,208	656
18 (Proj.)	5.50%	163,414	—	—	—	2,070	2,418	377
19 (Proj.)	5.50%	120,681	—	—	—	1,534	1,052	164
20 (Proj.)	5.50%	—	—	—	—	1,137	—	—
Present Values				$1,925,000	$300,000	$1,970,881		
k-factor				0.97672	0.15222			

(continued)

D-2: Schedule 2: Original Contracts Deferred Acquisition Costs and URL Amortization After Replacement—*continued*

Explanation of columns:

(*a*) Discount rate for FASB Statement No. 97 product, which is the rate that accrues to contract holder balances.
(*b*) Prior year-end account value plus premiums plus interest credited less fees less withdrawals (including "replacements").
(*c*) Premium deposits at beginning of contract year.
(*d*) Deferred acquisition costs as defined in FASB Statement No. 60 assumed to be incurred as of the beginning of the year.
(*e*) Front-end fees charged to contract holders at beginning of year for services to be provided over life of contract.
(*f*) EGPs as defined in FASB Statement No. 97.
(*g*) Ending deferred acquisition costs balance as defined in FASB Statement No. 97 using EGPs as basis for amortization.
EOY DAC = BOY DAC + Acquisition Costs + Interest – Amortization(f * 0.97672).
(*h*) Ending URL balance as defined in FASB Statement No. 97 using EGPs as basis for amortization.
EOY URL = BOY URL + Front-End Fees + Interest – Amortization(f * 0.15222).

D-2: Schedule 3: Calculation of Carryover Amounts

	Deferred Acquisition Costs Balance	URL Balance
	(a)	(b)
Balances just prior to replacement	$532,934	$83,055
Balances just after replacement, for contracts not electing to participate in the internal replacement transaction at the end of year 5	296,419	46,195
Carryover Amounts, allocated to contracts choosing the internal replacement at end of year 5	$236,515	$36,860

Explanation of columns:

(*a*) Deferred acquisition costs balances end of year 5 from Schedules 1 and 2.
(*b*) URL balances end of year 5 from Schedules 1 and 2.

D-2: Schedule 4: Account Value, Deferred Acquisition Costs, Front-End Fees, and EGPs of Replacement Contracts

Contract Year	*Account Value End of Year*	*Acquisition Costs*	*Front-End Fees*	*EGPs*	*Discount Rate*
	(*a*)	(*b*)	(*c*)	(*d*)	(*e*)
At Replacement	$8,408,782	$236,515	$36,860		
6 (Proj.)	8,669,979	—	—	$5,228	5.75%
7 (Proj.)	8,710,078	—	—	82,455	5.75%
8 (Proj.)	8,520,090	—	—	90,295	5.75%
9 (Proj.)	8,108,995	—	—	91,087	5.75%
10 (Proj.)	7,503,355	—	—	85,007	5.75%
11 (Proj.)	6,744,578	—	—	73,107	5.75%
12 (Proj.)	5,884,223	—	—	57,140	5.75%
13 (Proj.)	4,978,052	—	—	39,242	5.75%
14 (Proj.)	4,211,432	—	—	33,424	5.75%
15 (Proj.)	3,562,872	—	—	28,457	5.75%
16 (Proj.)	3,014,190	—	—	24,218	5.75%
17 (Proj.)	2,550,004	—	—	20,604	5.75%
18 (Proj.)	2,157,304	—	—	17,523	5.75%
19 (Proj.)	1,825,079	—	—	14,898	5.75%
20 (Proj.)	—	—	—	12,663	5.75%
Present Values		$236,515	$36,860	$489,000	
k-factor		0.4837	0.0754		

Explanation of columns:

(*a*) Prior year-end account value plus premiums plus interest credited less fees less withdrawals (per Appendix D1, Schedule 3, column b).
(*b*) Carryover deferred acquisition costs as defined in FASB Statement No. 60, assumed to be incurred as of the beginning of the year (carryover amount calculated per Schedule 3).
(*c*) Carryover front-end fees charged to contract holders at beginning of year for services to be provided over life of contract (carryover amount calculated per Schedule 3)
(*d*) EGPs as defined in FASB Statement No. 97 (per Appendix D1, Schedule 4, column b).
(*e*) Discount rate for FASB Statement No. 97 product, which is the rate at which contract holder's funds accumulate.

D-2: Schedule 5: Deferred Acquisition Costs and URL Amortization for Replacement Contracts

	Deferred Acquisition Costs Amortization				*Unearned Revenue Amortization*			
Contract Year	*Acquisition Costs*	*Interest Added*	*Amortization*	*Deferred Acquisition Costs (End of Year)*	*Front-End Fees*	*Interest Added*	*Amortization*	*URL (End of Year)*
	(*a*)	(*b*)	(*c*)	(*d*)	(*e*)	(*f*)	(*g*)	(*h*)
6 (Proj.)	$236,515	$13,599	$ (2,529)	$247,585	$36,860	$2,119	$ (394)	$38,585
7 (Proj.)	—	14,236	(39,881)	221,940	—	2,219	(6,215)	34,589
8 (Proj.)	—	12,762	(43,673)	191,029	—	1,989	(6,806)	29,772
9 (Proj.)	—	10,984	(44,056)	157,957	—	1,712	(6,866)	24,618
10 (Proj.)	—	9,083	(41,115)	125,925	—	1,415	(6,408)	19,625
11 (Proj.)	—	7,241	(35,360)	97,806	—	1,128	(5,511)	15,242
12 (Proj.)	—	5,624	(27,637)	75,793	—	877	(4,307)	11,812
13 (Proj.)	—	4,357	(18,980)	61,170	—	679	(2,958)	9,533
14 (Proj.)	—	3,517	(16,166)	48,521	—	548	(2,519)	7,562
15 (Proj.)	—	2,790	(13,764)	37,547	—	435	(2,145)	5,852
16 (Proj.)	—	2,159	(11,714)	27,992	—	336	(1,826)	4,362
17 (Proj.)	—	1,610	(9,965)	19,637	—	251	(1,553)	3,060
18 (Proj.)	—	1,129	(8,475)	12,291	—	176	(1,321)	1,915
19 (Proj.)	—	707	(7,206)	5,792	—	110	(1,123)	902
20 (Proj.)	—	333	(6,125)	(0)	—	52	(954)	(0)

Explanation of columns:

(*a*) Carryover deferred acquisition costs.
(*b*) Interest on deferred acquisition costs.
(*c*) Deferred acquisition costs amortization (—-factor x EGP, per Schedule 4).
(*d*) Ending DAC = BOY DAC + (a) + (b) + (c).
(*e*) Total front-end fees from original and replacement policies.
(*f*) Interest on URL.
(*g*) URL amortization (—-factor x EGP, per Schedule 4).
(*h*) Ending URL = BOY URL + (e) + (f) + (g).

D-2: Schedule 6: Combined Deferred Acquisition Costs and URL After the Internal Replacement Transaction

Contract Year	*Deferred Acquisition Costs Original Contracts*	*Deferred Acquisition Costs Replaced Contracts*	*Total Deferred Acquisition Costs*	*URL Original Contracts*	*URL Replaced Contracts*	*Total URL*
	(*a*)	(*b*)	(*c*)	(*d*)	(*e*)	(*f*)
1 (Act.)	$1,745,439		$1,745,439	$272,016		$272,016
2 (Act.)	1,519,194		1,519,194	236,757		236,757
3 (Act.)	1,127,912		1,127,912	175,778		175,778
4 (Act.)	664,643		664,643	103,581		103,581
5 (Act.)	296,419	236,515	532,934	46,195	36,860	83,055
6 (Proj.)	188,696	247,585	436,281	29,407	38,585	67,992
7 (Proj.)	126,289	221,940	348,229	19,681	34,589	54,270
8 (Proj.)	93,388	191,029	284,417	14,554	29,772	44,326
9 (Proj.)	68,907	157,957	226,864	10,739	24,618	35,357
10 (Proj.)	50,691	125,925	176,616	7,900	19,625	27,525
11 (Proj.)	37,135	97,806	134,941	5,787	15,242	21,029
12 (Proj.)	27,042	75,793	102,835	4,214	11,812	16,026
13 (Proj.)	19,521	61,170	80,691	3,042	9,533	12,575
14 (Proj.)	13,910	48,521	62,431	2,168	7,562	9,730
15 (Proj.)	9,717	37,547	47,264	1,514	5,852	7,366
16 (Proj.)	6,573	27,992	34,565	1,024	4,362	5,386
17 (Proj.)	4,208	19,637	23,845	656	3,060	3,716
18 (Proj.)	2,418	12,291	14,709	377	1,915	2,292
19 (Proj.)	1,052	5,792	6,844	164	902	1,066
20 (Proj.)	0	(0)	0	0	(0)	0

Explanation of columns:

(*a*) EOY DAC for original contracts. After year 6, DAC related to contracts not electing the internal replacement transaction (per Schedule 2, column g).

(*b*) EOY DAC for contracts electing the internal replacement transaction at the end of year 5 (per Schedule 5, column d).

(*c*) Combined EOY DAC.

(*d*) EOY URL for original contracts. After year 6, URL related to contracts not electing the internal replacement transaction (per Schedule 2, column h).

(*e*) EOY URL for contracts electing the internal replacement transaction at the end of year 5 (per Schedule 5, column h).

(*f*) Combined EOY URL.

D-2: Schedule 7: Summary of Deferred Acquisition Costs and URL as a Result of Internal Replacement That Is Not Substantially Different

	Deferred Acquisition Costs	*URL*
Original (Year 5 balances)	$532,934	$83,055
Nonreplaced Contracts (Year 5 balances)	296,419	46,195
After Replacement (Year 5 balances)	236,515	36,860
	532,934	83,055
Difference	$ —	$ —

Summary of Accounting Entries

Deferred acquisition costs	$ 0	
Deferred Acquisition Costs Amortization		$ 0
Change in Unearned Revenue	$ 0	
URL		$ 0

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Glossary

Base contract. The type of contract specified in the policy form prior to the addition or election of riders or other contract features. For example, for an annuity with a guaranteed minimum income benefit (GMIB) rider, the annuity would be considered the base contract.

Contract exchange. The legal extinguishment of one contract and the issuance of another.

Coverage. An insurance enterprise's exposure to loss. The concept of coverage would typically include policy limits, deductible, insured, and covered property or insured event.

Existing contract. The contract that is currently held by the contract holder and excludes nonintegrated contract features.

General account. All operations of an insurance enterprise that are not reported in a separate account.

Integrated contract feature. A contract feature in which the benefits provided by the feature can be determined only in conjunction with the base contract.

Internal replacement. A modification in product benefits, features, rights, or coverages that occurs by the legal extinguishment of one contract and the issuance of another contract (a contract exchange); or by amendment, endorsement, or rider to a contract; or by the election of a benefit, feature, right, or coverage within the contract.

Nonintegrated contract feature. A contract feature in which the benefits provided are not related or dependent on the provisions of the base contract.

Original contract. The contract that was initially entered into by the contract holder prior to any potential internal replacement activity.

Ratchet death benefit. A death benefit equal to the highest account balance among prior specified anniversary dates adjusted for deposits less partial withdrawals since the specified anniversary date.

Replaced contract. The contract that currently is held by the contract holder, and is exchanged or modified in an internal replacement transaction.

Replacement contract. The new or modified contract in an internal replacement transaction.

Return of premium death benefit. A death benefit equal to the total deposits made by the contract holder less any withdrawals.

Reunderwriting. The reexamination of the insurance risk of the entire contract for purposes of acceptance or rejection or for rating the risk for pricing purposes.

Roll-up death benefit. A death benefit equal to the total of deposits made to the contract less an adjustment for partial withdrawals, accumulated at a specified interest rate.

Sales inducement to a contract holder. A product feature that enhances the investment yield to the contract holder. The three main types of sales inducements are (1) day one bonus, which increases the account value at inception, also called immediate bonus; (2) persistency bonus, which increases the account value at the end of a specified period; and (3) enhanced yield, which credits interest for a specified period in excess of rates currently being offered for other similar contracts. Sales inducements are defined as contractually obligated inducements that are explicitly identified in the contract and are in excess of current market conditions.

Separate account. A separate investment account established and maintained by an insurance enterprise under relevant state insurance law to which funds have been allocated for certain contracts of the insurance enterprise or similar accounts used for foreign originated products.

Surrender charge. Charges assessed at contract redemption, whole or partial, regardless of how the charges are labeled, such as contingent deferred sales charges.

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Section 10,930

Statement of Position 07–1 *Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*

June 11, 2007

NOTES

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, as amended, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

FASB Defers Effective Date of SOP 07-1

On February 14, 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) 07-1-1, *Effective Date of AICPA Statement of Position 07-1*. The FSP delays indefinitely the effective date of this Statement of Position (SOP). Entities that early adopted SOP 07-1 before December 15, 2007, are permitted but not required to continue to apply the provisions of the SOP. No other entities may adopt the provision of the SOP, subject to the following exception: If a parent entity that early adopted the SOP chooses not to rescind its early adoption, an entity consolidated by the parent entity that is formed or acquired after that parent entity's adoption of the SOP must apply the provisions of the SOP in its stand-alone financial statements. For the full text of the FSP, visit the FASB's Web site at www.fasb.org/pdf/fsp_sop07-1-1.pdf. Because of the issuance of FSP 07-1-1, the changes specified within this SOP have not been made to AICPA Audit and Accounting Guide *Investment Companies*.

Summary

This Statement of Position (SOP) provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide). For those entities that are investment companies under this SOP, this SOP also addresses whether the specialized industry accounting principles of the Guide (referred to as *investment company accounting*) should be retained by a parent company in consolidation or by an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment

in the entity (referred to as an *equity method investor*). In addition, this SOP includes certain disclosure requirements for parent companies and equity method investors in investment companies that retain investment company accounting in the parent company's consolidated financial statements or the financial statements of an equity method investor.

For purposes of the separate financial statements of an entity, the Guide is applicable to (1) entities regulated by the Investment Company Act of 1940 or similar requirements (as defined in paragraph .09 of this SOP) and (2) separate legal entities whose business purpose and activity are investing in multiple substantive investments for current income, capital appreciation, or both, with investment plans that include exit strategies. This SOP includes guidance on the application of that definition and other factors to consider in determining whether the entity is investing for (1) current income, capital appreciation, or both or (2) strategic operating purposes.

Entities that are investment companies are required to apply the provisions of the Guide in presenting their financial statements. Entities that are not investment companies should not apply the provisions of the Guide.

This SOP also provides guidance for determining whether investment company accounting applied by a subsidiary or equity method investee should be retained in the financial statements of the parent company or an equity method investor. That guidance should be used to evaluate relationships between (1) the parent company or equity method investor and (2) investees to determine, among other matters, whether the parent company or equity method investor (through the investment company) is investing for current income, capital appreciation, or both, rather than for strategic operating purposes. If the application of that guidance leads to the conclusion that investment company accounting should not be retained in the financial statements of the parent company or equity method investor, the financial information of the investment company should be adjusted as if investment company accounting had not been applied by the subsidiary or equity method investee for purposes of the consolidated financial statements of the parent company or the application of the equity method of accounting by an equity method investor.

The provisions of this SOP are effective for fiscal years beginning on or after December 15, 2007, with earlier application encouraged. Entities that previously applied the provisions of the Guide but that, pursuant to paragraphs .05–.29 of this SOP, do not meet the provisions of this SOP to be an investment company within the scope of the Guide (or that previously retained investment company accounting in the financial statements of a parent company or equity method investor, but do not meet the provisions of paragraphs .30–.45 of this SOP to retain investment company accounting in the financial statements of a parent company or equity method investor), should report the effects of adopting this SOP prospectively by accounting for their investments in conformity with applicable generally accepted accounting principles (GAAP) other than investment company accounting, beginning as of the date of the adoption using fair value in conformity with investment company accounting at the date of adoption as the carrying amount of investments at the date of adoption. Entities that are investment companies within the scope of the Guide (or meet the provisions of paragraphs .30–.45 to retain investment company accounting in the financial statements of a parent company or equity method investor), but that previously had not followed the provisions of the Guide (or previously did not retain investment company accounting in the financial statements of a parent company or equity method investor), should report the cumulative effect of adopting this SOP as an adjustment to opening retained earnings as of the beginning of the year that this SOP is adopted.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed

exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least four of the seven FASB members do not object to AcSEC undertaking the project,[1] issuing the proposed exposure draft, or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing a final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Introduction and Background

.01 The purpose of this Statement of Position (SOP) is to clarify the scope of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide) to assist preparers and auditors in determining whether the provisions of the Guide should be applied. This SOP clarifies the scope of the Guide by amending the Guide to provide specific guidance for determining whether an entity is within its scope. In addition, this SOP provides guidance for determining whether the specialized industry accounting principles of the Guide (referred to as *investment company accounting*) should be retained in the financial statements of a parent company of an investment company or an equity method investor in an investment company, and includes certain disclosure requirements.

Conclusions

.02 Paragraphs 1.01 to 1.06 in Chapter 1 of the Guide, including related footnotes, are deleted and replaced with the following paragraphs .03–.29 and paragraph .48 of this SOP. Other paragraph numbers in Chapter 1 of the Guide, starting with paragraph 1.07, are renumbered accordingly.[2] Paragraphs .30 to .47 and paragraph .49 of this SOP, including related footnotes,

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[1] At the time AcSEC undertook this project, at least five of the seven FASB members were required to not object to AcSEC undertaking the project.

[2] For practical purposes, paragraphs .03–.53 of this SOP include the conclusions in this SOP that are amendments to the Guide, rather than including those amendments to the Guide in a separate section of the SOP. In addition, certain wording in this SOP may undergo minor editorial revision to conform it to inclusion in the Guide. For example, in certain circumstances the sections of this SOP that are amendments to the Guide refer to the Guide as "this Guide," to reflect wording that will be included in the amended Guide. In other circumstances, however, such as circumstances in which paragraph numbers within this SOP are cited, the sections of this SOP that are amendments to the Guide refer to "paragraph XX of this *SOP*," rather than "paragraph XX of this *Guide*," in order to help readers of this SOP more easily refer to those paragraphs as they are numbered within this SOP. When including the provisions of this SOP in the Guide, references to paragraphs as they are numbered within this SOP will be changed to refer to the paragraph numbers as they will be numbered within the Guide, and those references will refer to the Guide, rather than to the SOP.

will be inserted as a separate chapter of the Guide. The disclosure requirements included in paragraphs .50, .51, and .53 of this SOP will be included in that new chapter. The disclosure requirements included in paragraph .52 of this SOP will be inserted before paragraph 7.79 in Chapter 7 of the Guide. The illustrations in Appendix B [paragraph .60], "Illustrations," of this SOP will be included as an appendix of the Guide. Appendix C [paragraph .61], "Applying the Provisions of This SOP to Entities That Hold Investments in Real Estate," of this SOP will be included as an appendix of the Guide. Appendix E [paragraph .63], "Schedule of Paragraph Numbers in This SOP and How They Will Be Reflected in the Revised Guide," of this SOP provides a schedule of paragraph numbers in this SOP and how they will be reflected in the Guide, as amended by this SOP.

Background

.03 *(Replaces paragraph 1.01 of the Guide)* The business activity of an ***investment company***,[3] as defined in paragraph .05 of this SOP, is investing for current income, capital appreciation, or both. Those investments typically consist of securities of other entities, but may also include commodities, securities based on indices, derivatives, real estate, and other forms of investments. An investment company sells its capital shares to an investor(s), invests the proceeds to achieve its investment objectives, and distributes to its investor(s), in the form of cash or distributions of ownership interests in investees, income earned on investments, and proceeds realized on the disposition of investments, net of expenses of the investment company. Investment companies, other than certain separate accounts of insurance companies, which are discussed in paragraph .09 of this SOP, are organized as separate legal entities, such as corporations (in the case of mutual funds, under the laws of certain states that authorize the issuance of common shares redeemable on demand of individual shareholders), common law trusts (sometimes referred to as *business trusts*), limited partnerships, limited liability investment partnerships and companies, and other specialized entities.

.04 *(Replaces paragraph 1.02 of the Guide)* The investment company industry is highly specialized and certain entities may be subject to specific governmental regulation and special tax treatment. Accordingly, before starting an engagement to audit an investment company's financial statements, an auditor should become familiar with the entity's business, organization, and operating characteristics; the industry's terminology; and pertinent legislation, as well as any applicable securities and income tax rules and regulations.

Scope

Overview

.05 *(Replaces paragraph 1.03 of the Guide)* An investment company is a separate legal entity[4] whose business purpose and activity are investing in multiple substantive investments for current income, capital appreciation, or both, with investment plans that include exit strategies. Accordingly, investment companies do not acquire or hold investments for strategic operating purposes and do not obtain benefits (other than current income, capital appreciation,

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[3] Terms defined in the "glossary" of the Guide are set in **boldface** type the first time they appear in this SOP.

[4] Separate accounts of insurance companies as defined in the "glossary" of the Guide, which are discussed in paragraph .09 of this SOP, are not separate legal entities but nevertheless are investment companies under the scope of the Guide.

or both) from investees that are unavailable to noninvestor entities that are not related parties to the investee.[5]

.06 *(Replaces paragraph 1.04 of the Guide)* The initial determination of whether an entity is an investment company within the scope of the Guide should be made upon formation of the entity and that determination should be reconsidered each reporting period.[6]

.07 *(Replaces paragraph 1.05 of the Guide)* Entities that meet the definition of an *investment company* in paragraph .05 of this SOP and entities regulated by the Investment Company Act of 1940 (the 1940 Act) or similar requirements as described in paragraphs .09 and .10 of this SOP should apply the accounting principles and reporting requirements in the Guide (investment company accounting) to their separate financial statements.[7] Entities that are neither entities regulated by the 1940 Act or similar requirements as described in paragraphs .09 and .10 nor an *investment company* under the definition in paragraph .05 should not apply investment company accounting.

.08 *(Replaces paragraph 1.06 of the Guide)* Entities other than entities regulated by the 1940 Act or similar requirements as described in paragraphs .09 and .10 of this SOP should apply the guidance in paragraphs .11–.29 of this SOP to determine whether the entity meets the definition of an *investment company* in paragraph .05 of this SOP. In addition, paragraphs .11–.18 of this SOP elaborate on certain requirements and terms used in the definition in paragraph .05. Paragraphs .19–.29 of this SOP discuss factors that provide evidence about whether an entity meets the definition of an *investment company*. Appendix B [paragraph .60] of this SOP includes illustrations of the application of that guidance to specific fact patterns. In considering the factors discussed in paragraphs .19–.29 and their effect on the conclusion about whether an entity is an investment company, some factors may be more or less significant than others, depending on the facts and circumstances, and therefore more or less heavily weighted in determining whether an entity is an investment company. No single factor discussed in paragraphs .19–.29, however, is necessarily determinative of whether the entity is an investment company.

Entities Regulated by the 1940 Act or Similar Requirements

.09 *(Added as paragraph 1.07 of the Guide)* Entities, including entities in foreign jurisdictions, that are regulated or registered in such a manner that

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[5] FASB Statement No. 57, *Related Party Disclosures*, defines *related parties* as follows:

> Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

[6] Paragraph .48 of this SOP provides guidance pertaining to circumstances in which the conclusion about whether an entity is within the scope of the Guide changes in a subsequent period.

[7] Entities are not within the scope of the Guide if pronouncements in categories (*a*) or (*b*) of Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1, AU sec. 411), as amended, provide measurement guidance for their investments. For example, entities that are within the scope of FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, are not within the scope of the Guide. Similarly, entities that are within the scope of the AICPA Audit and Accounting Guide, *Employee Benefit Plans*, are not within the scope of the Guide.

they are subject to the requirements of the 1940 Act, the Small Business Investment Company Act of 1958, or similar requirements are within the scope of the Guide (referred to herein as *entities regulated by the 1940 Act or similar requirements*). Examples of entities regulated by the 1940 Act or similar requirements include management investment companies and unit investment trusts (UITs) registered under the 1940 Act (which may be open-end mutual funds or closed-end funds), small business investment companies (SBICs), business development companies (BDCs), and certain offshore funds. Also, for purposes of applying the guidance in this Guide, the separate accounts of insurance companies as defined in the glossary of the Guide and common (collective) trust funds are considered entities regulated by the 1940 Act or similar requirements.[8]

.10 *(Added as paragraph 1.08 of the Guide)* To be an entity regulated by the 1940 Act or similar requirements, the entity should be subject to regulations or similar rules that require the entity to report its investments at fair value for regulatory or similar reporting purposes. In addition, regulations or similar rules regarding the following should be considered in determining whether the entity is subject to certain reporting and other requirements sufficiently similar to the regulations of the 1940 Act or the Small Business Investment Company Act of 1958:

a. Registration requirements

b. Reporting and disclosures to investor(s)

c. Fiduciary duties of the investment manager and related entities

d. Diversification of investments

e. Recordkeeping and internal controls

f. Purchases and redemptions of shares at fair value

Express Business Purpose

.11 *(Added as paragraph 1.09 of the Guide)* The definition of an *investment company* in paragraph .05 of this SOP requires that the business purpose of an investment company is investing for current income, capital appreciation, or both. In determining whether that requirement is met, the express business purpose of the entity should be considered. Evidence about the entity's express business purpose may include the manner in which the entity presents itself to other parties (including potential investor(s), if any, and potential investees). For example, an entity that presents itself as a *private equity investor* with the objective of investing for capital appreciation has an express business purpose that is consistent with the business purpose of an investment company. Alternatively, an entity that presents itself as an investor whose objective is to invest for strategic operating purposes has an express business purpose that is inconsistent with the business purpose of an investment company.

[8] This Guide addresses explicitly the financial statements of separate accounts of insurance companies as defined in the glossary of the Guide. This Guide does not address an insurance enterprise's accounting for its proportionate interest in a separate account. Paragraph .13 of SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts,* provides that an insurance enterprise's proportionate interest in the assets of a separate account does not qualify for separate account treatment, as it does not represent contract holder funds. Consequently, the assets underlying the insurance enterprise's proportionate interest should be classified and measured as general account assets in conformity with paragraphs 45–51 of FASB Statement No. 60, *Accounting and Reporting by Insurance Companies*, as amended.

Other evidence about the entity's express business purpose may include a prior history of purchasing and selling investments, the entity's offering memorandum, publications distributed by the entity, and other corporate or partnership documents that indicate the investment objectives of the entity. Entities that have express business purposes other than investing for current income, capital appreciation, or both do not meet the definition of an *investment company* in paragraph .05.

The Entity's Activities, Assets, and Liabilities are Limited to Investment Activities, Assets, and Liabilities

.12 *(Added as paragraph 1.10 of the Guide)* The definition of an *investment company* in paragraph .05 of this SOP requires that the business purpose and activity of an investment company is investing for current income, capital appreciation, or both. To meet that requirement, the entity should have no substantive activities other than its investment activities and have no significant assets or liabilities other than those related to its investment activities, subject to the exceptions in paragraph .13 of this SOP. Entities that have substantive activities other than investment activities or have significant assets or liabilities unrelated to investment activities do not meet the definition of an *investment company* in paragraph .05, subject to the exceptions in paragraph .13.

.13 *(Added as paragraph 1.11 of the Guide)* Undertaking the following activities and having the following assets or liabilities does not lead to the conclusion that the business purpose and activity of the entity is other than investing for current income, capital appreciation, or both:

- Operating activities related to services provided to investment companies, as discussed in paragraph 7.05 of the Guide.
- Investment companies sometimes make investments in securities that are collateralized by noninvestment assets. If the investment company takes control of the collateral as a result of defaults related to the investments, holding such assets (and related liabilities) on a temporary basis does not affect the status of the entity as an investment company, provided that the entity did not acquire those investments with the intention of taking control of the collateral.

Multiple Substantive Investments

.14 *(Added as paragraph 1.12 of the Guide)* The definition of an *investment company* in paragraph .05 of this SOP requires that the investment company invest in multiple substantive investments. That requirement contemplates that the entity should hold multiple substantive investments directly or through another investment company. For equity investments in other entities, those investees should be organized as separate legal entities, except for temporary investments resulting from the foreclosure or liquidation of the original investment, as discussed in the second bullet of paragraph .13 of this SOP. Paragraphs .15 and .16 of this SOP discuss other applications of that guidance.

.15 *(Added as paragraph 1.13 of the Guide)* The provisions of the definition of an *investment company* pertaining to multiple substantive investments do not require that an investment company hold multiple substantive investments at all times throughout its existence. For example, entities that have not yet completed their initial offering period, or have not yet identified suitable investments, may have not yet executed their investment plan to acquire multiple substantive investments. Also, entities sometimes have less than multiple substantive investments during their liquidation stage. The definition of an *investment company* is not intended to exclude entities merely because those entities at times do not hold multiple substantive investments. However, the business purpose of the entity should include plans to hold multiple substantive investments simultaneously to meet the definition of an *investment company*.

.16 *(Added as paragraph 1.14 of the Guide)* Investment companies sometimes have less than multiple substantive investments in circumstances in which they are formed (for legal, regulatory, tax, or other reasons) in conjunction with another investment company that holds multiple substantive investments (directly or indirectly) or by investors in that other investment company in order to hold certain investments. For example, investment companies sometimes establish subsidiary investment companies to hold certain individual investments for legal reasons. Also, certain investors in an investment company sometimes, for regulatory or other reasons, form a separate legal entity to hold certain investments that cannot be owned directly by the investment company or indirectly by certain investors in the investment company for regulatory or other reasons. The provisions of the definition of an *investment company* pertaining to multiple substantive investments do not preclude treatment of such related entities as investment companies if such entities otherwise meet the definition of an *investment company*.

Exit Strategies

.17 *(Added as paragraph 1.15 of the Guide)* The definition of an *investment company* in paragraph .05 of this SOP requires that the investment company have investment plans that include exit strategies. That requirement contemplates that, for each investment, both of the following exist:

a. The entity has identified potential exit strategies even though it may not yet have determined the specific method of exiting the investment; for example, whether the investment may be exited through the sale of securities in a public market, an initial public offering of equity securities, a private placement of equity securities, distributions to investors of ownership interests in investees (typically in the form of marketable equity securities), sales of assets (including the sale of an investee's assets followed by a liquidation of the investee), or holding a debt security to maturity.

b. The entity has defined the time at which it expects to exit the investment, which may be either an expected date or range of dates; a time defined by specific facts and circumstances, such as achieving certain milestones; the limited life of the entity; or the investment objectives of the entity.

Not for Strategic Operating Purposes

.18 *(Added as paragraph 1.16 of the Guide)* The definition of an *investment company* in paragraph .05 of this SOP prohibits investment companies from holding investments for strategic operating purposes. Investments are held for strategic operating purposes if the entity or its affiliates[9] obtain or have the objective of obtaining benefits (other than benefits attributable to the

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[9] FASB Statement No. 57 defines an *affiliate* as "a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise."

ownership interest, such as dividends) as a result of investments in any investee, through relationships with the investee or its affiliates, that are unavailable to noninvestor entities that are not related parties to the investee. Examples of relationships and activities that violate this requirement include, but are not limited to, the following:

a. The acquisition, use, exchange, or exploitation of the processes, intangible assets, or technology of the investee or its affiliates by the entity or its affiliates.

b. Significant purchases or sales of assets (other than products or services as discussed in item *e* below) between the investee or its affiliates and the entity or its affiliates.

c. Joint ventures or similar arrangements between the investee or its affiliates and the entity or its affiliates.

d. Other arrangements between the investee or its affiliates and the entity or its affiliates to jointly develop, produce, market, or provide products or services.

e. Other transactions between the investee or its affiliates and the entity or its affiliates that (1) are on terms that are unavailable to entities that are not related parties to the investee, (2) are not at a price the transaction would occur in an orderly transaction between market participants at the measurement date (and that price is objectively verifiable), or (3) represent a significant portion of the investee's or the entity's business activity, including business activities of investees or affiliates of the entity. (Transactions that (1) do not represent a significant portion of the investee's business activities and that are between the investee or its affiliates and the entity or its affiliates and (2) involve products or services of the investee or its affiliates that are available to entities or customers that are not related parties to the investee on similar terms do not violate this condition if the transactions occur at a price the transaction would occur in an orderly transaction between market participants at the measurement date and that price is objectively verifiable by similar transactions between (*a*) the investee or its affiliates and entities that are not related parties to the investee or (*b*) the investor or its affiliates and entities that are not investees or affiliates of the investor or investees.)

f. The entity or its affiliates have disproportionate rights, exclusive rights, or rights of first refusal to purchase or otherwise acquire assets, technology, products, or services of investees or their affiliates, subject to the exception in the second bullet of paragraph .13 of this SOP. (Rights of first refusal to purchase or otherwise acquire direct ownership interests would not violate this provision.)

Entities that hold investments for strategic operating purposes as demonstrated by relationships with investees or their affiliates, such as those described above, do not meet the definition of an *investment company.*

Factors to Consider

.19 *(Added as paragraph 1.17 of the Guide)* All relevant facts and circumstances should be considered in applying the definition of an *investment company* in paragraph .05 of this SOP. In particular, the factors in paragraphs .20–.29 of this SOP should be considered in applying that definition. In considering the factors discussed in paragraphs .20–.29 and their effect on the conclusion about whether an entity is an investment company, some factors may be more or less significant than others, depending on the facts and circumstances, and therefore more or less heavily weighted in determining whether an entity is an investment company. The factors in paragraph .20 of this SOP, pertaining to the number of substantive investors in the entity (pooling of funds), and paragraph .21 of this SOP, pertaining to the level of ownership interests held in investees, typically are more significant and therefore typically provide more persuasive evidence than other factors. Accordingly, as the (*a*) extent of pooling of funds increases, or (*b*) level of ownership interests held in investees decreases, the weight of other factors providing evidence that the entity is investing for strategic operating purposes typically decreases. Conversely, as the (*a*) extent of pooling of funds decreases or (*b*) level of ownership interests held in investees increases, the weight of other factors providing evidence that the entity is investing for strategic operating purposes typically increases. No single factor discussed in paragraphs .20–.29, however, is necessarily determinative of whether the entity is an investment company.

.20 *(Added as paragraph 1.18 of the Guide) Number of substantive investors in the entity (pooling of funds).* Pooling of funds from numerous investors to avail owners of professional investment management provides significant evidence about the business purpose of the entity. The more extensive the pooling of funds (more investors and smaller ownership interests by the investors) to avail owners of professional investment management, the greater the evidence that the entity is investing for current income, capital appreciation, or both.[10] (Investments of investors that are related parties as defined in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 57, *Related Party Disclosures,* should be combined and treated as a single investor for purposes of considering this factor.)

.21 *(Added as paragraph 1.19 of the Guide) Level of ownership interests in investees*. The level of ownership interests held in investees provides significant evidence about the business purpose of the entity. Significant levels of ownership interests in investees, particularly in circumstances in which the entity has controlling financial interests in investees, provide significant evidence that the entity is investing for strategic operating purposes. Conversely, relatively minor levels of ownership interests in investees may provide significant evidence that the entity is investing for current income, capital appreciation, or both, rather than for strategic operating purposes. In considering this factor, entities should consider the level of ownership interests in investees and the significance of those investees in relation to the total investment portfolio.[11]

.22 *(Added as paragraph 1.20 of the Guide) Substantial ownership by passive investors*. Substantial ownership by passive investors, as opposed to

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[10] An investment company that is formed (for legal, regulatory, tax, or other reasons) in conjunction with another investment company that holds multiple substantive investments (directly or indirectly), as discussed in paragraph .14 of this SOP, may be wholly owned without providing evidence that it is investing for strategic operating purposes. For example, the primary investment company's documents may provide that the general partner is required to invest in all the same investments as the primary investment company, but must do so through a separate wholly-owned entity. In circumstances in which the wholly-owned entity is formed in conjunction with another investment company, the fact that the entity is wholly owned would not necessarily provide evidence that it is investing for strategic operating purposes.

[11] In considering the level of ownership interests in investees and the significance of those investees in relation to the total investment portfolio, entities should consider the remaining amount of committed capital to be invested and the investment plans for those future capital contributions.

substantial ownership by principal investors who determine the strategic direction or run the day-to-day operations of the entity, in an entity with the express business purpose of investing for current income, capital appreciation, or both provides evidence that supports that express business purpose. The more substantial the ownership by passive investors, the greater the evidence supporting the express business purpose.

.23 *(Added as paragraph 1.21 of the Guide) Substantial ownership by employee benefit plans.* Substantial ownership by employee benefit plans provides evidence that the entity is investing for current income, capital appreciation, or both. The more substantial the ownership by employee benefit plans, the greater the evidence that the entity is investing for current income, capital appreciation, or both.

.24 *(Added as paragraph 1.22 of the Guide) Involvement in the day-to-day management of investees, their affiliates, or other investment assets.* Involvement in the day-to-day management of investees, their affiliates, or other investment assets by the entity or its affiliates provides evidence that the entity is investing for strategic operating purposes. The more extensive the involvement in the day-to-day management of investees, their affiliates, or other investment assets, the greater the evidence that the entity is investing for strategic operating purposes. For investment companies, such involvement sometimes is initiated in order to address a particular concern pertaining to a particular investee to maximize the value of the investment. In such circumstances, the period of involvement typically is limited to the period of time necessary to address the concern, rather than being open-ended or permanent. As the reasons for and extent of involvement in the day-to-day management of investees, their affiliates, or other investment assets go beyond that described in the previous two sentences, the evidence that the entity is investing for strategic operating purposes becomes greater. Participation on the boards of directors of investees or their affiliates or providing limited temporary assistance to management of investees or their affiliates is not necessarily inconsistent with the definition of an *investment company*. (Assistance to investees or their affiliates is not considered temporary or occasional if it is provided on a continuous or repeated basis to multiple investees or their affiliates that represent a significant portion of the investment portfolio of the entity, or if the entity and its affiliates do not have plans to discontinue such assistance to each investee or investee affiliate).

.25 *(Added as paragraph 1.23 of the Guide) Significant administrative or support services provided to investees or their affiliates.* Investees or their affiliates sometimes utilize significant administrative or support services provided by the entity or its affiliates. Examples of such administrative or support services include legal advice, centralized cash management, or other administrative services that typically are provided by a parent to its subsidiaries or its operating divisions. In some circumstances, investees may be required to utilize such services, while in other circumstances investees have the option of utilizing such services. Such involvement provides evidence that the entity is investing for strategic operating purposes. The greater the level of such administrative or support services, particularly on a required, continuous, or repeated basis to multiple investees or their affiliates, the greater the evidence that the entity is investing for strategic operating purposes.

.26 *(Added as paragraph 1.24 of the Guide) Financing guarantees or assets to serve as collateral provided by investees for borrowing arrangements of the entity or its affiliates.* At the entity's request, investees or their affiliates sometimes provide financing guarantees or assets to serve as collateral for borrowing arrangements of the entity or the entity's affiliates. Such arrangements provide evidence that the entity is investing for strategic operating purposes. The more extensive such financing guarantees or assets serving as collateral, the greater the evidence that the entity is investing for strategic operating purposes. Arrangements in which the entity's ownership interest in an investee serves as collateral for borrowing arrangements of the entity or the entity's affiliates, however, are not inconsistent with the definition of an *investment company*. Also, arrangements in which the entity or its affiliates guarantee debt of an investee or its affiliates are not necessarily inconsistent with the definition of an *investment company*.

.27 *(Added as paragraph 1.25 of the Guide) Provision of loans by noninvestment company affiliates of the entity to investees or their affiliates.* Noninvestment company affiliates of the entity sometimes provide loans to investees or their affiliates. Depending on the terms of the loans and other factors, such arrangements may provide evidence that the entity is investing for strategic operating purposes. However, such loans are not inconsistent with the definition of an *investment company* if all of the following exist:

- The terms of the loans are at fair value.
- The loans are not required as a condition of the investment.
- The loans are not made to most of the investees or their affiliates.
- Making the loans is part of the usual business activity of the noninvestment company affiliate.

.28 *(Added as paragraph 1.26 of the Guide) Compensation of management or employees of investees or their affiliates is dependent on the financial results of the entity or the entity's affiliates*. Compensation of management or employees of investees or their affiliates sometimes is dependent on the financial results of the entity or the entity's affiliates. An example of compensation of management or employees of investees or their affiliates being dependent on the financial results of the entity is the granting of options to acquire stock in the entity or its affiliates to management or employees of an investee or its affiliates. Such compensation arrangements provide evidence that the entity is investing for strategic operating purposes. The more extensive such compensation arrangements, the greater the evidence that the entity is investing for strategic operating purposes.

.29 *(Added as paragraph 1.27 of the Guide) Directing the integration of operations of investees or their affiliates or the establishment of business relationships between investees or their affiliates*. The entity or its affiliates sometimes direct the integration of operations of investees or their affiliates or the establishment of business relationships between investees or their affiliates. Such relationships may include joint ventures or other arrangements between investees, significant purchases or sales of assets or other transactions between investees, investees' participation with other investees in administrative arrangements, investees providing financing to other investees, or investees providing guarantees or collateral for borrowing arrangements of other investees. Directing the integration of operations of investees or their affiliates or establishing business relationships between investees or their affiliates provides evidence that the entity is investing for strategic operating purposes. The more extensive the direction of the integration of operations or establishment of business relationships, the greater the evidence that the entity is investing for strategic operating purposes.

Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies[12, 13]

Overview

.30 *(Added as paragraph 9.01 of the Guide)* An investment company that is within the scope of the Guide may be (*a*) a subsidiary of another entity or (*b*) an investment of an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the entity (referred to collectively as *parent company* or *equity method investor*).[14] [15] If so, investment company accounting should be retained in the financial statements of the parent company or equity method investor only if the applicable conditions in items *a* through *c* below exist:

a. In order to retain investment company accounting in the financial statements of the parent company or equity method investor, a subsidiary or equity method investee that is an entity regulated by the 1940 Act or similar requirements as described in paragraphs .09–.10 of this SOP and, therefore, within the scope of the Guide for purposes of its separately issued financial statements, should also meet the definition of an *investment company* pursuant to the guidance in paragraphs .05 and .11–.29 of this SOP.

b. In order to retain investment company accounting in the financial statements of the parent company, the consolidated group (the parent company and its consolidated subsidiaries) should follow established policies that effectively distinguish the nature and type of investments made by the investment company from the nature and type of investments made by other entities within the consolidated group that are not investment companies.[16] Those policies should address, at a minimum, (1) the degree of influence held by the investment company and its related parties over the investees of the investment company, (2) the extent to which investees

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[12] *Note to Readers: The following paragraphs .30–.47, and paragraphs .49–.51 and .53 of this SOP, including related footnotes, will be inserted as a separate chapter of the Guide. That new chapter will be Chapter 9, "Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies." Other chapter numbers of the Guide are renumbered accordingly.*

[13] Investors in investment companies that are other than parent companies or equity method investors should refer to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* which applies to investments in equity securities that have readily determinable fair values and to all investments in debt securities, for guidance on accounting for investments in investment companies that have readily determinable fair values. Not-for-profit organizations that are investors in investment companies that are other than parent companies or equity method investors should refer to FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, which applies to not-for-profit organizations' investments in equity securities that have readily determinable fair values and to all investments in debt securities, for guidance on accounting for investments in investment companies that have readily determinable fair values.

[14] If an investor applies the equity method of accounting under Emerging Issues Task Force (EITF) Topic D-46, *Accounting for Limited Partnership Investments,* EITF Issue No. 03-16, *Accounting for Investments in Limited Liability Companies*, or the provisions of SOP 78-9, *Accounting for Investments in Real Estate Ventures,* to an investment in an investment company, in circumstances in which the investor does not have the ability to exercise significant influence over the investee, that investor should retain investment company accounting in the application of the equity method, as discussed in paragraph .47 of this SOP.

[15] As discussed in footnote 8, this Guide does not address an insurance enterprise's accounting for its proportionate interest in a separate account.

[16] The consolidated group need not follow those policies in order to retain investment company accounting in circumstances in which the investments and the effects of holding the investments would be reported the same in the consolidated financial statements regardless of whether they are held by the parent company or the investment company. For purposes of

of the investment company or their affiliates are in the same line of business as the parent company or its related parties, and (3) the level of ownership interest held in the investment company by the consolidated group. The guidance in this condition is intended to prohibit the consolidated group from selectively making investments within an investment company subsidiary that are similar to investments held by noninvestment company members of the consolidated group when those investments would be accounted for by the equity method, by consolidation, or at cost if the investment were made by a noninvestment company member of the consolidated group.[17] Such policies should include sufficient details and information to distinguish investment company investments from other investments in the consolidated group.

c. In order to retain investment company accounting in the financial statements of the parent company or equity method investor, the parent company, or equity method investor (through the investment company), should be investing for current income, capital appreciation, or both, rather than for strategic operating purposes. (Paragraphs .34 to .45 of this SOP discuss this condition further.)

.31 *(Added as paragraph 9.02 of the Guide)* The parent company should, at the inception of acquiring its interest in a particular investment company subsidiary or upon formation of an investment company subsidiary, make a determination about whether, pursuant to the provisions of this Guide, the subsidiary is an investment company for which investment company accounting should be retained in the consolidated financial statements. If any of the applicable conditions in paragraph .30 of this SOP do not exist in relation to any investment company subsidiary for which it was previously concluded that investment company accounting should be retained in the consolidated financial statements of the parent company, investment company accounting should not be retained in the consolidated financial statements of the parent company, and the financial information of all investment company subsidiaries should be adjusted (as if the investment company subsidiary(ies) had not applied the Guide) in applying consolidation accounting to all investment company subsidiaries. The parent company may, at the inception of acquiring its interest in a particular investment company or upon formation of an investment company subsidiary, reach a conclusion that, pursuant to the provisions of this Guide, investment company accounting for that particular subsidiary should not be retained in the consolidated financial statements of the parent company.[18] In those circumstances in which investment company accounting has never been retained in the consolidated financial statements of the parent company for a particular investment company subsidiary (that subsidiary has never been considered an investment company for purposes of the consolidated financial

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applying the guidance in the previous sentence, reporting an item in other comprehensive income rather than in income from operations is not considered "the same in the consolidated financial statements."

[17] Equity investments are discussed in this paragraph for purposes of illustrating how the guidance would be applied to those investments. The same guidance would apply, however, to investments other than equity investments, such as investments in commodities, real estate, securities based on indices, derivatives, and other forms of investments.

[18] As discussed in paragraph .57 of this SOP, the parent company should make a similar determination at adoption of this SOP for all investment company subsidiaries. Accordingly, if it is determined at adoption of this SOP that, pursuant to the provisions of this SOP, investment company accounting for a particular investment company subsidiary should not be retained in the consolidated financial statements of the parent company, the fact that the conditions to retain investment company accounting in consolidation for that particular subsidiary are not met has no effect on whether the parent company should retain investment company accounting in its consolidated financial statements for other investment company subsidiary(ies).

statements of the parent company), the fact that the conditions to retain investment company accounting in consolidation for that particular subsidiary are not met has no effect on whether the parent company should retain investment company accounting in its consolidated financial statements for other investment company subsidiary(ies).

.32 *(Added as paragraph 9.03 of the Guide)* The equity method investor should, at the inception of acquiring its interest in a particular investment company, make a determination about whether, pursuant to the provisions of this Guide, the equity method investee is an investment company for which investment company accounting should be retained in the financial statements of the equity method investor. If any of the applicable conditions in paragraph .30 of this SOP do not exist in relation to an investment in an investment company by an equity method investor for an investment company investee for which it was previously concluded that investment company accounting should be retained in the financial statements of the equity method investor, investment company accounting should not be retained in the financial statements of the equity method investor in reporting its investment in the investment company for which the applicable conditions in paragraph .30 do not exist. In addition, investment company accounting should not be retained in the financial statements of the equity method investor in reporting its investment in other investment companies that are both:

a. Subject to the equity method investor's ability to exercise significant influence, and

b. Managed by the same general partner, investment adviser, or functional equivalent or related party of that general partner, investment advisor, or functional equivalent of the entity for which the applicable conditions in paragraph .30 do not exist.

If investment company accounting is not retained in the financial statements of an equity method investor pursuant to the previous two sentences, the investment company's(ies') financial information should be adjusted (as if the investment company(ies) had not applied the Guide) in applying equity method accounting to investment companies for which investment company accounting is not retained. In some circumstances, an equity method investor may have equity method investments in other investment companies that are (*a*) subject to the equity method investor's ability to exercise significant influence but (*b*) not managed by the same general partner, investment adviser, or functional equivalent or related party of that general partner, investment adviser, or functional equivalent of the entity for which it was previously concluded that investment company accounting should be retained in the financial statements of the equity method investor entity and for which the applicable conditions in paragraph .30 are not met. In those circumstances, that equity method investor should consider whether the (*a*) facts and circumstances that cause the equity method investor not to meet the applicable conditions in paragraph .30 for investments in certain investment companies affect (*b*) the determination about whether investment company accounting should be retained for investments in other investment companies over which the investor has the ability to exercise significant influence but that are not managed by the same general partner, investment adviser, or functional equivalent or related party of that general partner, investment adviser, or functional equivalent of the entity for which for which the applicable conditions in paragraph .30 are not met. The equity method investor may, at the inception of acquiring its interest in a particular investment company or upon formation of an investment company investee, reach a conclusion that, pursuant to the provisions of this Guide, investment company accounting for that particular equity method investee should not be retained in the financial statements of the equity method investor.[19] In those circumstances in which investment company accounting has never been retained in the financial statements of the equity method investor for a particular investment company equity method investee (that equity method investee has never been considered an investment company for purposes of the financial statements of the equity method investor), the fact that the conditions to retain investment company accounting in the financial statements of the equity method investor for that particular equity method investee are not met has no effect on whether the equity method investor should retain investment company accounting in its financial statements for other investment company equity method investees.

.33 *(Added as paragraph 9.04 of the Guide)* As discussed in paragraph .30c of this SOP, in order to retain investment company accounting in the financial statements of the parent company or equity method investor, the parent company or equity method investor (through the investment company) should be investing for current income, capital appreciation, or both, rather than for strategic operating purposes. In determining whether investment company accounting should be retained, parent companies and equity method investors should consider:

a. The degree of influence held by the investment company and its related parties over the investees of the investment company or affiliates of investees.

b. The significance of the investments of the investment company that represent controlling financial interests.

c. The significance of services provided and activities engaged in between and among the parent company, equity method investor, the investment company, or related parties of the parent company, equity method investor, or the investment company and investees or affiliates of investees.

d. The level of ownership interest held in the investment company by the parent company or equity method investor.

e. The extent to which investees of the investment company or their affiliates are in the same line of business as the parent company, equity method investor, or related parties of the parent company or equity method investor (referred to herein as *their related parties*).

As the extent of items *a* through *e* in the previous sentence becomes more significant, it becomes less likely that the parent company or equity method investor would retain investment company accounting.[20]

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[19] As discussed in paragraph .57 of this SOP, the equity method investor should make a similar determination at adoption of this SOP for all investment company equity method investees. Accordingly, if it is determined at adoption of this SOP that, pursuant to the provisions of this SOP, investment company accounting for a particular investment company equity method investee should not be retained in the financial statements of the equity method investor, the fact that the conditions to retain investment company accounting for that particular equity method investee are not met has no effect on whether the equity method investor should retain investment company accounting in its financial statements for other investment company equity method investees.

[20] For parent companies, the guidance in paragraphs .30–.45 of this SOP should be applied for each consolidated financial statement presented. For example, assume entity *A* is an investment company under the provisions of this Guide. Assume entity *B* owns 100 percent of entity *A* in addition to other assets, and that entity *C* owns 100 percent of entity *B* in addition to other assets. Entity *B* should consider the guidance in paragraphs .30–.45 in accounting for its investment in entity *A* and entity *C* should consider the guidance in paragraphs .30–.45 in accounting for its indirect investment in entity *A*. However, in circumstances in which entity *B* does not qualify to retain investment company accounting in reporting its investment in entity *A*, entity *C* would not qualify to retain investment company accounting in reporting its indirect investment in entity *A*.

The Parent Company or Equity Method Investor (Through the Investment Company) Is Investing for Current Income, Capital Appreciation, or Both, Rather Than for Strategic Operating Purposes

.34 *(Added as paragraph 9.05 of the Guide)* Paragraph .30c of this SOP requires that to retain investment company accounting in the financial statements of the parent company or equity method investor, investees of the investment company should be held by the parent company or equity method investor (through the investment company) for current income, capital appreciation, or both, rather than for strategic operating purposes. That requirement is not met if the (*a*) conditions in paragraphs .35–.37 of this SOP are not met or (*b*) factors in paragraphs .38–.45 of this SOP lead to the conclusion that the parent company or equity method investor (through the investment company) is investing for strategic operating purposes. In considering the factors discussed in paragraphs .38–.45 and their effect on the conclusion about whether the parent company or equity method investor (through the investment company) is investing for strategic operating purposes, some factors may be more or less significant than others, depending on the facts and circumstances, and therefore more or less heavily weighted in determining whether the parent company or equity method investor (through the investment company) is investing for strategic operating purposes. No single factor discussed in paragraphs .38–.45, however, is necessarily determinative of whether the parent company or equity method investor (through the investment company) is investing for strategic operating purposes.

.35 *(Added as paragraph 9.06 of the Guide)* The parent company or equity method investor (through the investment company) is investing for strategic operating purposes if the parent company, equity method investor, or their related parties have obtained or have the objective of obtaining benefits (other than benefits attributable to the ownership interest, such as dividends) as a result of an investment in an investee of the investment company through relationships with the investee or its affiliates that are unavailable to noninvestor entities that are not related parties to the investee. Examples of relationships and activities that violate this include, but are not limited to, the following:

a. The acquisition, use, exchange, or exploitation of the processes, intangible assets, or technology of the investee or its affiliates by the parent company, equity method investor, or their related parties.

b. Significant purchases or sales of assets (other than products or services as discussed in item *e* below) between the investee or its affiliates and the parent company, equity method investor, or their related parties.

c. Joint ventures or similar arrangements between an investee or its affiliates and the parent company, equity method investor, or their related parties.

d. Other arrangements between the investee or its affiliates and the parent company, equity method investor, or their related parties to jointly develop, produce, market, or provide products or services.

e. Other transactions between the investee or its affiliates and the parent company, equity method investor, or their related parties that (1) are on terms that are unavailable to entities that are not related parties to the investee, (2) are not at a price the transaction would occur in an orderly transaction between market participants at the measurement date (and that price is objectively verifiable), or (3) represent a significant portion of the investee's or their affiliates' business activities, or the business activities of the parent company or equity method investor, including their related parties' business activities. (Transactions between investees or their affiliates and the parent company, equity method investor, or their related parties that (1) do not represent a significant portion of the investee's or their affiliates' business activities, or the business activities of the parent company or equity method investor, including their related parties' business activities and (2) involve products or services of investees or their affiliates that are available to entities or customers that are not related parties to the investee on similar terms do not violate this condition if the transactions occur at a price the transaction would occur in an orderly transaction between market participants at the measurement date and that price is objectively verifiable by similar transactions between (1) the investee or its affiliates and entities that are not related parties to the investee or (2) the parent company, equity method investor, or their related parties and entities that are not investees or affiliates of investees or related parties of the parent company or equity method investor.)

f. The equity method investor or its related parties [excluding separate accounts of insurance companies as defined in the glossary of the Guide, common (collective) trust funds, and other investments held by trust departments of financial institutions, and pension and profit-sharing trusts], have a direct investment in an investee or an affiliate of an investee (other than investments that are clearly insignificant) and the equity method investor has the ability to exercise significant influence over the investee or affiliate of the investee as a result of that direct investment.

g. The parent company, equity method investor, or their related parties have disproportionate rights, exclusive rights, or rights of first refusal to purchase or otherwise acquire direct ownership interests, assets, technology, products, or services of investees or affiliates of investees.

h. The parent company, equity method investor, or their related parties obtain tax benefits as a result of an ownership interest in the investment company and obtaining the tax benefits was a significant reason for making the investment. For example, some investors make investments to obtain low-income housing credits that pass through partnerships. If obtaining those credits was a significant reason for the parent company or equity method investor making the investment, the parent company or equity method investor has obtained or has the objective of obtaining benefits as a result of the investment through relationships with the investee that are unavailable to noninvestor entities that are not related parties to the investee. [Obtaining tax benefits is not inconsistent with investees of the investment company being held by the parent company or equity method investor (through the investment company) for other than strategic operating purposes if persuasive evidence exists that obtaining the tax benefits was not a significant reason for making the investment.]

.36 *(Added as paragraph 9.07 of the Guide)* Subject to the exceptions in paragraph .37 of this SOP, investees of the investment company are considered to be held by the parent company or equity method investor (through the investment company) for strategic operating purposes if transfers of investments, including, but not limited to, transfers made in exchange for cash or other consideration, are made (*a*) from an investment company to the parent company, equity method investor, or their related parties that are not investment companies or (*b*) from the parent company, equity method investor, or their related parties that are not investment companies to the investment company. Accordingly, any such transfers (other than the exceptions in paragraph .37) result in a change in status to be accounted for in conformity with paragraph .49 of this SOP.

.37 *(Added as paragraph 9.08 of the Guide)* The following transfers do not lead to the conclusion that the parent company or equity method investor (through the investment company) is investing for strategic operating purposes:

a. Transfers in circumstances in which the investments and the effects of holding the investments would be reported the same in the financial statements, regardless of whether they are held by the transferor or the transferee.[21]

b. Transfers that are pro-rata distributions to equity method investors in the investment company of shares of investees in circumstances in which (1) the equity method investor does not have the ability to initiate the distribution and (2) the shares are distributed in a final liquidation of the investment company or are publicly traded securities.

c. In rare situations, transfers between an investment company and a parent company, equity method investor, or their related parties in circumstances in which there have been (1) significant changes in facts and circumstances related to the nature of the parent company's, equity method investor's, or their related parties' business activities unrelated to the investee or its affiliates or (2) significant changes in the investee's or its affiliates' business activities in circumstances in which such change was not initiated or directed by the parent company, equity method investor, or their related parties such that retaining the investment in the investment company, parent company, equity method investor, or their related parties would result in the conclusion that the investment company would otherwise no longer be within the scope of the Guide. (Given the nature of investments held by investment companies, such transfers should be rare.)[22]

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[21] For purposes of applying the guidance in this Guide, reporting an item at fair value with changes in fair value reported in other comprehensive income rather than in income from operations is not considered "the same in the financial statements."

[22] An example of circumstances in which there have been significant changes in facts and circumstances related to the nature of the parent company's, equity method investor's, or their related parties' business activities unrelated to the investee or its affiliates could be as follows. Assume that Investor A holds a 25 percent interest in Investment Company A; Investment Company A holds a 20 percent interest in Investee A; Acquisition Target B holds a 5 percent interest in Investee A. Investor A acquires Acquisition Target B. The absence of a transfer of Acquisition Target B's interest in Investee A to Investment Company A (or the absence of a transfer of Investment Company A's investment in Investee A out of Investment Company A) would result in the conclusion that Investor A would no longer be able to retain investment company accounting, under the provisions of paragraph .30b of this SOP. Accordingly, such a transfer could occur without leading to the conclusion that Investor A (through the investment company) is investing for strategic operating purposes.

d. Transfers that are insignificant and immaterial in all relevant respects, such as in relation to (1) the parent company's or equity method investor's financial statements, (2) the parent company's or equity method investor's interest in the investment company, and (3) the aggregate investment portfolio of investment company subsidiaries and investment company investees reported using the equity method.

Factors to Consider

.38 *(Added as paragraph 9.09 of the Guide)* All relevant facts and circumstances should be considered in totality in determining whether the parent company or equity method investor (through the investment company) is investing for strategic operating purposes. In addition to the conditions discussed in paragraphs .35–.37 of this SOP, the factors discussed in paragraphs .39–.45 of this SOP also should be considered in determining whether the parent company or equity method investor (through the investment company) is investing for strategic operating purposes.In considering the factors discussed in paragraphs .39–.45, some factors may be more or less significant than others, depending on the facts and circumstances, and therefore more or less heavily weighted in determining whether the parent company or equity method investor (through the investment company) is investing for strategic operating purposes. In addition, parent companies and equity method investors should consider the factors in paragraph .33 of this SOP. As the extent of items in paragraph .33 becomes more significant, it becomes less likely that the parent company or equity method investor would retain investment company accounting. No single factor discussed in paragraphs .39–.45, however, is necessarily determinative of whether the parent company or equity method investor (through the investment company) is investing for strategic operating purposes.

.39 *(Added as paragraph 9.10 of the Guide) Involvement in the day-to-day management of investees, their affiliates, or other investment assets.* Involvement in the day-to-day management of investees, their affiliates, or other investment assets by the parent company, equity method investor, or their related parties provides evidence that the parent company or equity method investor is investing for strategic operating purposes. The more extensive the involvement in the day-to-day management of investees, their affiliates, or other investment assets, the greater the evidence that the parent company or equity method investor is investing for strategic operating purposes. Such involvement sometimes is initiated in order to address a particular concern pertaining to a particular investee to maximize the value of the investment. In such circumstances, the period of involvement typically is limited to the period of time necessary to address the concern, rather than being open-ended or permanent. As the involvement in the day-to-day management of investees, their affiliates, or other investment assets goes beyond that described in the previous two sentences, the evidence that the parent company or equity method investor (through the investment company) is investing for strategic operating purposes becomes greater. Investees of the investment company may, however, be held by the parent company or equity method investor (through the investment company) for current income, capital appreciation, or both, even though the parent company, equity method investor, or their related parties are represented on the boards of directors of investees or their affiliates, or if management or employees of the parent company, equity method investor, or their related parties occasionally provide limited temporary assistance to the management of investees or their affiliates. (Assistance to investees or their affiliates is not considered temporary or occasional if it is provided on a continuous or repeated basis to multiple investees or their affiliates that represent a significant portion of the investment portfolio of the entity, or if the parent company, equity method investor, or their related parties do not have plans to discontinue the assistance to each investee or investee affiliate.)

.40 *(Added as paragraph 9.11 of the Guide) Significant administrative or support services provided by the parent company, equity method investor, or their related parties.* Investees or their affiliates sometimes utilize significant administrative or support services provided by the parent company, equity method investor, or their related parties. Examples of such administrative or support services include legal advice, centralized cash management, or other administrative services that typically are provided by a parent to its subsidiaries or its operating divisions. In some circumstances, investees may be required to utilize such services, while in other circumstances investees may have the option of utilizing such services. Such involvement provides evidence that the parent company or equity method investor is investing for strategic operating purposes. The greater the level of such administrative or support services, particularly on a required, continuous, or repeated basis to multiple investees or their affiliates, the greater the evidence that the parent company or equity method investor is investing for strategic operating purposes.

.41 *(Added as paragraph 9.12 of the Guide) Financing guarantees or assets to serve as collateral provided by investees or their affiliates for borrowing arrangements of the parent company, equity method investor, or their related parties.* At the parent company's or an equity method investor's request, investees or their affiliates sometimes provide financing guarantees or assets to serve as collateral for borrowing arrangements of the parent company, equity method investor, or their related parties. Such arrangements, resulting from the parent company's or an equity method investor's request, provide evidence that the parent company or equity method investor is investing for strategic operating purposes. The more extensive such financing guarantees or assets serving as collateral, the greater the evidence that the parent company or equity method investor is investing for strategic operating purposes. Arrangements in which the parent company's, equity method investor's, or their related parties' ownership interest in the investment company, or a wholly-owned investment company's ownership interest in an investee serves as collateral for borrowing arrangements of the parent company, equity method investor, or their related parties, however, are not inconsistent with investees of the investment company being held by the parent company or equity method investor (through the investment company) for other than strategic operating purposes. Also, arrangements in which the parent company, equity method investor, or their related parties guarantee debt of an investee or its affiliates are not inconsistent with investees of the investment company being held by the parent company or equity method investor (through the investment company) for other than strategic operating purposes.

.42 *(Added as paragraph 9.13 of the Guide) Compensation of management or employees of investees or their affiliates is dependent on the financial results of the parent company, equity method investor, or their related parties.* Compensation of management or employees of investees or their affiliates sometimes is dependent on the financial results of the parent company, equity method investor, or their related parties. An example of compensation of management or employees of investees or their affiliates being dependent on the financial results of the parent company, equity method investor, or their related parties is the granting of options to acquire stock in the parent company, equity method investor, or their related parties to management or employees of an investee or its affiliates. Such compensation arrangements provide evidence that the parent company or equity method investor is investing for strategic operating purposes. The more extensive such compensation arrangements, the greater the evidence that the parent company or equity method investor is investing for strategic operating purposes.

.43 *(Added as paragraph 9.14 of the Guide) Directing the integration of operations of investees or their affiliates or the establishment of business relationships between investees or their affiliates.* The parent company, equity method investor, or their related parties sometimes direct the integration of operations of investees or their affiliates or the establishment of business relationships between investees or their affiliates. Such relationships may include joint ventures or other arrangements between investees, significant purchases or sales of assets, or other transactions between investees, investees' participation with other investees in administrative arrangements, investees providing financing to other investees, or investees providing guarantees or collateral for borrowing arrangements of other investees. Directing the integration of the operations of investees or their affiliates or establishing business relationships between investees or their affiliates provides evidence that the parent company or equity method investor is investing for strategic operating purposes. The more extensive the direction of the integration of operations or establishment of business relationships, the greater the evidence that the parent company or equity method investor is investing for strategic operating purposes.

.44 *(Added as paragraph 9.15 of the Guide) Active participation in the organization and formation of an investee or its affiliates*. The parent company, equity method investor, or their related parties sometimes actively participate in the organization and formation of an investee or its affiliates. Such participation provides evidence that the parent company or equity method investor is investing for strategic operating purposes. The more extensive such participation, the greater the evidence that the parent company or equity method investor is investing for strategic operating purposes.

.45 *(Added as paragraph 9.16 of the Guide) Acquiring equity interests in the investment company in exchange for interests in investees*. Investors in the investment company sometimes contribute interests in investees (that were obtained by the investor in exchange for other than cash, such as in exchange for services) to the investment company in exchange for equity interests in the investment company. Such arrangements provide evidence that the investor may be investing for strategic operating purposes. The more extensive such contributed interests in investees or equity interests in the investment company received in exchange for contributed interests in investees, the greater the evidence that the parent company or equity method investor is investing for strategic operating purposes.

Applying the Guidance in Paragraphs .30 to .45 to Equity Method Investors

.46 *(Added as paragraph 9.17 of the Guide)* Each equity method investor should apply the guidance in paragraphs .30–.45 of this SOP based on its own facts and circumstances without considering relationships or activities of other investors (that are not related parties to the equity method investor) in the investment company. Accordingly, an investment company may have multiple equity method investors and the determination about whether investment company accounting should be retained for purposes of applying the equity method in the financial statements of equity method investors should be determined individually by each of those equity method investors. Accordingly, investment company accounting may be retained for purposes of applying the equity method in the financial statements of certain equity method investors, but not retained for purposes of applying the equity method in the financial statements of other equity method investors.

.47 *(Added as paragraph 9.18 of the Guide)* As discussed in SOP 78-9, Emerging Issues Task Force (EITF) Topic D-46, and EITF Issue No. 03-16, certain investors should apply the equity method in situations in which they do not have the ability to exercise significant influence over the investee. The conditions discussed in paragraphs .30–.45 of this SOP do not apply to equity method investors that do not have the ability to exercise significant influence over the investment company. Those investors should retain investment company accounting in applying the equity method to investment in such investment companies.

Changes in Status

.48 *(Added as paragraph 1.28 of the Guide)* The initial determination of whether an entity is an investment company within the scope of the Guide should be made upon formation of the entity. In addition, the provisions of paragraphs .05–.29 of this SOP should be reconsidered each reporting period. Reconsideration of the provisions of paragraphs .05–.29 may result in changes in status. For example, under the provisions of paragraphs .05–.29, some entities many no longer be investment companies within the scope of the Guide, after an initial determination that the entity was an investment company. Similarly, under the provisions of paragraphs .05–.29, some entities may be investment companies within the scope of the Guide, after an initial determination that the entity was not an investment company. Entities with such changes in status should change to the appropriate accounting as of the date of the change in status (as opposed to the reporting date). If an entity no longer meets the applicable investment company conditions in paragraphs .05–.29 after an initial determination that the entity was an investment company, that entity should discontinue application of the Guide and report the change in status prospectively by accounting for its investments in conformity with applicable generally accepted accounting principles (GAAP) other than investment company accounting, beginning as of the date of the change using fair value in conformity with investment company accounting at the date of the change (as opposed to the reporting date) as the carrying amount of investments at the date of the change. If an entity that previously was not an investment company under the applicable provisions of paragraphs .05–.29 becomes an investment company under those paragraphs, the entity should report the effect of the change in status as of that date (as opposed to the reporting date) as an adjustment to retained earnings in the period in which the change occurred. The effect of the change in status reported as an adjustment to retained earnings represents the difference between the carrying amounts of the investments in conformity with the provisions of the Guide and the carrying amounts of the investments (or assets minus liabilities for consolidated investments) in conformity with GAAP other than the provisions of the Guide. All entities with changes in status should disclose the fact that a change in status occurred. In addition, an entity that previously was not an investment company under the applicable provisions of paragraphs .05–.29 and becomes an investment company under those paragraphs should disclose the effect of the change in status on the financial statements of the period of the change, including the effect of the change on the reported amounts of investments as of the date of the change in status and the related effects on net income, change in net assets from operations (for investment companies) or change in net assets (for not-for-profit organizations), and related per share amounts.

.49 *(Added as paragraph 9.19 of the Guide)* The initial determination about whether investment company accounting should be retained in the financial statements of a parent company or equity method investor in an investment company should be made upon the initial investment by the parent company or equity method investor. In addition, the provisions of paragraphs .30–.45 of this SOP should be reconsidered each reporting period. Reconsideration of the provisions of paragraphs .30–.45 may result in changes in status. If a parent company no longer meets the provisions of paragraphs .30–.45 to retain investment company accounting for any investment company subsidiary after an initial determination that investment company accounting should be retained in the financial statements of the parent company for that subsidiary (or if a subsidiary that previously was an investment company no longer meets the applicable investment company conditions in paragraphs .05–.29 of this SOP after an initial determination that the subsidiary was an investment company and investment company accounting was retained in consolidation for that investment company subsidiary), that parent company should discontinue the retention of investment company accounting for all subsidiaries. If an equity method investor in an investment company no longer retains investment company accounting under the provisions of paragraphs .30–.45 for an investment in an investment company after an initial determination that investment company accounting should be retained in the financial statements of the equity method investor for that investee (or if an equity method investee that previously was an investment company no longer meets the applicable investment company conditions in paragraphs .05–.29 after an initial determination that the equity method investee was an investment company and investment company accounting was retained by the investor for that investee), that equity method investor should discontinue retention of investment company accounting in reporting its investment in that investment company and in reporting its equity method investments in other investment companies that are both (*a*) subject to the equity method investor's ability to exercise significant influence and (*b*) managed by the same general partner, investment adviser, or functional equivalent or related party of that general partner, investment adviser, or functional equivalent of the investment company for which investment company accounting is no longer retained. In addition, paragraph .32 of this SOP provides that the equity method investor should consider whether it should discontinue retention of investment company accounting in reporting its equity method investments in other investment companies that are (*a*) subject to the equity method investor's ability to exercise significant influence but (*b*) not managed by the same general partner, investment adviser, or functional equivalent or related party of that general partner, investment adviser, or functional equivalent of the entity for which investment company accounting is disallowed. If a parent company or equity method investor no longer retains investment company accounting under the conditions in paragraphs .30–.45 for any investment company subsidiary or an investment of an equity method investor after an initial determination that investment company accounting should be retained in the financial statements of the parent company or equity method investor, that parent company or equity method investor should report the change in status prospectively by accounting for its investments in conformity with applicable GAAP other than investment company accounting, beginning as of the date of the change using fair value in conformity with investment company accounting at the date of the change (as opposed to the reporting date) as the carrying amount of investments at the date of the change. Also, a change in circumstances may lead to the conclusion that investment company accounting should be retained in the financial statements of a parent company or equity method investor under the provisions of paragraphs .30–.45 in circumstances in which investment company accounting previously was not retained in the financial statements of the parent company or an equity method investor. If a parent company or equity method investor previously did not retain investment company accounting in the financial statements under the provisions of paragraphs .30–.45 and, subsequently, due to a change in circumstances, retains investment company accounting, the parent or equity method investor should change to the appropriate accounting as of the date of the change in status (as opposed to the reporting date) and report the effect of the change in status as an adjustment to retained earnings in the period in which the change occurred. The effect of the change in status represents the difference between the carrying amounts of the investments in conformity with the provisions of the Guide and the carrying amounts of the investments (or assets minus liabilities for consolidated investments) in conformity with GAAP other than the provisions of the Guide. All entities with changes in status should disclose the fact that a change in status occurred. In addition, a parent company or equity method investor that previously did not retain investment company accounting in the financial statements under the provisions of paragraphs .30–.45, subsequently, due to a change in circumstances, retains investment company accounting, should disclose the effect of the change in status on the financial statements of the period of the change, including the effect of the change on the reported amounts of investments as of the date of the change in status and the related effects on net income, change in net assets from operations (for investment companies) or change in net assets (for not-for-profit organizations), and related per share amounts.

Disclosures

.50 *(Added as paragraph 9.20 of the Guide)* If investment company accounting is retained in the consolidated financial statements for investment company subsidiaries, the following should be disclosed:

a. The fact that investment company accounting is retained in the consolidated financial statements.

b. The carrying amount (fair value) as reported in the consolidated financial statements and cost of the portfolio of investment company subsidiaries for which investment company accounting has been retained as of each balance sheet date.

c. Disclosures about significant transactions between the parent company or its related parties and the investees of the investment company or their affiliates:

  (1) The nature of the relationship(s) involved.

  (2) A description of the transactions for each of the periods for which income statements are presented, and such other information deemed necessary to understand the effects of the transactions on the financial statements, such as the amount of gross profit (or similar measure) from the transactions.

  (3) The dollar amounts of transactions, such as sales and similar revenues, for each of the periods for which income statements

are presented and the effects of any change in the method of establishing the terms from that used in the preceding period.

(4) Amounts due from or to investees or their affiliates as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.

d. Gross unrealized aggregate appreciation and aggregate depreciation of investments in the investment company's(ies') investment portfolio as of each balance sheet date.

e. Net realized gains or losses from investments in the investment portfolio of investment company subsidiaries for which investment company accounting has been retained for each year an income statement is presented.

f. Net increase (decrease) in unrealized appreciation (or depreciation) of the investment portfolio (change in unrealized amounts during the year) for each year an income statement is presented.

g. The policy for distinguishing the nature and type of investments made by the investment company from the nature and type of investments made by other entities within the consolidated group that are not investment companies.

.51 *(Added as paragraph 9.21 of the Guide)* If investment company accounting is retained in the financial statements of an equity method investor in an investment company, the following should be disclosed:

a. The fact that investment company accounting is retained in the financial statements of the equity method investor in an investment company.

b. The carrying amount (fair value) and cost of the portfolio of equity method investees for which investment company accounting has been retained as of each balance sheet date. The amounts disclosed should represent the equity method investor's reported interest in the portfolio of equity method investees. Accordingly, for equity method investees for which investment company accounting has been retained, the amounts disclosed should represent the equity method investor's proportionate interest in the equity method investee's investment portfolio.

c. Disclosures about significant transactions between the equity method investor, or its related parties and the investees of the investment company or their affiliates:

(1) The nature of the relationship(s) involved.

(2) A description of the transactions for each of the periods for which income statements are presented, and such other information deemed necessary to understand the effects of the transactions on the financial statements, such as the amount of gross profit (or similar measure) from the transactions.

(3) The dollar amounts of transactions, such as sales and similar revenues, for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period.

(4) Amounts due from or to investees or their affiliates as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.

.52 *(Added as paragraph 7.79 of the Guide)* If changes in status are reported pursuant to paragraph .48 of this SOP, entities should disclose the following:

- The nature of and justification for the change in status
- Disclosures required by paragraph .48

.53 *(Added as paragraph 9.22 of the Guide)* If changes in status are reported pursuant to paragraph .49 of this SOP, entities should disclose the following:

- The nature of and justification for the change in status
- Disclosures required by paragraph .49

Amendments to Other Sections of the Guide

.54 Appendix A [paragraph .59] of the Guide "Venture Capital and Small Business Investment Companies," is revised to read as follows:

> Venture Capital and Small Business Investment Companies
>
> Venture capital investment companies, including most small business investment companies (SBICs), and business development companies may differ from other types of investment companies. The typical open-end or closed-end company is a more passive investor than is a venture capital investment company. A venture capital investment company typically is more actively involved with its investees, while still meeting the definition of an *investment company*. In addition to providing funds, whether in the form of loans or equity, the venture capital investment company often provides technical and management assistance to its investees. Such assistance typically is initiated in order to address a particular concern pertaining to a particular investee to maximize the value of the investment. In such circumstances, the period of involvement typically is limited to the period of time necessary to address the concern, rather than being open-ended or permanent.

The portfolio of a venture capital investment company may be illiquid by the very nature of the investments, which are typically securities with no public market. Often, gains and losses on those investments are realized over a relatively long holding period. The nature of the investments, therefore, requires valuation procedures that differ markedly from those used by the typical investment company primarily addressed by this Guide.

Venture capital investment companies may incur liabilities not generally found in other investment companies. Leverage opportunities available to the owners of those companies are not available to open-end companies and are not often found in closed-end companies. SBICs, by statute, may borrow from the Small Business Administration (SBA), often at advantageous rates, up to two or three times their paid-in capital.

Though all venture capital investment companies should prepare their financial statements in conformity with GAAP and are subject to audit as are other investment companies, the statement presentation of some companies may need to be tailored to present the information in a manner most meaningful to their particular group of investors. For example, if debt is a significant item, a balance sheet might be more appropriate than a statement of net assets. Also, different regulatory procedures may apply. Publicly owned SBICs are subject to the provisions of article 5 of Regulation S-X, whereas other publicly owned venture capital investment companies are subject to article 6.

The unique features (primarily the existence of significant debt) of SBICs often make it desirable that their financial statements be presented in a conventional balance sheet format. SBICs are regulated by the SBA and accordingly are required to comply with part 107 of the SBA rules and regulations. Appendixes I and II of part 107 address specific aspects of SBA regulation, such as the specific audit procedures and reporting requirements (for example, on Form 468) of the SBA for SBICs, the system of account classification, and guidance on proper techniques and standards to be followed in valuing portfolios. The auditor of an SBIC should be familiar with those publications and aware of changes in SBA regulations.

The format for reporting the results of SBIC operations varies from that presented in this Guide for other types of investment companies.

.55 The glossary of the Guide is revised to read as follows:

venture capital investment company. A closed-end investment company whose primary investment objective is capital growth and whose capital typically is invested wholly or largely in restricted securities of entities with new ideas, products, or processes.

Effective Date and Transition

EDITOR'S NOTE

On February 14, 2008, the FASB issued FASB Staff Position (FSP) 07-1-1, *Effective Date of AICPA Statement of Position 07-1*. The FSP delays indefinitely the effective date of this SOP. Entities that early adopted SOP 07-1 before December 15, 2007, are permitted but not required to continue to apply the provisions of the SOP. No other entities may adopt the provision of the SOP, subject to the following exception: If a parent entity that early adopted the SOP chooses not to rescind its early adoption, an entity consolidated by the parent entity that is formed or acquired after that parent entity's adoption of the SOP must apply the provisions of the SOP in its stand-alone financial statements. For the full text of the FSP, visit the FASB's Web site at http://www.fasb.org/pdf/fsp_sop07-1-1.pdf.

.56 The provisions of this SOP are effective for fiscal years beginning on or after December 15, 2007. Earlier application is encouraged.

.57 The consideration of the provisions of paragraphs .05–.29 of this SOP to determine whether an entity is an investment company within the scope of the Guide and in paragraphs .30–.45 of this SOP to determine whether investment company accounting should be retained in the financial statements of a parent company or an equity method investor should be made initially as of the beginning of the fiscal year for which this SOP is first applied. If a decision to initially apply this SOP is made in other than the first interim period of the year of change, the change should be reported by retrospective application to the previous interim periods of that year. If an entity that previously applied the provisions of the Guide meets the provisions of paragraphs .05–.29 (or meets the provisions of paragraphs .30–.45 to retain investment company accounting in the financial statements of a parent company or equity method investor) as of the date of initial application of this SOP, the entity should continue to apply the provisions of the Guide upon initial application of this SOP, even if the entity did not meet those provisions in all periods prior to the initial application of this SOP.

.58 Entities that previously applied the provisions of the Guide but that, pursuant to paragraphs .05–.29 of this SOP, do not meet the provisions of this

SOP to be an investment company within the scope of the Guide (or that previously retained investment company accounting in the financial statements of a parent company or equity method investor, but do not meet the provisions of paragraphs .30–.45 of this SOP to retain investment company accounting in the financial statements of a parent company or equity method investor), should report the effects of adopting this SOP prospectively by accounting for its investments in conformity with applicable GAAP other than investment company accounting, beginning as of the date of adoption using fair value in conformity with investment company accounting at the date of adoption as the carrying amount of investments at the date of adoption. Entities that, pursuant to paragraphs .05–.29, are investment companies within the scope of the Guide (or parent companies or equity method investors that meet the provisions of paragraphs .30–.45 to retain investment company accounting in the financial statements of the parent company or equity method investor), but that previously had not followed the provisions of the Guide (or parent companies or equity method investors that previously did not retain investment company accounting in the financial statements of the parent company or equity method investor), should report the cumulative effect of adopting this SOP as an adjustment to opening retained earnings as of the beginning of the year that this SOP is adopted. The cumulative effect of the change represents the difference between the carrying amount of the investments in conformity with the provisions of the Guide and the carrying amount of the investments (or assets minus liabilities for consolidated investments) in conformity with GAAP other than the provisions of the Guide. All entities with changes in accounting as a result of adopting this SOP should disclose the effect of adopting this SOP on the financial statements of the period of the change, including any changes in accounting for investments as a result of adopting this SOP, the effect of any changes on the reported amounts of investments as of the date of adoption and any related effects on net income, change in net assets from operations (for investment companies), or change in net assets (for not-for-profit organizations) and related per share amounts.[23]

The provisions of this Statement of Position need not be applied to immaterial items.

[23] The FASB *Action Alert* reporting the FASB's actions at its March 27, 2002, discussion of a document leading to the exposure draft of this SOP provides as follows:

> The Board expressed its view that an investment company (other than a separate account of an insurance company as defined in the Investment Company Act of 1940) must be a separate legal entity to be within the scope of the [Investment Companies] Guide. Accordingly, the specialized accounting principles in the Guide should be applied to an investment made after March 27, 2002, only if the investment is held by an investment company that is a separate legal entity. Investments acquired prior to March 28, 2002, or those acquired after March 27, 2002, pursuant to an irrevocable binding commitment that existed prior to March 28, 2002, should continue to be accounted for in accordance with the entity's existing policy for such investments.

AcSEC notes that entities that are not separate legal entities, except for separate accounts of insurance companies as discussed in footnote 4, would not retain the specialized accounting practices in the Guide upon adoption of this SOP.

.59

Appendix A

Background Information and Basis for Conclusions

Introduction

A-1. This section discusses considerations that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position (SOP). It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

Background

A-2. The AICPA Audit and Accounting Guide *Investment Companies* (the Guide) requires specialized industry accounting guidance (referred to as *investment company accounting*) for entities within its scope. Entities that are not within the scope of the Guide or other specialized industry practice generally account for investments in conformity with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities;* FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*; Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*; and Accounting Research Bulletin (ARB)51, *Consolidated Financial Statements*, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries,* and FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* and as interpreted by FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised December 2003), among other pronouncements.

A-3. During the development of the Guide in the late 1990s, the FASB expressed concern that the scope of the Guide may be unclear, particularly as it pertains to certain venture capital investment companies. Though AcSEC previously had a project on its agenda to develop an SOP on accounting for venture capital investment companies, that project was terminated. Representatives of the AICPA informally surveyed preparers and auditors, who shared the FASB's concerns that the scope of the Guide may be unclear.

A-4. In addition, in Emerging Issues Task Force (EITF) Issue No. 85-12, *Retention of Specialized Accounting for Investments in Consolidation*, the EITF discussed whether consolidated financial statements should retain specialized industry accounting principles applicable to wholly-owned small business development company subsidiaries or venture capital investment company subsidiaries. The EITF reached a consensus that, assuming the specialized industry accounting principles are appropriate at the subsidiary level, those principles should be retained in consolidation.

A-5. If an investment company is (*a*) a subsidiary of another entity or (*b*) an investment of an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the investment company (referred to collectively as *parent company* or *equity method investor*) and investment company accounting is carried over to the parent company's or equity method investor's financial statements, differences in accounting for the same investment could result depending on which entity within the consolidated group holds the investment. AcSEC concluded that in light of its reconsideration of the scope of the Guide, it should also provide guidance about whether investment company accounting should be retained in the financial statements of a parent company of an investment company or an equity method investor in an investment company.

A-6. In December 2002, AcSEC released for public comment an exposure draft of a proposed SOP, *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*. Forty-one comment letters were received and subsequently considered by AcSEC.

A-7. The exposure draft proposed guidance for determining whether an entity is within the scope of the Guide and for determining whether investment company accounting should be retained by a parent company in consolidation or by an equity method investor. That guidance was based primarily on the nature of the entity's activities and relationships with investees, as well as the organizational structure of the entity.

Basis for Conclusions

Overall Model

A-8. In practice, some perceive investment company accounting as more desirable to the reporting entity than accounting in conformity with generally accepted accounting principles (GAAP) other than investment company accounting. Further, some believe an entity should be prohibited from applying investment company accounting (or retaining investment company accounting in the financial statements of a parent company or equity method investor) unless the entity can demonstrate that it is an investment company (or that investment company accounting should be retained in the financial statements of a parent company or equity method investor). They believe, therefore, that the model in this SOP should include a bias against investment company accounting; a presumption that an entity is not an investment company (or that investment company accounting should not be retained in the financial statement of a parent company or equity method investor) unless it can demonstrate that it is an investment company (or that investment company accounting should be retained in the financial statements of a parent company or equity method investor). AcSEC does not support that view. AcSEC believes, and the model in this SOP reflects, that whether an entity is an investment company (and whether investment company accounting should be retained in the financial statements of a parent company or equity method investor) should be based on consideration of all relevant facts and circumstances without a bias for or against investment company accounting.

Separate Financial Statements of an Investment Company

A-9. For purposes of the separate financial statements of an entity, the exposure draft proposed that the Guide should be applicable to entities that are (*a*) regulated as investment companies; (*b*) separate legal entities owned by multiple investors (referred to as entities with *pooled funds*) meeting certain conditions leading to the conclusion that their business activity involves investing for current income, capital appreciation, or both; and (*c*) other separate legal entities meeting certain incremental conditions leading to the conclusion that their business activity is investing for current income, capital appreciation, or both in separate autonomous businesses. (The conditions for the third category of investment company entities were more extensive than those for the first two categories.) The exposure draft proposed guidance for determining whether an entity has pooled funds and provided specific conditions that should be met to conclude that the entity's business activity involves investment activity and that investees are separate autonomous businesses.

A-10. The majority of respondents who commented on the December 2002 exposure draft opposed the guidance on the specific conditions proposed in the exposure draft pertaining to the separate financial statements of the entity. Though many respondents agreed with the general description of the purpose and activities of an investment company as discussed in the exposure draft, many of those respondents believed the detailed requirements of the proposal might exclude from the scope of the Guide certain entities that typically have followed, and, in their view, should continue to follow investment company accounting. In addition, some respondents interpreted certain provisions of the exposure draft as bright line rules and believed that the SOP should instead establish general principles. Many such respondents also expressed concern that, based on the specific requirements in the exposure draft, certain entities may have frequent changes in status to and from investment company status.

A-11. AcSEC noted from the comment letters that there may be more diversity in activities of current investment companies and their relationships with investees than AcSEC anticipated. Though such activities and relationships may be consistent with the definition of an *investment company*, certain entities may have been excluded from the scope of the Guide by the specific nature of the provisions in the exposure draft. AcSEC believes that determinations about whether an entity is an investment company should be based on an overall consideration of the nature of the entity's activities and relationships with investees, as well as the organizational structure of the entity. In addition, AcSEC believes entities should consider all existing evidence in determining whether the entity is an investment company, and that judgment should be applied in making that determination, with less bright lines than some readers believed existed in the exposure draft. Accordingly, AcSEC concluded that the SOP should be revised to (*a*) simplify the application of the SOP, particularly pertaining to the determination about whether an entity is within the scope of the Guide, (*b*) change or eliminate certain provisions of the SOP that may be viewed as bright lines, and (*c*) provide illustrations of the application of the provisions of the SOP. AcSEC has therefore revised the SOP to incorporate the following model:

- A definition of an *investment company*. (The definition is derived from certain conditions in the exposure draft.)
- Guidance to apply the definition, including explanations of terms used in the definition.
- Factors that provide evidence about whether an entity meets the definition of an *investment company*. (Many of the factors are derived from the conditions in the exposure draft. Depending on the facts and circumstances, some factors may be more significant than others. Entities should weigh all existing evidence in determining whether the entity meets the definition of an *investment company*.)
- Illustrations demonstrating the application of the guidance in the SOP to various fact patterns.

A-12. AcSEC believes this approach generally is consistent with the original intent of the exposure draft and will not significantly change the intended scope of the Guide. In addition, AcSEC believes the benefits of this approach include:

- Making the SOP more understandable and simplifying the determination of whether an entity is within the scope of the Guide.
- Avoiding excluding from the scope of the Guide certain entities that typically have followed and should continue to follow investment company accounting.
- Retaining requirements that AcSEC believes are essential, such as investing for current income, capital appreciation, or both, rather than for strategic operating purposes.
- Retaining factors that AcSEC believes are important while permitting those factors to be considered in the totality of all relevant facts and circumstances, rather than in isolation.

Discussion of Relevant Accounting Issues[24]

A-13. As noted in paragraph .05 of this SOP, an investment company's business activity involves investing (typically by purchasing securities of other entities) for current income, capital appreciation, or both. Values and changes in values of investments held by investment companies may be as important to an investor(s) as the investment income earned. Transactions to buy and sell shares or units in an investment company are typically based on the fair value of the investment company's investments. Investment companies, therefore, report investments at fair value. Paragraphs 7.04 and 7.05 of the Guide provide that investment companies do not consolidate or apply the equity method of accounting to noninvestment company investees (except for investments in operating subsidiaries that provide services to the investment company and other investment companies) because investment companies carry their assets at fair value.

A-14. FASB Statement No. 115; FASB Statement No. 124; APB Opinion No. 18, as interpreted by FASB Interpretation No. 46 (revised December 2003); and ARB 51, as amended by FASB Statements No. 94 and No. 144, among other pronouncements, provide guidance on accounting for investments in investees. ARB 51 provides that all majority-owned subsidiaries shall be consolidated unless control does not rest with the majority owner. Entities that are not within the scope of the Guide are required to consolidate certain investees and apply the equity method of accounting to certain investments based on the provisions of those standards rather than account for such investments at fair value. As indicated in paragraph A-13 above, entities that are within the scope of the Guide do not consolidate or apply the equity method to their investments, except as discussed in paragraph 7.05 of the Guide.

A-15. APB Opinion No. 18, paragraph 2, provides that the Opinion does not apply to investments in common stock held by "investment companies registered under the Investment Company Act of 1940 or investment companies which would be included under the Act (including small business investment companies) except that the number of stockholders is limited and the securities are not offered publicly." Paragraph 53 of FASB Statement No. 94

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[24] In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—including an amendment of FASB Statement No. 115*. Measurement of certain investments by some entities affected by this SOP also may be affected by Statement No. 159. Specifically, for entities other than investment companies, Statement No. 159 permits certain investments currently reported at other than fair value to be reported at fair value. AcSEC's deliberations, and the discussion in this "Basis for Conclusions," predate Statement No. 159, and therefore do not reflect the fair value options permitted by Statement No. 159.

acknowledges the specialized industry practices for investment companies and that those practices are unaffected by FASB Statement No. 94.

A-16. This SOP does not address the valuation of investments by venture capital investment companies or similar entities that are within the scope of the Guide. If those entities are within the scope of the Guide, they should follow the provisions of the Guide for valuing their investments. If those entities are outside the scope of the Guide, they should follow the provisions of APB Opinion No. 18; ARB 51, as amended by FASB Statements No. 94 and No. 144 and as interpreted by FASB Interpretation No. 46 (revised December 2003); or FASB Statements No. 115 or No. 124, as applicable in the circumstances.

A-17. If an entity is within the scope of the Guide, all of the entity's investments and activities should be accounted for and reported in conformity with the provisions of the Guide. The provisions of this SOP prohibit any of those investments from being exempted from the provisions of the Guide. If an entity is outside the scope of the Guide, the Guide does not apply to any of the entity's investments or activities.

Financial Statements of Parent Companies and Equity Method Investors

A-18. AcSEC considered the accounting by parent companies and equity method investors for investments in investment companies. That is, should investment company accounting be retained in the financial statements of a parent company or equity method investor? As discussed in paragraph A-4 above, the EITF had concluded in Issue No. 85-12 that, assuming the specialized accounting principles applicable to wholly-owned small business development company subsidiaries or venture capital investment company subsidiaries are appropriate at the subsidiary level, those principles should be retained in consolidation. In practice, that conclusion has been applied also by equity method investors, as well as investors other than parent companies or equity method investors. AcSEC concluded that the guidance in EITF Issue No. 85-12 should no longer be applied in determining whether investment company accounting should be retained in the financial statements of parent companies and equity method investors for investments in investment companies. AcSEC observes that EITF Issue No. 85-12 did not address whether the activities of the investment company and the relationship of the parent company to the investment company and its investees (and, in practice, the relationship of equity method investors to the investment company and its investees) should be considered in determining whether investment company accounting should be retained in the financial statements of those parent companies and equity method investors. AcSEC believes that whether investment company accounting should be retained in the financial statements of the parent company or equity method investor should be based on the activities of the investment company and relationships between the parent company or equity method investor and the investees of the investment company. AcSEC believes, however, that investors other than parent company or equity method investors in investment companies should not be prohibited from retaining investment company accounting merely because of relationships between and among other investors, the investment company, or investees, because those investors other than parent company or equity method investors typically neither have influence over nor derive any benefits from relationships between and among other investors, the investment company, or investees. Accordingly, AcSEC developed a model under which investment company accounting may be retained in the financial statements of certain investors in an investment company, but not retained in the financial statements of other investors in the same investment company.

A-19. Some respondents to the exposure draft commented that the SOP should not nullify the guidance in EITF Issue No. 85-12 as it applies to investments in investment companies while others supported nullifying that guidance. Some believe that the guidance included in EITF Issue No. 85-12 is sound. Others believe that the guidance in EITF Issue No. 85-12 should apply unless the parent company or equity method investor clearly obtains benefits indicative of a strategic investor. Others believe it is internally inconsistent to establish criteria at the investment company level and then impose substantial barriers and restrictions that create a presumption that investment company accounting can exist at the separate company level, but not carry over to consolidation. Still others supported the guidance in the exposure draft. AcSEC continues to believe that the SOP should include guidance for determining whether investment company accounting should be retained in the financial statements of a parent company or equity method investor. AcSEC believes that retaining investment company accounting in the financial statements of a parent company or equity method investor without consideration beyond the appropriate accounting at the investment company level could lead to unintended consequences and potential abuses. In particular, AcSEC believes circumstances exist in which an entity may meet the definition of an *investment company* on a stand-alone basis, but the entity's parent or equity method investor holds interests in the investees of the investment company (through its interest in the investment company) for strategic operating purposes. In addition, without further guidance, AcSEC believes circumstances may exist in which the accounting by the entity's parent company may differ as a result of the parent company selectively making investments within an investment company subsidiary that are similar to investments held by noninvestment company members of the consolidated group when those investments would be accounted for by the equity method, by consolidation, or at cost if the investment were made by a noninvestment company member of the consolidated group.

A-20. AcSEC considered whether the conditions for determining whether investment company accounting should be retained in the financial statements of a parent company or equity method investor with an investment in an entity regulated by the Investment Company Act of 1940 (the 1940 Act) or similar requirements should be the same as the conditions for investment companies, as opposed to retaining investment company accounting in the financial statements of a parent company or equity method investor in all circumstances in which the investment company is an entity regulated by the 1940 Act or similar requirements. AcSEC believes that the reporting in the consolidated financial statements of a parent company or the financial statements of an equity method investor in an investment company should not depend on whether the investment company is an entity regulated by the 1940 Act or similar requirements. Accordingly, AcSEC concluded that investment company accounting should not be retained in the financial statements of the parent company or equity method investor in circumstances in which the investment company does not meet all of the investment company conditions applicable to entities in paragraphs .05 and .11–.29 of this SOP.

A-21. The guidance for determining whether investment company accounting should be retained in the financial statements of investors in the entity is similar to the guidance for determining whether an entity is an investment company, with some additional guidance. The following paragraphs discuss the basis for those conclusions from two perspectives, namely, determining whether (*a*) an entity is an investment company and (*b*) investment company accounting should be retained in the financial statements of an investor in the entity.

Definition of an Investment Company

A-22. AcSEC concluded that the SOP's conditions for inclusion or exclusion of entities from the scope of the Guide should be based on the nature of the entity's activities. Further, AcSEC concluded that certain entities subject to regulatory requirements should automatically be within the scope of the Guide.

A-23. The definition of an *investment company* included in this SOP is based on characteristics that AcSEC believes distinguish investment companies from entities that benefit from the operations of investees in ways other than through current income, capital appreciation, or both.

A-24. For purposes of the separate financial statements of an entity, AcSEC concluded that an investment company is a separate legal entity whose business purpose and activity are investing in multiple substantive investments for current income, capital appreciation, or both, with investment plans that include exit strategies. Also, AcSEC believes that entities regulated under the 1940 Act or the Small Business Investment Company Act of 1958, common (collective) trust funds, and the separate accounts of insurance companies as defined in the glossary of the Guide, that are required to report investments at fair value for regulatory reporting purposes and are subject to other requirements similar those of the 1940 Act or the Small Business Investment Company Act of 1958, should be included within the scope of the Guide without further consideration.[25] (These entities are referred to in this SOP as *entities regulated by the 1940 Act or similar requirements*.) AcSEC believes entities regulated by the 1940 Act or similar requirements should not be required to meet additional conditions to be an investment company within the scope of the Guide for purposes of their separate financial statements because the regulations and regulatory reporting requirements provide sufficient evidence that the entity's business activity is investment activity and because requiring those entities to report investments at amounts other than fair value for financial reporting purposes would create unjustified conflicts with regulatory reporting requirements.[26] As discussed in paragraph A-20 above, however, AcSEC believes that the conditions for determining whether investment company accounting should be retained in the financial statements of a parent company or equity method investor with an investment in an entity regulated by the 1940 Act or similar requirements should be the same as the conditions for investments in investment companies. Accordingly, AcSEC concluded that investment company accounting should be retained in the financial statements of a parent company or equity method investor in an entity regulated by the 1940 Act or similar requirements only if that entity regulated by the 1940 Act or similar requirements otherwise meets the definition of an *investment company* in this SOP.

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[25] For example, for foreign jurisdictions, AcSEC understands that as of the publication date of this SOP, Canada, the United Kingdom, the Bermuda Monetary Authority, the Cayman Island Monetary Authority, and countries in the European Union that are subject to the provisions of the Undertakings for Collective Investment in Transferable Securities are examples of foreign jurisdictions with regulations similar to the 1940 Act. Those regulations include provisions that require fair value reporting and are consistent with the concepts identified in paragraphs .11–.18 of this SOP. Also, responsibility for monitoring compliance with those regulations rests with a regulatory organization.

[26] Because entities regulated by the 1940 Act or similar requirements are not required to meet additional conditions to be an investment company within the scope of the Guide for purposes of their separate financial statements, this *Basis for Conclusions* discusses certain conclusions, conditions, and other factors as they pertain to entities other than entities regulated by the 1940 Act or similar requirements, without specifically mentioning each time that such discussions do not apply to entities regulated by the 1940 Act or similar requirements.

A-25. Footnote 3 to paragraph 1.04 of the existing Guide provides that "this Guide does not apply to [real estate investment trusts, or REITs], which have some of the attributes of investment companies but are covered by other generally accepted accounting principles." The exposure draft proposed retaining that guidance. Some respondents commented that REITs may or may not be investment companies, depending on their activities. AcSEC concluded that this SOP should not provide specific requirements for REITs and that REITs should be subject to the same provisions of this SOP as other entities. AcSEC observes, however, that REITs typically would not meet the definition of an *investment company* because REITs typically are involved in the day-to-day management of investees in ways that are inconsistent with the activities of an investment company. For example, REITs typically develop and operate real estate.

A-26. Some respondents commented that enterprise funds should be considered investment companies. They describe enterprise funds as not-for-profit organizations established and funded by the U.S. Government, in part to assist in the development of the economies of certain parts of the world by investing funds in small- and medium-sized enterprises and, if appropriate, to provide technical assistance to help those enterprises grow. They describe the grant agreements for particular enterprise funds as providing that the funds have been established to promote private sector development in designated countries through loans, grants, equity investments, feasibility studies, technical assistance, training, insurance, guarantees, and other measures. Also, they describe the activities of the enterprise fund as nevertheless being aimed at increasing current income, capital appreciation, or both. FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, defines a *not-for-profit organization* as follows:

> An entity that possesses the following characteristics that distinguish it from a business enterprise: (*a*) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, (*b*) operating purposes other than to provide goods or services at a profit, and (*c*) absence of ownership interests like those of business enterprises. Not-for-profit organizations have those characteristics in varying degrees ([FASB Statement of Financial Accounting] Concepts Statement No. 4, paragraph 6). Organizations that clearly fall outside this definition include all investor-owned enterprises and entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance companies, credit unions, farm and rural electric cooperatives, and employee benefit plans (FASB Concepts Statement No. 4, paragraph 7).

Though AcSEC concluded that this SOP should not include special provisions for not-for-profit organizations and that not-for-profit organizations should apply the provisions of this SOP in the same manner as other entities, AcSEC observes that the objectives of an investment company, whose definition includes a business purpose of investing for current income, capital appreciation, or both, and implicitly exists to return the economic benefits of that current income, capital appreciation, or both to its investors, generally would be inconsistent with the objectives of a *not-for-profit organization* as defined above. AcSEC observes, however, that not-for-profit organizations may be investors in investment companies. Accordingly, Appendix D [paragraph .62], "Effects on Other Pronouncements," of this SOP includes amendments to SOP 94–3, *Reporting of Related Entities by Not-for-Profit Organizations* [section 10,610], to reflect the view that not-for-profit organizations may be investors in investment companies.

A-27. For purposes of determining whether an entity is an investment company,[27] AcSEC developed guidance based on the activities of the reporting entity, the relationships between the entity and investees, and the relationships between investors and the entity. AcSEC believes that approach is sound because those attributes provide evidence about the nature of the entity, including its activities, and, therefore, whether the entity is an investment company.

A-28. The definition of an *investment company* provides that entities should be organized as a separate legal entity. AcSEC considered permitting or requiring investment company accounting for operating segments, divisions, departments, branches, reporting units that are otherwise separately identifiable, pools of assets subject to liabilities that give the creditor no recourse to other assets of the entity, aggregations of assets within an entity, or other components of an entity that are not separate legal entities that meet the investment company conditions. AcSEC concluded that an investment company should be a separate legal entity to (*a*) clearly and objectively distinguish and segregate investment company activities from other activities, (*b*) present itself as an investment company to other parties under the provisions of paragraph .11 of this SOP, and (*c*) allow investors to purchase or sell direct ownership interests in the entity. AcSEC believes that examples of such separate legal entities include corporations, partnerships, limited liability companies, grantor trusts, and other trusts, which AcSEC believes is consistent with the term *entity* as used in FASB Interpretation No. 46. Accordingly, AcSEC concluded that operating segments, divisions, departments, branches, reporting units that are otherwise separately identifiable, pools of assets subject to liabilities that give the creditor no recourse to other assets of the entity, aggregations of assets within an entity, or other components of an entity that are not separate legal entities, are not investment companies for purposes of their separate financial statements, if any, or for purposes of the parent company's financial statements.

A-29. Paragraph .12 of this SOP provides that to be an investment company, an entity should have no substantive activities other than its investment activities. Operations other than investing activities, such as holding investments in operating subsidiaries, are not undertaken by investors that hold investments for the purpose of current income, capital appreciation, or both. AcSEC considered whether investment company accounting should be permitted to be applied to selective activities within an entity, but concluded that it should not, because by definition an investment company has one activity—investing for current income, capital appreciation, or both. Having other substantive operations calls into question whether the entity exists for reasons other than to invest for current income, capital appreciation, or both.

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[27] As discussed in paragraph A-24 above, AcSEC concluded that regulated investment companies should be included within the scope of the Guide without further consideration. Also as discussed in paragraph A-24 above, however, AcSEC concluded that investment company accounting should be retained in the financial statements of a parent company or equity method investor in a regulated investment company only if that regulated investment company otherwise meets the definition of an *investment company* in this SOP. In addition, as discussed in paragraph A-21 above, this "Basis for Conclusions" discusses the conclusions from the perspective of both determining whether an entity is an investment company and determining whether investment company accounting should be retained in the financial statements of an investor in the entity. Accordingly, this "Basis for Conclusions" sometimes refers to conclusions that are applicable to nonregulated entities (as opposed to regulated entities) for purposes of the entities' separate financial statements and that are applicable to both nonregulated entities and regulated entities in considering whether investment company accounting should be retained by parent companies and equity method investors in investment companies.

A-30. Paragraph .14 of this SOP provides that to be an investment company, an entity should hold or plan to hold substantive investments in multiple investees. Investment companies make investments in multiple investees as a means of diversifying their portfolio and maximizing their returns. AcSEC believes that investing in multiple investees, therefore, is an important characteristic of an entity that invests for current income, capital appreciation, or both.

A-31. AcSEC considered whether specific guidance should be provided on the number of investments that should be held to meet the condition that the entity holds multiple investments. AcSEC concluded that it was unnecessary to provide a specific definition of *multiple investments*, but it should be more than one investment (either directly or through another investment company). AcSEC believes that entities will be able to apply judgment in determining whether the number of investments made by an entity is sufficient to lead to the conclusion that the entity is investing for current income, capital appreciation, or both.

A-32. The exposure draft proposed that an entity be required to hold multiple substantive investments in order to conclude that it is investing for current income, capital appreciation, or both. Further, the exposure draft proposed that to meet that requirement, the entity should hold multiple substantive investments directly or through another investment company or, for entities that have not yet completed their initial offering period, the entity should have an investment plan to acquire multiple substantive investments and it is anticipated that those multiple investments will be acquired within one year. Some respondents commented that this requirement should be revised or eliminated. Some commented that it is arbitrary and does not allow sufficient time for the research, due diligence, negotiation, and patience that is often required by difficult market conditions in making investment decisions. Some commented that the SOP should provide an exception for entities that have not yet completed their initial offering period but which have an investment plan to acquire more than one substantive investment within one year of the end of the marketing period. Some commented that the SOP should be revised to provide an exception for alternative investment vehicles, which may make only one investment, to be considered part of a larger fund to which they are in effect a part. Some commented that the requirement should be less restrictive in the liquidation stage of the entity's life, because at some point in the liquidation process, the entity may hold an investment in only one investee. AcSEC agrees that the guidance proposed in the exposure draft pertaining to multiple substantive investments was too restrictive and did not recognize various facts and circumstances under which investment companies might hold fewer than multiple investments. Accordingly, AcSEC revised the provisions of the SOP to recognize various facts and circumstances under which investment companies might hold fewer than multiple investments.

A-33. Paragraph .14 of this SOP provides that for equity investments made by investment companies in other entities, as opposed to investments in commodities, securities based on indices, derivatives, and other forms of investments, those other entities should be organized as separate legal entities, except in cases of foreclosure or liquidation of the original investment that are intended to be temporary. AcSEC believes that requiring those investees to maintain a separate legal status to be an investment company (*a*) distinguishes investments by investment companies for current income, capital appreciation, or both from investments by other entities in operating assets and (*b*) requires an appropriate level of autonomy between the investment company and those investees.

A-34. As discussed in paragraph A-24 above, the definition of an *investment company* contemplates that the entity's investment plans include exit strategies. AcSEC believes that parent companies with operating subsidiaries sometimes plan to own and operate those subsidiaries indefinitely to realize the benefits of the subsidiaries through operations. However, investment companies that hold investments plan to ultimately dispose of their investments after earning current income, capital appreciation, or both. AcSEC observes that the exit strategy of an investment company for investments in private equity securities typically is a limited period, such as three to seven years or may be based on the life of the entity. Though the exit strategy may vary depending on the nature and objectives of the investment, the maturity or development of the investee, market conditions, or other circumstances, potential exit strategies should be identified in order to meet the definition of an *investment company*. Also, in order to meet the definition of an *investment company*, the entity should have plans that address the time at which it expects to exit the investment, which may be either an expected date or range of dates, or a time defined by specific facts and circumstances, such as achieving certain milestones, the limited life of the entity, or the investment objectives of the entity. For investments in shares of public companies, temporary cash equivalents, commodities, securities based on indices, and derivatives, the time at which the entity expects to exit the investment may be a function of the entity's assessment of market conditions, cash flow needs, and other factors, such as the investment objectives of the entity.

A-35. Various exit strategies exist. For investments in private equity securities, examples of exit strategies include an initial public offering (IPO) of equity securities, a private placement of equity securities, distributions (to investors) of ownership interests in investees (typically in the form of marketable equity securities), and sales of assets (including the sale of an investee's assets followed by a liquidation of the investee). For investments in assets, such as real estate, an example of an exit strategy includes the sale of the real estate. For investments in debt securities, examples of exit strategies include holding the debt to maturity, selling the debt in a private placement, converting the debt to equity securities and selling those equity securities in a private placement, an IPO, or on the market, if publicly traded. For investments in ownership interests in shares of public companies, temporary cash equivalents, commodities, securities based on indices, and derivatives, examples of exit strategies include selling the investment in a private placement or on the market, if publicly traded.

A-36. As noted in paragraph .05 of this SOP, an investment company does not hold investments for strategic operating purposes. AcSEC believes that in order to conclude that investments are not held for strategic operating purposes, the benefits obtained from the investment should be limited to the typical benefits of passive ownership, such as rights to dividends or other distributions. Accordingly, the SOP requires that entities not obtain benefits (other than current income, capital appreciation, or both) that are unavailable to noninvestor entities that are not related parties to the investee. For example, investment companies and major investors in investment companies do not make investments for the purpose of using technological research or development of investees in their own operations. Joint venture arrangements, significant transactions between the entity or its major investor(s) and investees, agreements or plans regarding the use of research or development between the investor entity and the investee entity, or other business relationships demonstrate that the entity or its major investor(s) are holding investments for strategic operating purposes, rather than for current income, capital appreciation, or both. Those provisions do not, however, prohibit investment company accounting in circumstances in which one investee acquires another investee in a purchase business combination, provided that the acquisition was not directed by the investment company or its affiliates.

A-37. The exposure draft proposed guidance that included various conditions that should be met in order to conclude that an entity is an investment company. Some of those conditions were characterized as required to be met in order to conclude that the entity's business activity is investing for current income, capital appreciation, or both. Other conditions, which were incremental conditions for entities without pooled funds, were characterized as required to be met in order to conclude that "investees are separate autonomous businesses from the entity." AcSEC reconsidered the characterization of those conditions (some of which were revised in the SOP to be factors to consider rather than conditions) in light of the revised definition of an *investment company* and overall model in the SOP. AcSEC concluded that they should be characterized as conditions or factors that provide evidence about whether the investments are held for strategic operating purposes. AcSEC reached that conclusion because it believes that "held for strategic operating purposes" more succinctly and explicitly articulates what those conditions or factors provide evidence about than does "investing for current income, capital appreciation, or both" and "separate autonomous businesses from the entity." AcSEC reached that conclusion in part because the overall model in the SOP no longer requires incremental conditions for entities without pooled funds, and, therefore, it is unnecessary to have a separate category of conditions, that is separately characterized, for entities without pooled funds.

A-38. In addition to the requirements of and terms in the definition of an *investment company,* AcSEC believes other factors provide evidence about whether an entity meets the definition of an *investment company*. AcSEC believes that due to the diversity in the activities of investment companies and the relationships of investors in investment companies to the investment company and to the investment companies' investees, some factors may be more or less significant than others, depending on the facts and circumstances, and, therefore, more or less heavily weighted in determining whether an entity is an investment company.

A-39. AcSEC believes that the extent of influence over and ownership interests in the entity by investors (and indirectly over investees of the entity) are important factors in considering whether an entity's business purpose and activity are investing for current income, capital appreciation, or both. AcSEC believes that entities in which no single investor has the ability to exercise significant influence or control (as evidenced by substantial ownership interests) over the entity are more likely to be investing for current income, capital appreciation, or both, rather than for strategic operating purposes than are entities in which a single investor has the ability to exercise significant influence or control over the entity. Conversely, AcSEC believes that in circumstances in which a single investor has the ability to exercise significant influence or control over the entity, that investor may have the ability to, and objective of, managing those investments for strategic operating purposes, rather than for current income, capital appreciation, or both. AcSEC acknowledges, however, that entities in which a single investor has the ability to exercise significant influence or control may be investing for current income, capital appreciation, or both. Accordingly, AcSEC concluded that whether an entity has pooled funds (the extent to which numerous parties invest in the entity) is a significant factor that should be considered in determining whether the entity is investing for current income, capital appreciation, or both, but should not be a condition that is necessarily determinative of whether the entity is an investment company. Accordingly, paragraph .19 of this SOP provides that the extent of pooling of funds typically should be more significant and provide more persuasive evidence than certain other factors. Also, as the extent of pooling of funds increases, the weight of other factors providing evidence that the entity is investing for strategic operating purposes typically decreases. Conversely, as the extent of pooling of funds decreases, the weight of other factors providing evidence that the entity is investing for strategic operating purposes typically increases.

A-40. As noted in paragraph A-9 above, the exposure draft proposed that entities without pooled funds meet certain incremental conditions in order to conclude that their business activity is investing for current income, capital appreciation, or both in separate autonomous businesses.AcSEC reached that conclusion in developing the exposure draft because AcSEC believed that meeting those incremental conditions provided additional evidence that the entity is investing for current income, capital appreciation, or both, rather than for the operating purposes of the investor with significant influence or control. Though few comments were received disagreeing with the requirement to have incremental conditions for entities without pooled funds, some respondents commented that a 20 percent financial interest (the exposure draft threshold for pooled funds) does not necessarily indicate the ability to exercise significant influence or control over the entity. Some commented, for example, that ownership percentage is irrelevant in circumstances in which limited partners are required to be passive investors. Also, some commented that the definition of *pooled funds* is unclear and not operational, for various reasons. In developing this SOP, AcSEC concluded that in light of the revised model in the SOP, the SOP should not include incremental conditions that entities without pooled funds are required to meet in order to be an investment company. Consistent with the overall intent of the exposure draft, however, AcSEC concluded that the extent of pooling of funds is an important factor that should be considered in determining whether an entity meets the definition of an *investment company*. Also, AcSEC concluded that because, under the revised model, pooling of funds is one of several factors to be considered and weighed, rather than an absolute condition, and because of the difficulties encountered in trying to develop a clear and operational definition of *pooled funds*, a specific definition of *pooled funds* is unnecessary and might result in unintended consequences.

A-41. AcSEC considered whether the level of ownership interests held in investees should be a factor in determining whether an entity's business purpose and activity are investing for current income, capital appreciation, or both. AcSEC believes that entities that do not hold significant levels of ownership interests in investees are more likely to be investing for current income, capital appreciation, or both, rather than for strategic operating purposes, than are entities that do hold significant levels of ownership interests in investees. AcSEC, therefore, concluded that the level of ownership interests held in investees is a significant factor that should be considered in determining whether the entity is investing for current income, capital appreciation, or both, rather than for strategic operating purposes. Accordingly, paragraph .19 of this SOP provides that the level of ownership interests held in investees typically should be more significant and should provide more persuasive evidence than certain other factors. Also, as the level of ownership interests held in investees decreases, the weight of other factors providing evidence that the entity is investing for strategic operating purposes typically decreases.

Conversely, as the level of ownership interests held in investees increases, the weight of other factors providing evidence that the entity is investing for strategic operating purposes typically increases.

A-42. AcSEC considered whether an entity that owns a controlling financial interest in an investee should be precluded from being an investment company within the scope of the Guide, because owning a controlling financial interest provides evidence that the entity has the ability to and, perhaps, the objective of managing that investment for strategic operating purposes, rather than for current income, capital appreciation, or both. AcSEC concluded, however, that owning a controlling financial interest in an investee should not preclude an entity from being an investment company within the scope of the Guide because such ownership does not necessarily demonstrate that the entity's objective is managing that investment for strategic operating purposes, rather than for current income, capital appreciation, or both. AcSEC believes that circumstances exist in which entities own a controlling financial interest in an investee for current income, capital appreciation, or both. AcSEC believes, however, that owning a controlling financial interest provides evidence that the entity may be investing for strategic operating purposes, and such evidence should be considered with other evidence to determine whether the entity meets the definition of an *investment company*.

A-43. AcSEC considered the nature of the entity's investors and whether that should be a factor in determining whether the entity is investing for current income, capital appreciation, or both. AcSEC concluded that substantial ownership by passive investors who pool their funds to avail themselves of professional investment management is a factor pointing toward the conclusion that the entity is an investment company, investing for current income, capital appreciation, or both, while substantial ownership by investors who determine the strategic direction or run the day-to-day operations of the entity is a factor pointing toward the conclusion that the entity is not an investment company, but rather is investing for strategic operating purposes. In addition, AcSEC concluded that substantial ownership by employee benefit plans is a factor pointing toward the conclusion that the entity is an investment company, investing for current income, capital appreciation, or both. AcSEC reached that conclusion pertaining to substantial ownership by employee benefit plans in part because employee benefit plans tend to be passive investors and in part because employee benefit plans are required to report their investments at fair value.

A-44. AcSEC believes that the management of investees of an investment company should be separate from the management of the investment company or affiliates of the investment company. Accordingly, paragraph .24 of this SOP provides that involvement in the day-to-day management of investees by management of an entity or its affiliates provides evidence of a parent-subsidiary relationship for strategic operating purposes that is contrary to the nature of an investment company investment. For example, the entity's board of directors serving as the management of the investee is inconsistent with relationships between an investment company and its investees. Representation on the boards of directors of investees, however, is not inconsistent with relationships between an investment company and its investees. In addition, an investment company providing temporary support services to investees is not inconsistent with relationships between an investment company and its investees if such support is provided in order to address a particular concern pertaining to a particular investee to maximize the value of the investment. Such services demonstrate a parent-subsidiary relationship, however, if they are not limited to the period of time necessary to address that concern. In addition, paragraph .29 of this SOP provides that if the entity or its affiliates direct the integration of operations of investees or their affiliates or the establishment of business relationships between investees or their affiliates, that provides evidence that the entity is investing for strategic operating purposes.

A-45. The exposure draft proposed that entities are not investment companies if they or their affiliates are involved in the day-to-day management of investees, their affiliates, or other investment assets. That requirement could be met, however, if management of the entity or its affiliates is represented on the boards of directors of investees or their affiliates or provides limited temporary assistance to management of investees or their affiliates. (The exposure draft also proposed that to be considered temporary, such assistance should be limited to a relatively short period, such as an aggregate of approximately six months for any investee or its affiliates for which such assistance is provided, and specific plans should exist to discontinue such assistance.) Some respondents commented that such guidance is not appropriate or operational. They agree that relationships and activities, such as having seats on an investee's board of directors, acting as temporary executives, having veto rights over budgets, hiring and firing management, or having veto power over other operating decisions, are not inconsistent with characteristics of investment companies. They believe the SOP should be more flexible in allowing such activities for investment companies, and that the SOP should not impose a six-month time limit. Some commented that the existence of a limited life of the entity, or limited holding periods for investments, mitigates any evidence that such day-to-day management is undertaken for strategic operating purposes rather than for current income, capital appreciation, or both. AcSEC acknowledges that investment companies may undertake such activities for purposes of current income, capital appreciation, or both. Accordingly, AcSEC concluded that though involvement in the day-to-day management of investees, their affiliates, or other investment assets provides evidence that the entity is investing for strategic operating purposes, that factor should be considered with other evidence to determine whether the entity meets the definition of an *investment company*. In addition, AcSEC acknowledges that such activities, if undertaken by an investment company, may be undertaken in order to address a particular concern pertaining to a particular investee to maximize the value of that investment. Accordingly, AcSEC revised the guidance to eliminate the reference to a six-month time period and instead provide that such activities should be limited to the period of time necessary to address the concern.

A-46. AcSEC understands that some entities currently using investment company accounting may own direct interests in real estate. AcSEC considered whether the SOP should provide specific conclusions applicable to entities that own direct interests in real estate. AcSEC concluded that the SOP should not provide specific conclusions applicable to entities that own direct interests in real estate because AcSEC is unaware of reasons why real estate investments should be treated differently than other investments for financial reporting purposes. Entities with direct interests in real estate should consider whether the entity's activities pertaining to those investments would result in the entity not meeting the definition of an *investment company*. For example, entities with direct interests in real estate should consider the extent of their involvement in the day-to-day management of investees, their affiliates, or other investment assets, as discussed in paragraph .24 of this SOP. Appendix C [paragraph .61], "Applying the Provisions of This SOP to Entities That Hold Investments in Real Estate," provides additional discussion about applying the provisions of this SOP to entities that hold investments in real estate. Also, Appendix C [paragraph .61] includes examples specifically applicable to entities that invest in real estate and activities that they typically undertake.

A-47. Some respondents commented that the guidance in the exposure draft should be revised so that typical investment company activities pertaining to real estate are permitted. Some commented, among other things, that the guidance should be revised to consider the substance of the involvement pertaining to advisory and property management arrangements for investments in real estate, which they believe are consistent with board representation as discussed in paragraph .24 of this SOP. They note the distinction between fee-for-service property managers frequently used in real estate and management of operating companies. AcSEC acknowledges the challenges of applying the guidance in this SOP to investments in real estate. AcSEC observes that in contrast to investment companies that invest in other than real estate, the activities of real estate investment companies preceding exiting the investment are focused more on generating operating income and maintaining the property and focused less on capital appreciation through the maturation and development of the investment property or entity. The capital appreciation of real estate held by a real estate investment company tends to be more a function of overall market conditions than a function of the maturation and development of the investment property. Nevertheless, AcSEC believes that, conceptually, the guidance in this SOP should be applicable to investments in real estate.

Other Guidance Specific to Parent Companies and Equity Method Investors

A-48. AcSEC believes that if an investment company is a member of a consolidated group, policies should exist and be followed within the consolidated group that effectively distinguish the nature and type of investments made by the investment company from the nature and type of investments made by other entities within the consolidated group that are not investment companies. AcSEC believes those policies should address, at a minimum, (*a*) the degree of influence held by the investment company and its related parties over the investees of the investment company, (*b*) the extent to which investees of the investment company or their affiliates are in the same line of business as the parent company or its related parties, and (*c*) the level of ownership interest held in the investment company by the consolidated group. AcSEC believes this condition is necessary to prohibit the consolidated group from selectively making investments within an investment company subsidiary that are similar to investments held by noninvestment company members of the consolidated group when those investments would be accounted for by the equity method, by consolidation, or at cost if the investment were made by a noninvestment company member of the consolidated group. AcSEC believes that in order to be effective, such policies should include sufficient details and information to distinguish investment company investments from other investments in the consolidated group. The nature and detail of such policies will affect which investments are to be made by investment company subsidiaries and noninvestment company members of the consolidated group.

A-49. Paragraph .30 of this SOP includes certain conditions that should be considered in determining whether to retain investment company accounting in the financial statements of a parent company or equity method investor, including whether a subsidiary or equity method investee that is an entity regulated by the 1940 Act or similar requirements also meets the definition of an *investment company* pursuant to the guidance in paragraphs .05 and .11–.29 of this SOP, as well as whether the parent company or equity method investor (through the investment company) is investing for current income, capital appreciation, or both, rather than for strategic operating purposes. In determining whether those conditions are met, paragraph .33 of this SOP provides that parent companies and equity method investors should consider various factors, such as:

a. The degree of influence held by the investment company and its related parties over the investees of the investment company or affiliates of investees.

b. The significance of the investments of the investment company that represent controlling financial interests.

c. The significance of services provided and activities engaged in between and among the parent company, equity method investor, the investment company, or related parties of the parent company, equity method investor, or the investment company and investees or affiliates of investees.

d. The level of ownership interest held in the investment company by the parent company or equity method investor.

e. The extent to which investees of the investment company or their affiliates are in the same line of business as the parent company, equity method investor, or related parties of the parent company or equity method investor.

Due to the diversity in the activities of investment companies and the relationships of investors in investment companies to the investment company and to investees, all relevant facts and circumstances should be considered in determining whether to retain investment company accounting in the financial statements of a parent company or equity method investor. Accordingly, the factors in items *a* through *e* (above) should be considered in totality. Some factors may be more or less significant than others, depending on the facts and circumstances, and therefore more or less heavily weighted in determining whether an entity is an investment company. As the extent of items *a* through *e* becomes more significant, however, it becomes less likely that the parent company or equity method investor would retain investment company accounting.

A-50. AcSEC believes circumstances in which the parent company has a majority-owned investment company and the investment company consists substantially of majority-owned investments in investees provide significant evidence that the parent company is investing for strategic operating purposes. Also, AcSEC believes that in circumstances in which the investment company consists substantially of majority-owned investments in investees, it would be less likely for a parent of the investment company to retain investment company accounting than for an equity method investor in the investment company, because a parent would presumably be able to exert more influence than would an equity method investor.

A-51. The exposure draft proposed that if an investment company holds significant investments in investees or their affiliates that represent controlling financial interests, a rebuttable presumption exists that the parent company, equity method investor, or their related parties obtain or have the objective of obtaining benefits through relationships with investees or their affiliates that are unavailable to noninvestor entities and that investment company accounting, therefore, should not be retained in the financial statements of the parent company or equity method investor. The exposure draft included factors that could overcome that presumption. Some respondents commented that that presumption was inappropriate, while others supported it. Some commented that the SOP should require that transactions with investees or their affiliates be conducted at arm's length in order to retain investment company accounting. Others commented that if the investment company conditions are satisfied at the entity level, investment company accounting should be retained at the parent level. Some commented that ownership levels are relatively unimportant in determining the business activity of the entity if the entity and its investees operate with a significant degree of autonomy. AcSEC continues to believe that whether an investment company holds significant investments in investees or their affiliates that represent controlling financial interests is a significant factor that should be considered in determining whether investment company accounting should be retained in the financial statements of a parent company or equity method investor. AcSEC believes, however, that providing a rebuttable presumption that investment company accounting should not be retained in the financial statements of the parent company or equity method investor if the investment company holds significant investments that represent controlling financial interests is unnecessary under the revised approach in the SOP. Accordingly, AcSEC concluded that whether and the extent to which the investment company and its related parties have influence over the investees of the investment company and the significance of the investments of the investment company that represent controlling financial interests are significant factors in considering whether investment company accounting should be retained in the financial statements of a parent company or equity method investor.

A-52. Paragraph .31 of this SOP provides that if a parent company no longer meets the provisions of paragraph .30 of this SOP to retain investment company accounting for any investment company subsidiary after an initial determination that investment company accounting should be retained in the financial statements of the parent company, the parent company should discontinue retention of investment company accounting for all subsidiaries. AcSEC considered whether retention of investment company accounting should be discontinued for all investment company subsidiaries or discontinued merely for those subsidiaries that no longer meet the conditions to retain investment company accounting. AcSEC concluded that the parent company's accounting (and financial statements) should be identical, regardless of how many investment companies it has. AcSEC reached this conclusion, in part, to prevent potential abuses. For example, if the revised Guide provided that retention of investment company accounting should be discontinued merely for those investment company subsidiaries that no longer meet the conditions to retain investment company accounting, rather than for all investment company subsidiaries, a parent company might establish multiple investment company subsidiaries to minimize the financial reporting effects of anticipated future violations of the conditions to retain investment company accounting. By establishing multiple investment company subsidiaries, the parent company could avoid discontinuing retention of investment company accounting for some or most of its investment company subsidiaries (and by extension, therefore, avoid discontinuing retention of investment company accounting for some or most of its investees) by merely distributing its investees among several investment company subsidiary entities, rather than including all investees in the same investment company subsidiary entity.

A-53. Paragraph .32 of this SOP provides that if an equity method investor no longer meets the provisions of paragraph .30 of this SOP to retain investment company accounting for an investment in an investment company, after an initial determination that investment company accounting should be retained in the financial statements of the equity method investor, the equity method investor should discontinue retention of investment company accounting in reporting its investment in that investment company. In addition, that equity method investor should discontinue retention of investment company accounting in reporting its equity method investment in other investment companies (*a*) over which it has the ability to exercise significant influence and (*b*) that are managed by the same general partner, investment adviser, or functional equivalent or a related party of that general partner, investment advisor, or functional equivalent of the entity for which investment company accounting is discontinued. For example, assume the following facts:

- Equity Method Investor A owns a 20 percent interest in Investment Companies B, C, D, and E. Investment Companies B, C, D, and E are, therefore, related parties to Equity Method Investor A.
- Equity Method Investor A has the ability to exercise significant influence over Investment Companies B, C, D, and E.
- Entity X is the General Partner of Investment Companies B and C.
- Entity Y is the General Partner of Investment Company D.
- Entity Z is the General Partner of Investment Company E.
- Entity X is a related party to Entity Y.
- Equity Method Investor A no longer meets the provisions of paragraph .30 to retain investment company accounting for its investment in Investment Company B, after an initial determination that Equity Method Investor A should retain investment company accounting in reporting its investment in Investment Company B.

Equity Method Investor A should discontinue retention of investment company accounting in reporting its investment in Investment Company B. In addition, Equity Method Investor A should discontinue retention of investment company accounting in reporting its investment in Investment Company C and Investment Company D.

A-54. AcSEC considered whether retention of investment company accounting should be discontinued for all equity method investments in investment companies, similar to the provisions for investment company subsidiaries of parent companies, as discussed in paragraph A-52 above. AcSEC concluded that an equity method investor's accounting for investment companies (*a*) over which it has the ability to exercise significant influence and (*b*) that are managed by the same general partner, investment adviser, or functional equivalent or a related party of that general partner, investment adviser, or functional equivalent should be identical regardless of how many related investment company investees it has, for reasons similar to those applicable to investment company subsidiaries of parent companies, as discussed in paragraph A-52 above. AcSEC concluded that the SOP should include an exception, however, pertaining to investments in investment companies by an equity method investor in circumstances in which the investment companies are not (*a*) investment companies over which the equity method investor has the ability to exercise significant influence or (*b*) managed by the same general partner, investment adviser, or functional equivalent or a related party of that general partner, investment adviser, or functional equivalent. AcSEC reached this conclusion because circumstances may exist in which the equity method investor uses its influence over an investment company in a manner that leads to the conclusion that the equity method investor is investing for strategic operating purposes, but that influence may not extend to certain other investment companies, thereby limiting the equity method investor's ability to invest in those other investment companies for strategic operating purposes. AcSEC concluded, however, that if an equity method investor in an investment company is investing for strategic operating purposes, the equity method investor should consider the nature of the activities and relationships with that investment company that lead to the conclusion that the equity method investor is investing for strategic operating purposes in determining whether all or some investments in other investment companies (*a*) over which the equity method investor uses its influence and (*b*) that are not managed by the same general partner, investment adviser, or functional equivalent or a related party of that general partner, investment advisor, or functional equivalent are being held for strategic operating purposes and should, therefore, be adjusted (as if the investment company had not applied the Guide).

A-55. In certain circumstances, investment companies, parent companies, or equity method investors sometimes obtain tax benefits as a result of their ownership interests. AcSEC believes that tax effects are a component of all investments and any tax benefits resulting from investment ownership should not lead to the conclusion that the parent company or equity method investor has obtained or has the objective of obtaining benefits as a result of the investment through relationships with the investee that are unavailable to noninvestor entities that are not related parties to the investee, unless obtaining the tax benefits was a significant reason for making the investment, in which case the reasons for the investment would be other than for current income, capital appreciation, or both. Accordingly, paragraph .35 of this SOP provides that tax benefits that the parent company or equity method investor may obtain as a result of its ownership interest in the investment company are not inconsistent with the conditions for retaining investment company accounting if persuasive evidence exists that obtaining the tax benefits was not a significant reason for making the investment.

A-56. Paragraph .36 of this SOP provides that transfers of investments between a parent company or equity method investor or their related parties and an investment company subsidiary or equity method investee generally provide significant evidence that should lead to the conclusion that investees of the investment company are considered to be held by the parent company or equity method investor (through the investment company) for strategic operating purposes. AcSEC concluded, however, that transfers of investments in the following specific limited circumstances should not, by themselves, lead to a conclusion that such investments are held for strategic operating purposes:

- Transfers in circumstances in which the investments and the effects of holding the investments would be reported the same in the financial statements, regardless of whether they are held by the investment company or a noninvestment company entity. AcSEC believes investment company accounting should be retained in the event of such transfers because they have no effect on financial reporting.

- Transfers that are pro rata distributions to equity method investors of shares of investees in circumstances in which (*a*) the equity method investor does not have the ability to initiate the distribution and (*b*) the shares are distributed in a final liquidation of the investment company or can be publicly traded. AcSEC observes that such transfers are not uncommon by investment companies in the liquidation phase. AcSEC believes such transfers should result in not retaining investment company accounting in circumstances in which they are initiated by an equity method investor that has the ability to initiate the distribution or a parent company. AcSEC believes that such transfers initiated by the investor demonstrate the investor's intent to invest for strategic operating purposes and, therefore, should preclude retaining investment company accounting by the investor.

- In rare situations, transfers between an investment company and a parent company, equity method investor, or their related parties in circumstances in which there have been (*a*) significant changes in facts and circumstances related to the nature of the parent company's, equity method investor's, or their related parties' business activities unrelated to the investee or its affiliates or (*b*) significant changes in the investee's or its affiliates' business activities in circumstances in which such change was not initiated or directed by the parent company, equity method investor, or their related parties, such that retaining the investment in the investment company, parent company, equity method investor, or their related parties would result in the conclusion that the investment company would otherwise no longer be within the scope of the Guide. This exception to the limitations on the transfer of investments applies only in circumstances in which significant changes to the parent company's, equity method investor's, or investee's operations exist as described above. This exception is not intended to permit such transfers in circumstances in which the parent company, equity method investor, or investee has not experienced such changes in circumstances. Given the nature of investments held by investment companies, such transfers should be rare. AcSEC believes investment company accounting should be retained in the event of such transfers because to require otherwise could result in unintended consequences and less meaningful financial reporting in certain situations in which facts and circumstances change significantly.
- Transfers that are insignificant and immaterial in all relevant respects, such as in relation to (1) the parent company's or equity method investor's financial statements, (2) the parent company's or equity method investor's interest in the investment company, and (3) the aggregate investment portfolio of investment company subsidiaries and investment company investees reported using the equity method. AcSEC believes investment company accounting should be retained in the event of such transfers because to require otherwise could result in unintended consequences and less meaningful financial reporting.

Affiliates and Related Parties

A-57. The terms *affiliate* and *related party* are used in this SOP as defined in FASB Statement No. 57, *Related Party Disclosures*. FASB Statement No. 57 defines an *affiliate* as "a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise."FASB Statement No. 57 defines *related parties* as follows:

> Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one

> party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Accordingly, *affiliate* is a more narrow term than is *related party*, because all affiliates are related parties but not all related parties are affiliates. In particular, equity method investors in the investment company are related parties, but are not affiliates of the investment company and investees. AcSEC believes that relationships of affiliates, such as a controlling investor in the entity, should be considered in determining whether the entity is an investment company. Also, AcSEC concluded that relationships between related parties other than affiliates, such as equity method investors in the investment company and investees, should be irrelevant in determining whether the entity is an investment company. AcSEC believes that the entity may be investing for current income, capital appreciation, or both from the perspective of investors other than affiliates, such as equity method investors, regardless of relationships between and among related parties other than affiliates, such as equity method investors, the investment company, or investees. AcSEC believes relationships between and among related parties (including related parties other than affiliates) of a parent company or equity method investor, the investment company, or investees should be relevant, however, in determining whether investment company accounting should be retained in the financial statements of the parent company or equity method investor. Accordingly, activities and relationships in this SOP that result in the entity not qualifying for investment company accounting, or the parent company or the equity method investor not retaining investment company accounting, are framed in the context of relationships with affiliates at the entity level and with related parties at the parent company or equity method investor level.

Changes in Status

A-58. AcSEC recognizes that, as a result of changes in circumstances, the provisions of this SOP may result in an entity that previously was:

a. Considered an investment company under the provisions of the Guide, no longer being considered an investment company under the provisions of the Guide.

b. Not considered an investment company under the provisions of the Guide, now being considered an investment company under the provisions of the Guide.

In addition, as a result of changes in circumstances, the provisions of this SOP may result in a parent company or equity method investor that previously:

a. Retained investment company accounting in its financial statements no longer retaining that accounting under the provisions of the Guide.

b. Did not retain investment company accounting now retaining investment company accounting under the provisions of the Guide.

AcSEC considered how these changes in status should be reported. AcSEC considered whether these changes are *accounting changes* as described in FASB

Statement No. 154, *Accounting Changes and Error Corrections,*[28] and concluded that they are not because these changes are triggered by a change in the entity's activities and relationships rather than changes in the accounting principles applied or the method of applying those principles. AcSEC considered whether these changes are a change in reporting entity because some may view the underlying investees in aggregate as representing different entities depending on whether they were owned by an investment company or an operating company. AcSEC concluded that these changes are not necessarily a change in reporting entity because the provisions of this SOP are such that an entity could have a change in status without effectively becoming a different reporting entity. Also, reporting all changes in status as changes in the reporting entity would have required retrospective application to the financial statements of all prior periods presented under the provisions of paragraph 23 of FASB Statement No. 154 to show financial information for the new reporting entity for all periods, regardless of the direction of the change. AcSEC rejected requiring that all changes be accounted for through retrospective application primarily because the change does not result in financial statements that, in effect, are those of a different reporting entity, as required under paragraph 3f of FASB Statement No. 154, and, to a lesser extent, the difficulty of determining, at the time of change, the fair values of investees in prior periods in circumstances in which an entity that previously was not considered an investment company under the provisions of the Guide may be considered an investment company under the provisions of the Guide.

A-59. The exposure draft proposed that if an entity that previously was an investment company under the provisions of the Guide is no longer an investment company under the provisions of the Guide, the entity should reflect the change in status through retrospective application to the financial statements of prior periods as if the Guide had not been applied. In addition, the exposure draft proposed that if an entity that previously was not an investment company under the provisions of the Guide becomes an investment company under the provisions of the Guide, the entity should reflect the change in status by applying the provisions of the Guide as of the date of the change in status, without retrospective application to prior period financial statements. Similar provisions regarding changes in status also would have applied to the financial statements of the entity's parent company or an equity method investor.

A-60. Some respondents to the exposure draft commented that restatement of prior periods would be difficult, if not impossible, because the information needed would not be available. Also, some respondents commented that changes in status should be considered a change in accounting principle. AcSEC considered whether entities should report such changes retrospectively, but rejected that conclusion because of practical difficulties in obtaining the necessary information. Rather, AcSEC concluded that entities should report the effect of the change in status for an entity that no longer meets the applicable investment company conditions in paragraphs .05–.29 of this SOP after an initial determination that the entity was an investment company prospectively, by accounting for its investments in conformity with applicable GAAP other than investment company accounting, beginning as of the date of the change using fair value in conformity with investment company accounting at the date of the change. For an entity that previously was not an investment company

[28] Paragraph 2 of FASB Statement No. 154 defines an *accounting change* as follows:
a change in (*a*) an accounting principle, (*b*) an accounting estimate, or (*c*) the reporting entity. The correction of an error in previously issued financial statements is not an accounting change.

under the applicable provisions of paragraphs .05–.29, but that becomes an investment company under those paragraphs as a result of changes in the entity's operations and activities, AcSEC concluded that the entity should report the effect of the change in status as of that date in a manner similar to the cumulative effect of a change in accounting principle as an adjustment to retained earnings in the period in which the change occurred. AcSEC reached those conclusions in part, because of practical considerations about choosing another method of reporting changes in status, such as retrospective application. AcSEC considered whether an entity that no longer meets the applicable investment company conditions in paragraphs .05–.29 after an initial determination that the entity was an investment company, should report changes in status in a manner similar to the cumulative effect of a change in accounting principle as an adjustment to retained earnings in the period in which the change occurred. AcSEC rejected that approach, because it would require certain retrospective computations, which rely on information that may be impracticable to obtain. Accordingly, for entities that no longer meet the applicable investment company conditions in paragraphs .05–.29 after an initial determination that the entity was an investment company, AcSEC concluded that the change should be accounted for prospectively.

A-61. Some respondents commented that the SOP should provide a window of opportunity to cure any facts and circumstances that result in an entity temporarily not meeting the investment company criteria. Some commented that noncompliance for a period of one year or less should not result in a change in investment company status if the entity otherwise intends to remain an investment company. AcSEC considered whether the SOP should include such exceptions to changes in status. AcSEC concluded that the SOP should not include such exceptions because AcSEC believes that the financial statements should reflect the assets and liabilities for the entity as of the reporting date, as well as the activity of the entity for the reporting period, in conformity with generally accepted accounting principles. AcSEC believes it would be misleading for an entity that is not an investment company under the provisions of this SOP as of the balance sheet date to report using investment company accounting. In addition, AcSEC believes that because of the changes made to the SOP, changes in status will be less frequent than respondents to the exposure draft anticipated.

A-62. AcSEC considered what financial statement disclosures, if any, should be required in addition to those required by existing GAAP. AcSEC believes the disclosures required by paragraphs .50–.53 of this SOP, addressing disclosures required in circumstances in which investment company accounting is retained in the consolidated financial statements for investment company subsidiaries or in the financial statements of an equity method investor in an investment company, as well as disclosures required in circumstances in which a change in status exists, provide useful information to financial statement users. Those disclosures are aimed primarily at providing information to financial statement users that would otherwise be unavailable because investment companies carry their investments at fair value, rather than consolidating or applying the equity method of accounting to those investments.

Effective Date

A-63. AcSEC recognizes that entities previously considered investment companies under the Guide may no longer be considered investment companies under the provisions of this SOP and visa versa, but that those entities may be able to modify existing arrangements, policies, and activities to be considered investment companies under the provisions of this SOP. AcSEC believes that, for practical reasons, these entities should be given the opportunity to modify existing arrangements, policies, and activities prior to the initial application of this SOP to meet or not meet the definition of an *investment company* and continue their current accounting method. In addition, AcSEC believes entities should be given sufficient opportunity to obtain the information necessary to report under the provisions of this SOP. Further, as discussed in footnote 23 of this SOP, in February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—including an amendment of FASB Statement No. 115*, which may affect measurement of certain investments by some entities affected by this SOP. (Specifically, for entities other than investment companies, Statement No. 159 permits certain investments currently reported at other than fair value to be reported at fair value.) Entities are permitted to early adopt Statement No. 159. In order to minimize accounting changes and transition issues for entities affected by this SOP, AcSEC believes the effective date of this SOP should be such that entities could apply FASB Statement No. 159 upon adopting this SOP. Accordingly, AcSEC concluded that the provisions of this SOP should be effective for fiscal years beginning on or after December 15, 2007, which would give entities approximately six months after issuance of this SOP to implement its provisions, and avoid requiring entities to adopt this SOP prior to adopting Statement No. 159.

A-64. The exposure draft proposed that the provisions of the SOP be effective for fiscal years beginning after December 15, 2003, which was intended to be approximately six months after its expected issuance date. Some respondents commented that more than a six-month window should be provided between the issuance date and the effective date. AcSEC believes that adopting the provisions of this SOP will be less burdensome than adopting the proposed provisions of the exposure draft, in part because of the changes in the transition provisions, as discussed in paragraph A-65 below. AcSEC believes, however, that the effective date should be delayed based on the reasons in paragraph A-63 above.

Transition

A-65. AcSEC concluded that entities that previously applied the provisions of the Guide, but that, pursuant to paragraphs .05–.29 of this SOP, do not meet the provisions of this SOP to be an investment company within the scope of the Guide (or that previously retained investment company accounting in the financial statements of a parent company or equity method investor, but do not meet the provisions of paragraphs .30–.45 of this SOP to retain investment company accounting in the financial statements of a parent company or equity method investor), should report the effects of adopting this SOP prospectively by accounting for its investments in conformity with applicable GAAP other than investment company accounting, beginning as of the date of adoption using fair value in conformity with investment company accounting at the date of adoption. In addition, AcSEC concluded that entities that, pursuant to paragraphs .05–.29, are investment companies within the scope of the Guide (or parent companies or equity method investors that meet the provisions of paragraphs .30–.45 to retain investment company accounting in the financial statements of the parent company or equity method investor), but that previously had not followed the provisions of the Guide (or parent companies or equity method investors that previously did not retain investment company accounting in the financial statements of the parent company or equity method investor), should report the cumulative effect of adopting this SOP as an adjustment to opening retained earnings as of the beginning of the year that this SOP is adopted. In addition, all entities with changes in accounting as a result of adopting this SOP should disclose the effect of adopting this SOP on the financial statements of the period of adoption, including any changes in accounting for investments as a result of adopting this SOP, the effect of any changes on the reported amounts of investments as of the date of adoption, and any related effects on net income, change in net assets from operations (for investment companies), or change in net assets (for not-for-profit organizations) and related per share amounts.

A-66. The exposure draft proposed that entities that previously applied the provisions of the Guide (or parent companies or equity method investors that previously retained investment company accounting in the financial statements of the parent company or equity method investor), but that did not meet the investment company conditions in the SOP (or parent companies or equity method investors that do not meet the conditions to retain investment company accounting in the financial statements of the parent company or equity method investor), should be required to apply the provisions of the SOP by retrospective application to the financial statements of prior fiscal years, as if the Guide had not been applied. Also, the exposure draft proposed that entities that met the investment company conditions in the SOP (or parent companies or equity method investors that previously retained investment company accounting in the financial statements of the parent company or equity method investor), but that previously had not followed the provisions of the Guide (or parent companies or equity method investors that previously did not retain investment company accounting in the financial statements of the parent company or equity method investor), should be permitted to adopt the provisions of the SOP either as the cumulative effect of an accounting change or by retrospective application to the financial statements for any number of consecutive prior fiscal years. Some respondents commented that the SOP should require that such changes be reported as the cumulative effect of a change in accounting principle or prospectively. Some respondents commented that the information necessary to apply the provisions of the SOP retroactively is either unavailable or, if available, is available only at unjustified costs. Some respondents commented that entities should be permitted, but not required to apply the provisions of the SOP retroactively. In considering the transition guidance in this SOP, AcSEC concluded that, conceptually, retrospective application provides the most meaningful information because it provides the most comparability. AcSEC believes that in certain circumstances, however, retrospective application may be impracticable because the required information may be unavailable. Accordingly, AcSEC concluded that entities that meet the investment company conditions in the SOP (or parent companies or equity method investors that meet the provisions to retain investment company accounting in the financial statements of the parent company or equity method investor), but that previously had not followed the provisions of the Guide (or parent companies or equity method investors that previously did not retain investment company accounting in the financial statements of the parent company or equity method investor) should report the effects of adopting the SOP in a manner similar to the cumulative effect of a change in accounting principle as an adjustment to opening retained earnings as of the beginning of the year that the SOP is adopted. For entities that previously applied the provisions of the Guide (or parent companies or equity method investors that previously retained investment company accounting in the financial statements of the parent company or equity method investor), but that do not meet the investment company conditions in the SOP (or parent companies or equity method investors that do not meet the conditions to retain investment company accounting in the financial statements of the parent company or equity method investor), AcSEC believes it may be impracticable to obtain some of the information necessary to report the cumulative effect of a change in accounting principle, particularly certain retrospective information pertaining to required disclosures. Accordingly, AcSEC concluded that entities that previously applied the provisions of the Guide (or parent companies or equity method investors that previously retained investment company accounting in the financial statements of the parent company or equity method investor), but that do not meet the investment company conditions in the SOP (or parent companies or equity method investors that do not meet the conditions to retain investment company accounting in the financial statements of the parent company or equity method investor) should report such changes prospectively, beginning as of the date of the adoption using fair value in conformity with investment company accounting at the date of adoption.

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Appendix B

Illustrations

B-1. This appendix provides illustrations to help readers understand and apply certain provisions of this Statement of Position (SOP) to specific fact patterns. These illustrations do not address all possible situations or applications of this SOP.

Separate Financial Statements of an Investment Company

Illustration 1

B-2. Facts: Venture Partners I is formed in XX01 as a limited partnership with a 10-year life. Venture Partners I's offering memorandum provides that its purpose is to "invest in companies having rapid growth potential, with the objective of realizing superior capital appreciation over the life of Venture Partners I."

B-3. GP I serves as the general partner of Venture Partners I and provides 1 percent of the capital to Venture Partners I. GP I is charged with the responsibility of identifying suitable investments for Venture Partners I.

B-4. Approximately 75 limited partners in Venture Partners I provide 99 percent of the capital to Venture Partners I. No limited partner provides 10 percent or more of the total capital of Venture Partners I. The 75 limited partners include entities subject to ERISA regulations (such as pension plans), public employee retirement systems of several states and municipalities, insurance companies, and wealthy individuals. By definition, the limited partners are passive investors in Venture Partners I and have no role in the management of Venture Partners I.

B-5. Venture Partners I commences its investment activities in XX01 and acquires equity interests in five entities during its first year of operations. Other than acquiring these equity interests, Venture Partners I conducts no other activities. Such equity interests represent less than a 20 percent ownership interest in each investee. GP I is not on the board of directors of any investee. However, to satisfy certain ERISA regulations, Venture Partners I obtains certain management rights with respect to each investee. These rights include:

- The opportunity to meet annually with the management of the investee to discuss the annual operating plan
- The right to examine the books and records of the investee
- The right to receive copies of all minutes, consents, and other materials provided to the board of directors of the investee (except those items which the investee considers highly confidential proprietary information)
- The right to address the board of directors of the investee regarding significant business issues facing the investee

No relationships or activities described in paragraph .18 of this SOP exist that provide evidence that Venture Partners I is investing for strategic operating purposes.

B-6. Venture Partners I makes similar investments in each of the next three years. Venture Partners I intends to dispose of its interests in each of its investees during the 10-year stated life of Venture Partners I. Such dispositions may include the outright sale for cash of the equity interest, the distribution of marketable equity securities to investors following the successful public offering of the investees' securities, or the acquisition of the investee by a public company.

B-7. *Question:* Is Venture Partners I an investment company within the scope of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide)?

B-8. *Conclusion:* Venture Partners I is an investment company within the scope of the Guide.

B-9. *Analysis:* Though Venture Partners I is not an entity regulated by the 1940 Act or similar requirements and therefore is not automatically an investment company within the scope of the Guide pursuant to paragraph .09 of this SOP, Venture Partners I meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Venture Partners I satisfies the basic investment company requirements—it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple substantive investments from which it intends to exit within a defined time period; and none of its investments is made for strategic operating purposes.

B-10. Consideration of the "Factors to Consider" in paragraphs .19–.29 of this SOP provides evidence to support the conclusion that Venture Partners I is an investment company within the scope of the Guide. Specifically, Venture Partners I has pooling of funds from numerous investors with none having a significant interest in Venture Partners I or an ability to influence Venture Partners I's activities; Venture Partners I's level of ownership in its investees provides no evidence that Venture Partners I is investing for strategic operating purposes; Venture Partners I has substantially all passive investors, including employee benefit plans; and neither Venture Partners I nor GP I, the general partner, is involved in the day-to-day management of the investees, provides significant administrative or support services to the investees, or directs the integration of operations of the investees or establishment of business relationships. Though Venture Partners I has obtained certain management rights, those rights impose no obligation on the investees and do not result in Venture Partners participating in the day-to-day management of investees.

Illustration 2

Illustration 2 builds upon Illustration 1. Information in the fact pattern of Illustration 2 that differs from the facts in Illustration 1 is highlighted by using italics.

B-11. *Facts:* Venture Partners II is formed in XX01 as a limited partnership with a 10-year life. Venture Partners II's offering memorandum provides that its purpose is to "invest in companies having rapid growth potential, with the objective of realizing superior capital appreciation over the life of Venture Partners II."

B-12. GP II serves as the general partner of Venture Partners II and provides 1 percent of the capital to Venture Partners II. GP II is charged with the responsibility of identifying suitable investments for Venture Partners II.

B-13. Approximately 75 limited partners in Venture Partners II provide 99 percent of the capital to Venture Partners II. No limited partner provides 10 percent or more of the total capital of Venture Partners II. The 75 limited partners include entities subject to ERISA regulations (such as pension plans), public employee retirement systems of several states and municipalities, insurance companies, and wealthy individuals. By definition, the limited partners are passive investors in Venture Partners II and have no role in the management of Venture Partners II.

B-14. Venture Partners II commences its investment activities in XX01. *However, no suitable investments are identified by the end of XX01. In XX02, Venture Partners II acquires an equity interest in one entity, Widget Corporation. Venture Partners II is unable to close another investment transaction until XX03, at which time it acquires equity interests in five additional operating companies. Additionally, in XX03, an employee of GP II, the general partner, assumes a temporary role as chief executive officer (CEO) of Widget Corporation following the unexpected departure of the previous CEO. The GP II employee serves as the CEO for a period of 18 months before a suitable permanent CEO is identified and retained. During substantially all of the period that GP II's employee serves as CEO of Widget Corp, an active search for the replacement CEO is under way.* Further, to satisfy certain ERISA regulations, Venture Partners II obtains certain management rights with respect to each investee. These rights include:

- The opportunity to meet annually with management of the investee to discuss the annual operating plan
- The right to examine the books and records of the investee
- The right to receive copies of all minutes, consents, and other materials provided to the board of directors of the investee (except those items which the investee considers highly confidential proprietary information)
- The right to address the board of directors of the investee regarding significant business issues facing the investee

No relationships or activities described in paragraph .18 of this SOP exist that provide evidence that Venture Partners II is investing for strategic operating purposes.

B-15. Other than acquiring these equity interests, Venture Partners II conducts no other activities. Such equity interests represent less than a 20 percent ownership interest in each investee.

B-16. Venture Partners II intends to dispose of its interests in each of its investees during the 10-year stated life of Venture Partners II. Such dispositions may include the outright sale for cash of the equity interest, the distribution of marketable equity securities to investors following the successful public offering of the investees' securities, or the acquisition of the investee by a public company.

B-17. *Question:* During any relevant period from XX01 through XX03, is Venture Partners II an investment company within the scope of the Guide?

B-18. *Conclusion:* Venture Partners II is an investment company within the scope of the Guide during the entire period from XX01 through XX03.

B-19. *Analysis:* Though Venture Partners II is not an entity regulated by the 1940 Act or similar requirements and, therefore, is not automatically an investment company within the scope of the Guide pursuant to paragraph .09

of this SOP, Venture Partners II meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Venture Partners II satisfies the basic investment company requirements—it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple substantive investments from which it intends to exit within a defined time period; and none of its investments is made for strategic operating purposes.

B-20. Though Venture Partners II does not have multiple substantive investments until XX03, during each of XX01, XX02, and XX03, its business purpose is to hold multiple substantive investments and Venture Partners II is actively pursuing investment opportunities during these periods. Paragraph .15 of this SOP provides that the criterion does not require an investment company to have multiple substantive investments at all times throughout its existence, noting in particular periods during which suitable investments have not been identified, provided, however, that the business purpose of the entity includes plans to hold multiple substantive investments. Venture Partners II meets this criterion. Also, its disposition plan satisfies the criterion for an exit within a defined time period.

B-21. As noted in paragraph B-19 above, Venture Partners II meets the definition of an *investment company*; consideration of the "Factors to Consider" in paragraphs .19–.29 of this SOP, as well as the guidance in paragraphs .05 and .11–.18 of this SOP, in totality, supports the conclusion that Venture Partners II is an investment company within the scope of the Guide. Specifically, Venture Partners II has pooling of funds from numerous investors with none having a significant interest in Venture Partners II or an ability to influence Venture Partners II's activities; Venture Partners II's level of ownership in its investees provides no evidence that Venture Partners II is investing for strategic operating purposes; Venture Partners II has substantially all passive investors, including employee benefit plans; and neither Venture Partners II nor GP II, the general partner, is involved in the day-to-day management of the investees, provides significant administrative or support services to the investees, or directs the integration of operations of the investees or establishment of business relationships.

B-22. Though the role of an employee of GP II, the general partner, as the CEO, provides evidence that Venture Partners II may be investing for strategic operating purposes, that evidence is not considered significant in this situation because the involvement in management is provided on a temporary basis to address a particular concern pertaining to a particular investee, the investee is actively searching for a permanent CEO, and such involvement has not been provided on a required, continuous, or repeated basis to many investees. Accordingly, that evidence does not outweigh other evidence that Venture Partners II is an investment company within the scope of the Guide.

Illustration 3

Illustration 3 builds upon Illustration 2. Information in the fact pattern of Illustration 3 that differs from the facts in Illustration 2 is highlighted by using italics.

B-23. *Facts:* Venture Partners III is formed in XX01 as a limited partnership with a 10-year life. Venture Partners III's offering memorandum provides that its purpose is to "invest in companies having rapid growth potential, with the objective of realizing superior capital appreciation over the life of Venture Partners III."

B-24. GP III serves as the general partner of Venture Partners III and provides 1 percent of the capital to Venture Partners III. GP III is charged with the responsibility of identifying suitable investments for Venture Partners III.

B-25. *Venture Partners III has four limited partners that provide 99 percent of the capital to Venture Partners III. These limited partners each provide from 10 percent to 50 percent of the total capital of Venture Partners III. The limited partners include one pension plan subject to ERISA regulations, a corporation, and two wealthy individuals.* By definition, the limited partners are passive investors in Venture Partners III and have no role in the management of Venture Partners III.

B-26. *Venture Partners III commences its investment activities in XX01 and acquires equity interests in multiple investees during a four-year investment cycle. By XX03, Venture Partners III ultimately invests in 35 companies. The capital structure of the investees typically includes one or two other institutional investors, and Venture Partners III has ownership interests in the investees typically ranging from 15 percent to 35 percent, though Venture Partners III owns 55 percent of one of the investees.* To satisfy certain ERISA regulations, Venture Partners III obtains certain management rights with respect to each investee. These rights include:

- The opportunity to meet annually with management of the investee to discuss the annual operating plan
- The right to examine the books and records of the investee; the right to receive copies of all minutes, consents, and other materials provided to the board of directors of the investee (except those items which the investee considers highly confidential proprietary information)
- The right to address the board of directors of the investee regarding significant business issues facing the investee

An employee of GP III, the general partner, or an individual designated by Venture Partners III, typically takes a board seat with each investee. Over the four-year investment cycle, GP III serves on the boards of directors of 21 investees and Venture Partners III designates five other individuals, including the employee of one of its limited partner investors, to serve on the boards of directors of five other investees. No relationships or activities described in paragraph .18 of this SOP exist that provide evidence that Venture Partners III is investing for strategic operating purposes.

B-27. *In XX02, GP III, the general partner, becomes involved in the management of certain investees on a temporary basis to address particular concerns. Ultimately, from XX02 through XX03, the employees of GP III serve as temporary CEO of one investee for three months; temporary chief operating officer (COO) of another investee for eight months; temporary CEO of a third investee for nine months; and assists five other investees (at the investees' request) in the development of either their marketing plan or project engineering development. During the course of the temporary CEO and COO roles, ongoing efforts exist to retain permanent replacements. Additionally, on two separate occasions, the chief financial officer (CFO) of GP III and Venture Partners III assists two start-up investees in establishing accounting policies and procedures and in developing their initial budgets at the investees' request.*

B-28. Other than acquiring these equity interests, Venture Partners III conducts no other activities.

B-29. Venture Partners III intends to dispose of its interests in each of its investees during the 10-year stated life of Venture Partners III. Such dispositions may include the outright sale for cash of the equity interest, the distribution of marketable equity securities to investors following the successful public offering of the investee's securities, or the acquisition of the investee by a public company.

B-30. *Question:* During any relevant period from XX01 through XX03, is Venture Partners III an investment company within the scope of the Guide?

B-31. *Conclusion:* Venture Partners III is an investment company within the scope of the Guide during the entire period from XX01 through XX03.

B-32. *Analysis:* Though Venture Partners III is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and, therefore, is not automatically an investment company within the scope of the Guide, Venture Partners III meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Venture Partners III satisfies the basic investment company requirements—it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation or both; it makes multiple substantive investments from which it intends to exit within a defined time period; and none of its investments is made for strategic operating purposes.

B-33. The "Factors to Consider" in paragraphs .19–.29 of this SOP require a more thorough review and consideration because of the existent circumstances, though ultimately, the evidence in totality supports the conclusion that Venture Partners III is an investment company within the scope of the Guide. Extensive pooling of funds does not exist due to the relatively small number of investors (four), some with relatively high investment levels (in particular the 50 percent interest of one investor); Venture Partners III has a significant level of ownership interests in investees (ranging from 15 percent to 35 percent, though Venture Partners III owns 55 percent of one of the investees); and one investor has direct involvement with an investee through the position of the investor's employee as a board member of an investee. Nevertheless, the limited partnership structure, as well as partial ownership by an employee benefit plan, points toward the passive nature of the investors (by definition, limited partners are passive investors and, therefore, have no active role in the management of the entity). The active involvement by employees of GP III, the general partner, in several of the investees (rather than just one), however, provides evidence that Venture Partners III may be investing for strategic operating purposes. In this fact pattern, however, GP III's involvement in each case was for a limited and temporary time period to address a particular concern pertaining to a particular investee and ongoing efforts exist to identify permanent management personnel. Also, Venture Partners III was involved with only three investees (out of 35) in a management role and with seven others at the request of the investees. (As discussed in paragraph .24 of this SOP, participation on the board of directors of investees is not necessarily inconsistent with the definition of an *investment company.)* Accordingly, the evidence pointing toward the conclusion that Venture Partners III is an investment company within the scope of the Guide outweighs the evidence pointing toward the conclusion that Venture Partners III is not an investment company.

Illustration 4

Illustration 4 builds upon Illustration 3. Information in the fact pattern of Illustration 4 that differs from the facts in Illustration 3 is highlighted by using italics.

B-34. *Facts:* Venture Partners IV is formed in XX01 as a limited partnership with a 10-year life. Venture Partners IV's offering memorandum provides that its purpose is to "invest in companies having rapid growth potential, with the objective of realizing superior capital appreciation over the life of Venture Partners IV."

B-35. GP IV serves as the general partner of Venture Partners IV and provides 1 percent of the capital to Venture Partners IV. GP IV is charged with the responsibility of identifying suitable investments for Venture Partners IV.

B-36. *Venture Partners IV has 11 limited partners that provide 99 percent of the capital to Venture Partners IV. The limited partners include two pension plans subject to ERISA regulations (each with a 45 percent interest) and nine individuals (each with a 1 percent interest). The pension plans are sponsored by XYZ Corporation and the individual investors are board members or members of management of XYZ Corporation.* By definition, the limited partners are passive investors in Venture Partners IV and have no role in the management of Venture Partners IV. *However, as described below, management and other representatives of XYZ Corporation are involved in the day-to-day management of certain investees. Under the terms of the partnership agreement, the general partner can be replaced by a vote of two-thirds of the limited partnership interests.*

B-37. Venture Partners IV commences its investment activities in XX01 and acquires equity interests in multiple investees during a four-year investment cycle. By XX04, Venture Partners IV ultimately invests in 35 companies. The capital structure of the investees typically includes one or two other institutional investors, and Venture Partners IV has ownership interests in the investees typically ranging from 15 percent to 35 percent, *though several of the investments represent greater than 50 percent ownership interests in investees.*

B-38. Like many entities with investors subject to ERISA regulations, Venture Partners IV obtains certain management rights with respect to each investee. *Also, Venture Partners IV imposes certain other conditions (referred to as* higher conditions*) on each investee. Examples of these higher conditions include:*

- *Rather than a more customary right to meet annually with management of the investee to discuss the annual operating plan, Venture Partners IV obtains the right to approve the annual operating plan.*
- *Rather than a right to address the board of directors of the investee regarding significant business issues facing each investee, Venture Partners IV requires the board to consult with the management of XYZ Corporation and to obtain the approval of the management of XYZ Corporation on all important decisions.*
- *Venture Partners IV has blocking rights on all votes of investees regarding mergers, acquisitions, public sales of stock, and all other liquidating events.*

An employee of GP IV, the general partner, or an individual designated by Venture Partners IV typically takes a board seat with each investee. Over the four-year investment cycle, GP IV serves on the boards of directors of five investees, and Venture Partners IV designates employees of XYZ Corporation to fill board seats on all other investees.

B-39. *XYZ Corporation has a broad diversification of operations and expertise in many industries. As a result, XYZ Corporation has extensive management expertise in many of the industries in which investees of Venture Partners IV* *operate. In XX02, GP IV, the general partner, hires a number of new individuals from XYZ Corporation to provide management assistance to investees. These new employees have expertise in marketing, engineering, and finance. These new employees serve as temporary CEOs, COOs, and CFOs for many of the investees. In addition, other employees of GP IV or XYZ Corporation assist many other investees in the development of either their marketing plans, budgets, or project engineering. During the course of the management involvement and assistance, limited efforts have been made to retain permanent management personnel because plans have been established to sell operations of investees to other companies. As a result of GP IV's and XYZ Corporation's involvement in the management of investees, GP IV directs the integration of operations between certain investees.*

B-40. Venture Partners IV conducts no other activities.

B-41. Venture Partners IV intends to dispose of its interests in each of its investees during the 10-year stated life of Venture Partners IV. Such dispositions may include the outright sale for cash of the equity interest, the distribution of marketable equity securities to investors following the successful public offering of the investees' securities, *the sale of operations of investees*, or the acquisition of the investee by a public company.

B-42. *Question:* During any relevant period from XX01 through XX04, is Venture Partners IV an investment company within the scope of the Guide?

B-43. *Conclusion:* Venture Partners IV is not an investment company within the scope of the Guide during any relevant period from XX01 through XX04.

B-44. *Analysis:* Venture Partners IV is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and, therefore, is not automatically an investment company within the scope of the Guide. In some respects, Venture Partners IV's activities are consistent with the definition of an *investment company* in paragraph .05 of this SOP. Specifically, Venture Partners IV is a separate legal entity; its stated business purpose is investing for current income, capital appreciation, or both; it has made multiple substantive investments; and it has a defined exit strategy.

B-45. However, further consideration of the evidence leads to the conclusion that Venture Partners IV is investing for strategic operating purposes. Though Venture Partners IV is owned by a number of investors, all of the limited partner investors are related to XYZ Corporation. Also, Venture Partners IV has significant ownership interests in certain investees, including some interests over 50 percent. In addition, though limited partners typically are passive investors and the investors are primarily employee benefit plans, representatives of both XYZ Corporation and GP IV are involved in the management of many of Venture Partners IV's investees. Accordingly, evidence exists that Venture Partners IV, XYZ Corporation, and GP IV are exerting significant, continuous, and repeated influence on the day-to-day activities and the strategic direction of Venture Partners IV's investee's. Examples of that evidence include the following:

- XYZ Corporation and GP IV participate on the boards of directors of a significant number of the investees.
- Management of Venture Partners IV, XYZ Corporation, and GP IV have significant involvement in the day-to-day operations of the investees as evidenced by the right to approve the annual operating plan, the requirement to obtain the approval of management of

> XYZ Corporation on all important decisions, and blocking rights on all votes of investees regarding mergers, acquisitions, public sales of stock, and all other liquidating effects.

Also, the ability and the practice of Venture Partners IV to compel investees to utilize GP IV and employees of XYZ Corporation as investee board members and management personnel constitutes significant, continuous, and repeated involvement in the day-to-day management of investees. Consequently, significant evidence exists that Venture Partners IV is investing for strategic operating purposes and, based on consideration of the "Factors to Consider," as discussed in paragraphs .19–.29 of this SOP, little evidence exists to support a conclusion that Venture Partners IV is an investment company within the scope of the Guide. Accordingly, though some evidence exists that Venture Partners IV is an *investment company* within the scope of the Guide, other, more persuasive, evidence exists that Venture Partners IV is investing for strategic operating purposes and, therefore, Venture Partners IV is not an investment company within the scope of the Guide.

Illustration 5

B-46. Facts: Technology Investors Corporation is formed in XX01 by Major Retail Corporation, a publicly-traded retail company. Technology Investors Corporation's articles of incorporation provide that Technology Investors Corporation's purpose is to "invest in technology companies having rapid growth potential, with the objective of realizing superior capital appreciation." Technology Investors Corporation is not an entity regulated by the 1940 Act or similar requirements. Employees of Major Retail Corporation direct the investment activities of Technology Investors Corporation.

B-47. Technology Investors Corporation commences its investment activities in XX01 with investments in two entities and subsequently makes additional investments in 25 more entities in XX02 through XX06. Major Retail Corporation is not involved in the formation or start-up of the investees. An employee of Major Retail Corporation participates on the boards of directors of some investees. Technology Investors Corporation's investment in each investee generally is made with other entities (some of whom are investment companies). Technology Investors Corporation typically holds between 5 percent and 25 percent of each investee on a fully diluted basis. Other than its participation on the boards of directors of certain investees, Major Retail Corporation is not involved in the operations of the investees and the operations of investees are unrelated to the operations of Major Retail Corporation. No relationships or activities described in paragraph .18 of this SOP exist that provide evidence that Technology Investors Corporation is investing for strategic operating purposes.

B-48. Technology Investors Corporation expects to liquidate its holdings in each investee within six years of its initial investment. The exit strategy is for each investee to either have an initial public offering of equity securities (in which case Technology Investors Corporation will eventually liquidate its holdings through the public markets) or to be acquired for cash or the acquirer's public stock (in which case Technology Investors Corporation will eventually liquidate its holdings in the acquirer's public stock through the public markets). As of December 31, XX06, Technology Investors Corporation has liquidated its investments in five of the investees.

B-49. *Question:* During any relevant period from XX01 through XX06, is Technology Investors Corporation an investment company within the scope of the Guide?

B-50. *Conclusion:* Technology Investors Corporation is an investment company within the scope of the Guide during the entire period from XX01 through XX06.

B-51. *Analysis:* Though Technology Investors Corporation is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and, therefore, is not automatically an investment company within the scope of the Guide, Technology Investors Corporation meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Technology Investors Corporation satisfies the basic investment company requirements—it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple substantive investments from which it intends to exit within a defined time period; and none of its investments is made for strategic operating purposes.

B-52. Consideration of the "Factors to Consider" in paragraphs .19–.29 of this SOP provides evidence to support the conclusion that Technology Investors Corporation is an investment company within the scope of the Guide. Though Technology Investors Corporation is wholly owned and, therefore, does not have pooled funds nor is it owned substantially by passive investors, Technology Investors Corporation:

- Has relatively low levels of ownership interests in investees.
- Is not involved in the day-to-day management of investees.
- Does not provide investees with significant administrative or support services.
- Does not direct the integration of operations of investees or the establishment of business relationships between investees or their affiliates.

Though Major Retail Corporation participates on boards of directors of investees, such participation is not necessarily inconsistent with the definition of an *investment company*, as discussed in paragraph .24 of this SOP.

B-53. Though Technology Investors Corporation has not exited from all of its investments as of December 31, XX06, no evidence exists that Technology Investors Corporation's relationships with investees differs from those of the other investors in the investees, and Technology Investors Corporation does have a stated exit strategy. More specifically, no evidence exists to support the conclusion that Technology Investors Corporation is retaining its investment in any investee for strategic operating purposes rather than for current income, capital appreciation, or both.

Illustration 6

B-54. *Facts:* High Technology Fund is formed by six high-technology companies to invest in high-technology start-up companies. Investments generally are expected to represent controlling financial interests in investees. In certain circumstances, investments held by High Technology Fund are expected to be transferred to or acquired by certain investors in High Technology Fund if the technology developed by the investees would benefit the operations of the investors. Though High Technology is managed by an investment adviser that is otherwise not related to the investors, the investors in the High Technology Fund provide significant advice to the investment adviser concerning potential investments. High Technology Fund generally does not participate in the day-to-day management of investees. However, investors in High Technology

Fund sometimes provide strategic direction to investees and participate on the boards of directors of investees. In addition, High Technology Fund intends to direct the integration of certain operations of investees to attempt to maximize the overall value of the portfolio.

B-55. *Question:* Is High Technology Fund an investment company within the scope of the Guide?

B-56. *Conclusion:* High Technology Fund is not an investment company within the scope of the Guide.

B-57. *Analysis:* High Technology Fund is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and, therefore, is not automatically an investment company within the scope of the Guide. As discussed in the description of High Technology Fund's activities and its relationships with its investors, the business purpose of High Technology Fund is for strategic operating purposes, rather than for current income, capital appreciation, or both. High Technology Fund expects to have controlling financial interests in investees and an active role in the management of investees, including providing strategic direction and directing the integration of certain operations of investees. In addition, the exit strategies of High Technology Fund include the potential transfer of operations of investees to investors in High Technology Fund. Those arrangements and circumstances provide evidence that the business purpose of High Technology Fund is investing for strategic operating purposes.

Parent Companies[29]

Illustration 7

B-58. *Facts:* Parent Company I owns a 99 percent limited partnership interest in Private Equity Partners I. Private Equity Advisers I GP, a wholly-owned subsidiary of Parent Company I, owns a 1 percent general partnership interest in Private Equity Partners I. Private Equity Partners I's business objective is to invest in private companies that offer the potential for significant capital appreciation. Private Equity Advisers I GP has a staff of investment professionals with expertise in management, restructuring, and financing. Private Equity Partners I's investment strategy is to hold controlling financial interests in investees in distressed situations, work with investee management to restructure and reposition the investee to increase its value, and then sell the investee within three to five years.

B-59. As part of the effort to restructure and reposition the investees, Private Equity Advisers I GP, as general partner of Private Equity Partners I, directs the integration of certain investees. Such integration activities include buying and selling divisions or operating units between investees or merging investees. In addition, employees of Private Equity Advisers I GP typically participate in the day-to-day management of investees. Though such participation generally is for limited time periods, those employees generally are active in management activities of most investees.

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[29] Illustrations 7 to 9 illustrate certain provisions of this SOP pertaining to whether investment company accounting should be retained in the financial statements of a parent company or equity method investor in circumstances in which an entity in which the parent company or equity method investor invests qualifies for investment company accounting under the provisions of this SOP. In order to retain investment company accounting in the financial statements of a parent company or equity method investor, therefore, the entity in which the parent company or equity method investor invests should qualify as an investment company under the provisions of this SOP.

B-60. *Question:* Is Private Equity Partners I an investment company within the scope of the Guide and, if so, should Parent Company I retain investment company accounting in consolidating its interest in Private Equity Partners I?

B-61. *Conclusion:* Private Equity Partners I is not an investment company within the scope of the Guide and, therefore, Parent Company I should not apply investment company accounting in consolidating its interest in Private Equity Partners I.

B-62. *Analysis:* Private Equity Partners I is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and, therefore, is not automatically an investment company within the scope of the Guide. Though Private Equity Partners I has a stated business objective that is consistent with the definition of an *investment company*, the activities related to the implementation of the investment strategy provide evidence that Private Equity Partners I is investing for strategic operating purposes.

B-63. Consideration of the "Factors to Consider" in paragraphs .19–.29 of this SOP provides evidence to support the conclusion that Private Equity Partners I is not an investment company within the scope of the Guide. Pooled funds do not exist. Parent Company I owns, directly and indirectly, 100 percent of the ownership interests in Private Equity Partners I and controls the investment decisions through the investment management personnel who are employees of Private Equity Advisers I GP, the general partner and a wholly-owned subsidiary of Parent Company I. The lack of pooled funds provides significant evidence that the entity is investing for strategic operating purposes. Also, Private Equity Partners I typically holds controlling financial interests in investees. Such interests provide significant evidence that Private Equity Partners I is investing for strategic operating purposes. Also, Private Equity Partners I is not substantially owned by passive investors. Rather, Private Equity Partners I is effectively wholly-owned by Parent Company I, which (through its wholly-owned subsidiary, Private Equity Advisers I GP) is involved in management of Private Equity Partners I, determines the strategic direction, and runs the day-to-day operations of Private Equity Partners I. This provides evidence that Private Equity Partners I is investing for strategic operating purposes. Also, Private Equity Partners I is involved in the day-to-day management of investees. Though that involvement generally is intended to be on a temporary basis, Private Equity Partners I's investment strategy includes plans to participate in day-to-day management to assist distressed investees. That involvement provides evidence that Private Equity Partners I is investing for strategic operating purposes. Also, as part of the effort to restructure and reposition investees, Private Equity Advisers I GP, as general partner of Private Equity Partners I, directs the integration of certain investees. Though Private Equity Partners I has an express business purpose that appears to be consistent with the definition of an *investment company*, the significant evidence described above outweighs any positive evidence that Private Equity Partners I may be an investment company within the scope of the Guide. Accordingly, Private Equity Partners I is not an investment company within the scope of the Guide.

B-64. In this example, Private Equity Partners I is not an investment company within the scope of the Guide, in part due to the relationships and activities between Parent Company I (and its subsidiaries) and Private Equity Partners I (and its investees). As discussed in this SOP, relationships and activities of affiliates of an entity, such as a parent company, and its investees affect the determination of whether the entity is an investment company within the scope of the Guide. Parent Company I and Private Equity Advisers I GP, the general partner, are affiliates of Private Equity Partners I. Because Private Equity Partners I is not an investment company within the scope of the Guide, further analysis of whether investment company accounting should be retained by Parent Company I in consolidation is unnecessary. (The guidance in this SOP pertaining to retaining investment company accounting in consolidated financial statements of a parent company or the financial statements of an equity method investor applies only in situations in which the subsidiary or equity method investee is an investment company within the scope of the Guide. If the subsidiary or equity method investee is not an investment company within the scope of the Guide, investment company accounting should not be applied in the consolidated financial statements of the parent company nor in the financial statements of an equity method investor.) Accordingly, Private Equity Partners I is not treated as an investment company in its separate financial statements nor in the consolidated financial statements of Parent Company I.

Illustration 8

B-65. *Facts:* Parent Company II has business segments in banking, insurance, investment banking, and consumer finance. Parent Company II owns a 99 percent limited partnership interest in Private Equity Partners II. Private Equity Advisers II GP, a wholly-owned subsidiary of Parent Company II, owns a 1 percent general partnership interest in Private Equity Partners II.

B-66. The purpose of Private Equity Partners II is to invest in companies having rapid growth potential with the objective of realizing superior capital appreciation. Private Equity Partners II develops exit strategies for each investment at the time of acquisition, generally with the expectation that the investments will be sold within three to five years.

B-67. Private Equity Partners II holds a portfolio of over 100 investments in equity securities of investees. Private Equity Partners II has four investments (approximately 8 percent of the value of the portfolio) that represent controlling financial interests in investees (ownership interests range from 60 to 100 percent). Investments in the remaining investees represent ownership interests ranging from 5 to 45 percent. Management of Private Equity Advisers II GP participates on the boards of directors of approximately one-half of investees. In addition, due to the temporary lack of appropriate management expertise at certain investees, Private Equity Advisers II GP has provided limited temporary management assistance to approximately 15 investees over the past several years to address particular concerns to maximize the value of those investments. The period of that assistance generally does not extend beyond several months. However, in one instance, that assistance was necessary for two years due to the extended time required to identify and hire appropriate management at the investee, which was in a highly specialized industry. Other than the temporary involvement in management in certain instances and participation on the boards of directors of many investees, Private Equity Partners II, Private Equity Advisers II GP, and Parent Company II are not otherwise involved in the activities of investees. No relationships or activities described in paragraphs .18 and .35 of this SOP exist that provide evidence that Parent Company II or Private Equity Partners II are investing for strategic operating purposes.

B-68. Parent Company II has established policies concerning the types and nature of investments that may be made by Private Equity Partners II. Those policies provide that Private Equity Partners II may invest in equity securities of private companies in industries specified by an investment committee of Parent Company II (the specified industries currently exclude those in the same line of business as Parent Company II and its subsidiaries); that such investments, unless otherwise approved by the investment committee (including documentation pertaining to the investment committee's consideration of such approval), should not represent controlling financial interests in investees; and that investees should not have any significant business activities with Parent Company II or its related parties. (The controlling financial interests held in certain investees by Private Equity Partners II were approved by the investment committee. Those controlling financial interests were acquired in investees that had financial difficulties subsequent to the initial investments in the companies.) In addition, prior to making investments, Private Equity Partners II is required to make specified inquiries with other business segments of Parent Company II and the treasury group of Parent Company II to identify any potential business activities between Parent Company II or its related parties and potential investees. Any such relationships are referred to the investment committee for evaluation and approval prior to making the investment to ensure that they are not held for strategic operating purposes, and the investment committee documents its consideration of such approval. The intent of these policies is to prohibit Private Equity Partners II from making investments in investees that are involved in the same lines of business as Parent Company II or its related parties or that have significant business activities with Parent Company II or its related parties.

B-69. As a result of complying with the consolidated group policies described above, none of Private Equity Partners II's investees has significant business activities with Parent Company II or its related parties and no investments are held in companies that have significant business activities in banking, insurance, investment banking, or consumer finance.

B-70. In certain cases following an initial public offering by an investee, Private Equity Partners II transfers marketable equity securities to Parent Company II. In all cases, Parent Company II accounts for those marketable equity securities as trading securities in conformity with Financial Accounting Standards Board (FASB) Statement of Financial Accounting No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Parent Company II has a policy that Private Equity Partners II may not distribute investments to Parent Company II unless such investments are (*a*) in marketable equity securities that would not represent significant influence or controlling financial interests or (*b*) otherwise approved by the investment committee.

B-71. *Question:* Is Private Equity Partners II an investment company within the scope of the Guide and, if so, should Parent Company II retain investment company accounting in reporting its interest in Private Equity Partners II?

B-72. *Conclusion:* Private Equity Partners II is an investment company within the scope of the Guide and Parent Company II should retain investment company accounting in its consolidated financial statements.

B-73. *Analysis:* Though Private Equity Partners II is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and, therefore, is not automatically an investment company within the scope of the Guide, Private Equity Partners II meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Private Equity Partners II satisfies the basic investment company requirements—it is a separate legal entity;

its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple substantive investments from which it intends to exit within a defined time period; and none of its investments is made for strategic operating purposes.

B-74. Consideration of the "Factors to Consider" in paragraphs .19–.29 of this SOP provides evidence to support the conclusion that Private Equity Partners II is an investment company within the scope of the Guide. Specifically, Private Equity Partners II generally holds less than controlling financial interests in investees and does not direct the integration of activities of investees or the establishment of business relationships between investees or their affiliates. Evidence that Private Equity Partners II is investing for strategic operating purposes includes the single nonpassive investor in the entity; ownership of controlling financial interests in a limited number of investees; and temporary involvement in the day-to-day management of certain investees. However, due to the few investees in which Private Equity Partners II has controlling financial interests (and the fact that such controlling interests were acquired subsequent to the initial investments due to financial difficulties of the investees) and the limited nature of the involvement in day-to-day management (both in the reasons for such involvement, its duration, and number of investees in which it is involved), evidence that Private Equity Partners II is an investment company within the scope of the Guide outweighs evidence that Private Equity Partners II is not an investment company within the scope of the Guide.

B-75. Parent Company II has established policies effectively distinguishing the nature and types of investments to be made by Private Equity Partners II from investments made by Parent Company II and no other relationships exist between Parent Company II or its related parties with investees that provide evidence that investment company accounting should not be retained in consolidation. In addition, any investments transferred to Parent Company II are marketable equity securities that are reported the same regardless of whether they are held by Parent Company II or Private Equity Partners II.

Equity Method Investors

Illustration 9

B-76. *Facts:* Venture Capital Fund I is formed in XX01 as a limited partnership with a 10-year life. Venture Capital Fund I's offering memorandum states that its purpose is to "invest in technology companies having rapid growth potential, with the objective of realizing superior capital appreciation over the life of Venture Capital Fund I."

B-77. Venture Capital Management Company I GP serves as the general partner of Venture Capital Fund I and provided 1 percent of the capital to Venture Capital Fund I. Venture Capital Management Company I GP is responsible for identifying suitable investments for Venture Capital Fund I. Four limited partners in Venture Capital Fund I exist. Limited partner A has a 9 percent limited partnership interest; limited partner B has a 10 percent limited partnership interest; and limited partners C and D each have a 40 percent limited partnership interest. Other than their investments in Venture Capital Fund I, the limited partners have no relationships with each other or with Venture Capital Management Company I GP. Limited partners A and B do not have the ability to exercise significant influence over Venture Capital Fund I. Representatives of limited partner C and limited partner D participate as advisers to the investment committee of Venture Capital Fund I, which is composed of representatives of Venture Capital Management Company GP I. Limited partner C is a manufacturing company. Limited partner D is a technology company.

B-78. Venture Capital Fund I commences its investment activities in XX01 and acquires equity interests in 35 companies in XX01 through XX03. Venture Capital Fund I typically holds ownership interests in investees ranging from 15 percent to 35 percent. However, Venture Capital Fund I holds two investments that represent greater than 50 percent ownership interests in investees. Approximately 80 percent of the investees of Venture Capital Fund I are in the same line of business as limited partner D. No relationships or activities between Venture Capital Fund I and the investees described in paragraph .18 of this SOP exist that provide evidence that Venture Capital Fund I is investing for strategic operating purposes. In addition, no relationships between limited partners A, B, and C and investees as described in paragraph .35 of this SOP exist that provide evidence that limited partners A, B, and C are investing for strategic operating purposes. Limited partner D, however, has entered into joint venture arrangements with several investees to jointly develop certain technology products. Limited partner D also has acquired certain patents and technology from other investees.

B-79. Representatives of Venture Capital Fund I participate as members of the boards of directors for five of the investees. In addition, representatives of limited partner D participate on the board of directors of 10 of the investees. Management of Venture Capital Fund I is not involved in the day-to-day management of investees. However, a number of investees have met separately with representatives of limited partner D to discuss product development and other issues.

B-80. Venture Capital Fund I intends to dispose of its interests in each of the investees during the 10-year life of Venture Capital Fund I. Such dispositions may include the outright sale for cash of the equity interest, the distribution of marketable equity securities to investors, or other sales of the operations of investees. In addition, limited partner D has expressed interest to Venture Capital Fund I in acquiring operations from certain investees.

B-81. *Question:* Is Venture Capital Fund I an investment company within the scope of the Guide and, if so, should the limited partners retain investment company accounting in applying the equity method to their investments in Venture Capital Fund I?

B-82. *Conclusion:* Venture Capital Fund I is an investment company within the scope of the Guide and limited partners A, B, and C should retain investment company accounting in applying the equity method to their investments in Venture Capital Fund I. Limited partner D, however, does not qualify to retain investment company accounting in applying the equity method to its investment in Venture Capital Fund I.

B-83. *Analysis:* Venture Capital Fund I is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and, therefore, is not automatically an investment company within the scope of the Guide. However, Venture Capital Fund I's business purpose and activities are consistent with the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Venture Capital Fund I satisfies the basic investment company requirements--it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple substantive investments from which it intends to exit within a defined time period; and none of its investments is made for strategic operating purposes.

B-84. Though Venture Capital Fund I has controlling financial interests in two investees, no other significant evidence exists that Venture Capital Fund I may be investing for strategic operating purposes. Though limited partner D has certain other relationships with investees, those relationships should not be considered in the determination of whether Venture Capital Fund I is an investment company within the scope of the Guide because limited partner D is not an affiliate of Venture Capital Fund I.

B-85. Limited partners A and B do not have the ability to exercise significant influence over the operations of Venture Capital Fund I. However, in accordance with SOP 78–9 , *Accounting for Investments in Real Estate Ventures* [section 10,240], and Emerging Issues Task Force (EITF) Topic D-46, *Accounting for Limited Partnership Investments,* as described in paragraph .47 of this SOP, those investors are required to apply the equity method to their investments in Venture Capital Fund I. As discussed in footnote 13 and paragraph .47 of this SOP, those investors should retain investment company accounting in applying the equity method to their investments in Venture Capital Fund I.

B-86. Limited partner C has the ability to exercise significant influence over Venture Capital Fund I and, therefore, the additional provisions of paragraphs .30–.45 of this SOP should be applied to determine whether limited partner C should retain investment company accounting in applying the equity method to its investment in Venture Capital Fund I. Based on the facts and circumstances, no evidence exists that limited partner C is investing for strategic operating purposes. Therefore, limited partner C should retain investment company accounting in applying the equity method to its investment in Venture Capital Fund I.

B-87. Limited partner D also should consider the provisions of paragraphs .30–.45 of this SOP to determine whether investment company accounting should be retained in applying the equity method to its investment in Venture Capital Fund I. In the case of limited partner D, a number of facts and circumstances exist that provide evidence that limited partner D is investing for strategic operating purposes. In particular, the joint venture relationships to jointly develop certain technology products with investees and the acquisition of certain patents and technology from investees provide evidence that limited partner D is investing for strategic operating purposes, as discussed in paragraph .35 of this SOP. In addition, limited partner D's other involvement with investees provides evidence that it is investing for strategic operating purposes, particularly due to the large portion of Venture Capital Fund I's investment portfolio that is in the same line of business as limited partner D. Further, limited partner D has expressed interest in acquiring the operations of certain investees. Accordingly, limited partner D should not retain investment company accounting in applying the equity method to its investment in Venture Capital Fund I. Limited partner D should adjust the financial information of Venture Capital Fund I to account for its investment in Venture Capital Fund I as if Venture Capital Fund I did not apply investment company accounting.

Real Estate

Illustration 10

B-88. *Facts:* Real Estate Company I is formed as a limited partnership with a 10-year life. Its offering memorandum provides that its purpose is to obtain capital appreciation through investments in high-quality operating office buildings. Real Estate Adviser I GP serves as the general partner and holds a 1 percent interest in Real Estate Company I. (Real Estate Adviser I GP also serves as general partner for five other similar limited partnerships.) Six limited partners hold limited partnership interests, representing 99 percent of the interests in Real Estate Company I. Those limited partners include four pension plans subject to ERISA regulations and two wealthy individuals. One of the pension plan investors owns a 40 percent interest in Real Estate Company I and the remaining investors own varying interests from 10 to 15 percent. The limited partners are not otherwise related to Real Estate Company I or Real Estate Adviser I GP, except that certain limited partners also are limited partners in other partnerships managed by Real Estate Adviser I GP. By definition, the limited partners are passive investors in Real Estate Company I and have no role in the management of Real Estate Company I, selection of investment properties, or management of the investment properties. However, the limited partners have the right to replace the general partner with a vote of a simple majority of the limited partners' interests. As general partner, Real Estate Adviser I GP has the ability to exercise significant influence over Real Estate Company I, but does not control Real Estate Company I because Real Estate Adviser I GP can be removed by a vote of a simple majority of the limited partners' interests. Real Estate Adviser I GP therefore is a related party, but not an affiliate of Real Estate Company I.

B-89. In accordance with the terms of the partnership agreement, investment properties are to be disposed of prior to termination of the partnership and proceeds from sales of properties are to be distributed to the partners.

B-90. Real Estate Company I holds all of the ownership interests in ten existing office buildings. Real Estate Company I has no employees. Real Estate Adviser I GP, the general partner, hires independent third-party property managers to perform management functions at seven of the properties. A property management affiliate of Real Estate Adviser I GP is hired to perform property management activities at the other three properties. The arrangement with the affiliate is under the same terms as the arrangements with the third-party property managers. Beginning in the seventh year of the partnership, Real Estate Company I begins to dispose of the investment properties. All properties are sold prior to the termination of the partnership and the proceeds of each sale are distributed to the partners.

B-91. *Question:* Is Real Estate Company I an investment company within the scope of the Guide?

B-92. *Conclusion:* Real Estate Company I is an investment company within the scope of the Guide.

B-93. *Analysis:* Though Real Estate Company I is not an entity regulated by the 1940 Act or similar requirements and, therefore, is not automatically an investment company pursuant to paragraph .09 of this SOP, Real Estate Company I meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Real Estate Company I satisfies the basic investment company requirements—it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple substantive investments from which it exits within the limited life of the entity; and none of its investments is made for strategic operating purposes.

B-94. Consideration of the "Factors to Consider" in paragraphs .19–.29 of this SOP provides evidence to support the conclusion that Real Estate Company

I is an investment company within the scope of the Guide. Specifically, Real Estate Company I has pooled funds; passive investors, including employee benefit plans; management by an unaffiliated investment adviser; and partnership terms requiring proceeds on sales of properties to be distributed to the partners. Evidence that Real Estate Company I is investing for strategic operating purposes includes holding controlling interests in the real estate investment properties and an affiliate of Real Estate Adviser I GP, the general partner, performing the day-to-day management of certain properties.[30] Evidence that Real Estate Company I is an investment company within the scope of the Guide outweighs evidence that Real Estate Company I is not an investment company within the scope of the Guide.

Illustration 11

B-95. *Facts:* Real Estate Partnership I is a limited partnership with a 25-year life. Real Estate Partnership I was formed to own and operate retail properties. The general partner, Retail Property Company I GP, initially has a 20 percent interest in Real Estate Partnership I. The limited partners include ten individuals and five companies. Several of the limited partners are actively involved in other real estate businesses. The limited partners do not have the right to replace or remove the general partner, except in cases of fraud. Retail Property Company I GP has a controlling interest in Real Estate Partnership I and therefore is an affiliate of Real Estate Partnership I.

B-96. Real Estate Partnership I acquires land for development through contributions of properties from the general partner, Retail Property Company I GP. Retail Property Company I GP's interest in Real Estate Partnership I is increased based on the value of the contributed properties. The properties are developed into retail centers through development agreements with Retail Property Company I GP. After development, the properties are managed by Retail Property Company I GP. Retail Property Company I GP also develops, owns, and operates other retail properties.

B-97. Real Estate Partnership I holds land and develops three retail centers. No specific plans for disposal of the properties exist. Upon termination of Real Estate Partnership I, the properties may be sold to third parties or Retail Property Company I GP, the general partner, may acquire properties from Real Estate Partnership I at values determined by independent appraisals.

B-98. *Question:* Is Real Estate Partnership I an investment company within the scope of the Guide?

B-99. *Conclusion:* Real Estate Partnership I is not an investment company within the scope of the Guide.

B-100. *Analysis:* Real Estate Partnership I is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and therefore is not automatically an investment company within the scope of the Guide. Real Estate Partnership I does not meet the definition of an *investment company* because the business purpose and activities of Real Estate Partnership I are to own, develop, and operate retail properties. Though Real Estate Partnership I has a limited life, the general partner of Real Estate Partnership I (an affiliate) is actively involved in the development and operation

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[30] As noted in the fact pattern, Real Estate Adviser I GP, the general partner, is a related party, but not an affiliate of Real Estate Company I. Accordingly, the fact that day-to-day management of certain properties is performed by an affiliate of Real Estate Adviser I GP provides less significant evidence than it would if Real Estate Adviser I GP were an affiliate of Real Estate Company I.

of the properties. Also, Retail Property Company I GP may acquire certain properties upon termination of the partnership.

Illustration 12

B-101. *Facts:* Real Estate Partnership II is a limited partnership with a 10-year life. Its offering memorandum provides that its purpose is to obtain capital appreciation through investments in high-quality operating office buildings. Real Estate Adviser II GP serves as the general partner and holds a 1 percent general partner's interest in Real Estate Partnership II. Real Estate Adviser II GP also holds a 10 percent limited partnership interest in Real Estate Partnership II. (Real Estate Adviser II GP also serves as general partner for five other similar limited partnerships, and affiliates of Real Estate Adviser II GP develop, own, and operate numerous real estate properties, including other office buildings.) In addition to Real Estate Adviser II GP, 50 other investors with limited partnership interests in Real Estate Partnership II exist. Those limited partners include pension plans subject to ERISA regulations, endowment funds of colleges and universities, and wealthy individuals. No investor owns more than a 15 percent interest in Real Estate Partnership II. The limited partners are not otherwise related to Real Estate Partnership II or Real Estate Adviser II GP, the general partner, except that certain limited partners also are limited partners in other partnerships managed by Real Estate Adviser II GP. By definition, the limited partners are passive investors in Real Estate Partnership II and have no role in its management, selection of investment properties, or management of the investment properties. However, the limited partners have the right to replace the general partner with a vote of a majority of the limited partners' interests. As general partner, Real Estate Adviser II GP has the ability to exercise significant influence over Real Estate Partnership II, but does not control Real Estate Partnership II because Real Estate Adviser II GP can be removed by a majority vote of the limited partners. Real Estate Adviser II GP, therefore, is a related party but not an affiliate of Real Estate Partnership II.

B-102. In accordance with the terms of the partnership agreement, investment properties are to be disposed of prior to termination of the partnership and proceeds from sales of properties are to be distributed to the partners.

B-103. Real Estate Partnership II acquires all of the ownership interests in ten existing office buildings. In addition, Real Estate Partnership II acquires three new office building properties that were recently developed by an affiliate of Real Estate Adviser II GP, the general partner.

B-104. Real Estate Adviser II GP, the general partner, generally hires independent third-party property managers to perform management functions at the properties. However, Real Estate Adviser II GP's personnel perform certain property management functions at certain properties for limited periods of time though Real Estate Adviser II GP is searching for appropriate full-time property managers. Beginning in the seventh year of the partnership, Real Estate Partnership II begins to dispose of the investment properties. Eleven properties are sold to independent parties prior to the termination of the partnership and proceeds from each sale are distributed to partners. The remaining two properties are sold to an affiliate of Real Estate Adviser II GP for their appraised fair values.

B-105. *Question:* Is Real Estate Partnership II an investment company within the scope of the Guide and, if so, should Real Estate Adviser II GP, the general partner, an equity method investor, retain investment company accounting in reporting its interest in Real Estate Partnership II?

B-106. *Conclusion:* Real Estate Partnership II is an investment company within the scope of the Guide. However, Real Estate Adviser II GP, the general partner, an equity method investor, should not retain investment company accounting in reporting its interest in Real Estate Partnership II.

B-107. *Analysis:* Though Real Estate Partnership II is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and therefore is not automatically an investment company within the scope of the Guide, Real Estate Partnership II meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Real Estate Partnership II satisfies the basic investment company requirements—it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple substantive investments with a defined exit strategy; and none of its investments is made for strategic operating purposes.

B-108. Consideration of the "Factors to Consider" in paragraphs .19–.29 of this SOP provides evidence to support the conclusion that Real Estate Partnership II is an investment company within the scope of the Guide. Specifically, Real Estate Partnership II has pooled funds; substantive ownership by passive investors, including employee benefit plans; management of Real Estate Partnership II by an unaffiliated investment adviser; and partnership terms requiring properties to be disposed of prior to termination of the partnership and proceeds thereof to be distributed to the partners. Though Real Estate Partnership II holds controlling interests in the real estate investment properties, the day-to-day management of the properties generally is performed by unaffiliated property managers. Though employees of Real Estate Adviser II GP, the general partner, participate in property management functions at certain properties, those arrangements are intended to be temporary until permanent property management personnel are hired. Evidence that Real Estate Partnership II is an investment company within the scope of the Guide outweighs evidence that Real Estate Partnership II is not an investment company within the scope of the Guide.

B-109. However, in assessing whether Real Estate Adviser II GP, the general partner, an equity method investor, should retain investment company accounting in reporting its interest in Real Estate Partnership II, relationships between Real Estate Adviser II GP, the general partner, its related parties, and the underlying properties should be considered. In this situation, Real Estate Adviser II GP's affiliates develop certain properties that are transferred to Real Estate Partnership II; Real Estate Adviser II GP's affiliates acquire certain properties from Real Estate Partnership II; affiliates of Real Estate Adviser II GP are in the same line of business as the investments held by Real Estate Partnership II; and significant purchases or sales of the underlying properties between affiliates of Real Estate Adviser II GP and Real Estate Partnership II exist. The evidence therefore leads to the conclusion that Real Estate Adviser II GP, an equity method investor, is investing in Real Estate Partnership II for strategic operating purposes.

Collateralized Loan Obligations

Illustration 13

B-110. *Facts:* Collateralized Loan Obligation Trust (CLO) was formed in XX03 by Commercial Bank, with Commercial Bank receiving preferred shares of CLO and Commercial Bank transferring loans to CLO in exchange for cash. CLO funds the purchase of the loans by issuing senior notes, preferred shares, and common shares to independent investors. CLO's business purpose is investing for current income, capital appreciation, or both. Commercial Bank does not provide cash collateral or recourse obligations. Commercial Bank receives fees from CLO as manager of CLO's assets and also retains a subordinate interest in CLO in the form of preferred shares in CLO. Cash collections from the loans, net of related expenses, are distributed to the beneficial interest holders in CLO, namely the holders of the senior notes, preferred shares, and the common shares.

B-111. CLO's activities and assets are limited by the terms of its Trust documents (and the related asset management agreement) to investment activities related to the acquired loans. In certain limited circumstances, CLO takes control of collateral on a temporary basis as a result of defaults on loans. CLO does not acquire loans with the intent of taking control of the collateral.

B-112. CLO intends to hold the loans to maturity unless Commercial Bank, as asset manager, determines that the loans should be sold prior to maturity.

B-113. Commercial Bank consolidates CLO in its consolidated financial statements based on the provisions of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised December 2003). Upon formation of CLO, Commercial Bank determines that pursuant to the provisions of this SOP, it should not retain investment company accounting in reporting CLO in its consolidated financial statements.

B-114. *Question:* Is CLO an investment company within the scope of the Guide and, if so, should Commercial Bank retain investment company accounting in consolidating its interest in CLO?

B-115. *Conclusion:* CLO is an investment company within the scope of the Guide. Commercial Bank should not, however, retain investment company accounting in reporting CLO in its consolidated financial statements. (The conclusion that investment company accounting for CLO should not be retained in the consolidated financial statements of Commercial Bank does not affect the analysis or conclusions about whether investment company accounting should be retained by Commercial Bank for other investment company subsidiaries or equity method investees.)

B-116. *Analysis:* Though CLO is not an entity regulated by the 1940 Act or similar requirements and, therefore, is not automatically an investment company within the scope of the Guide pursuant to paragraph .09 of this SOP, CLO meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, CLO meets the basic investment company requirements—it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple substantive investments from which it intends to exit within a defined time; and none of its investments is made for strategic operating purposes.

B-117. Consideration of the "Factors to Consider" in paragraphs .19–.29 of this SOP provides evidence to support the conclusion that CLO is an investment company within the scope of the Guide. Specifically, CLO has pooled funds from numerous investors with none having a significant interest in CLO or an ability to influence its activities; due to the limitations imposed by the terms of CLO's Trust documents and the related asset management agreement, CLO's investors are in effect passive; and CLO is not involved in the day-to-day management of investees[31] (except in limited circumstances in which CLO takes

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[31] In this illustration, investments consist of investments in debt instruments. Those investments are referred to herein as *investees*.

control of collateral, such as upon loan defaults, which is permitted as described in paragraph .13 of this SOP).

B-118. Though CLO is an investment company within the scope of the Guide, investment company accounting should not be retained in the consolidated financial statements of Commercial Bank. Commercial Bank does not have policies that effectively distinguish loans in CLO from other loans held by Commercial Bank. The investments (loans) of CLO are similar to other investments (loans) held by Commercial Bank that are not reported in the same manner as investment company accounting. That is, in the financial statements of CLO, the loans are reported at fair value whereas Commercial Bank has other loans that are not reported at fair value. Accordingly, in conformity with paragraph .30b of this SOP, Commercial Bank should not retain investment company accounting. In addition, in this situation, the loans were transferred from Commercial Bank to CLO. As discussed in paragraphs .36 and .37 of this SOP, such transfers lead to the conclusion that the investments are held by the parent company for strategic operating purposes.

B-119. The determination that investment company accounting for CLO should not be retained in the consolidated financial statements of Commercial Bank was made upon formation of CLO, and it was therefore not previously concluded that investment company accounting should be retained by Commercial Bank in reporting CLO in its consolidated financial statements. Accordingly, the conclusion that Commercial Bank should not retain investment company accounting for CLO does not affect the analysis or conclusions about whether investment company accounting should be retained by Commercial Bank for other investment company subsidiaries or equity method investees.

B-120. Commercial Bank should report the loans in its consolidated financial statements using the same accounting principles that apply to other loans held by Commercial Bank.

B-121. Paragraph 22 of FASB Interpretation No. 46 provides that "any specialized accounting requirements applicable to the type of business in which the variable interest entity operates shall be applied as they would be applied to a consolidated subsidiary." The guidance in this SOP to determine whether investment company accounting should be retained in consolidation applies to both entities that are consolidated based on voting interests and variable interest entities that are consolidated based on the provisions of FASB Interpretation No. 46. In this situation, however, investment company accounting does not apply to the consolidated subsidiary for purposes of the consolidated financial statements of Commercial Bank based on the provisions of this SOP.

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Appendix C

Applying the Provisions of This SOP to Entities That Hold Investments in Real Estate

C-1. As discussed in paragraph .03 of this Statement of Position (SOP) and in paragraphs A-25, A-46, and A-47 of the "Basis for Conclusions" of this SOP, certain entities that hold investments in real estate may meet the definition of an *investment company*. Paragraph .05 of this SOP defines an *investment company*, in part, as a "separate legal entity whose business purpose and activity are investing in multiple substantive investments for current income, capital appreciation, or both, with investment plans that include exit strategies." This SOP includes no specific conclusions applicable to entities that own direct interests in real estate. Entities with direct interests in real estate should consider whether the entity's activities pertaining to those investments would result in the entity not meeting the definition of an *investment company*. The Accounting Standards Executive Committee (AcSEC) acknowledges, however, the challenges of applying the guidance in this SOP to investments in real estate. Accordingly, AcSEC has developed this appendix to help readers apply the (*a*) definition of an *investment company* and (*b*) additional guidance in paragraphs .11–.29 of this SOP to entities that hold investments that represent direct ownership interests in real estate. The following information therefore should be considered in determining whether the entity is a real estate investment company (an investment company that holds direct ownership of real estate) or an operating company (not an investment company).

Express Business Purpose

C-2. Real estate investment companies typically are managed by professional investment advisers that establish and express specified investment objectives that are consistent with investing for current income, capital appreciation, or both. As discussed further below, that express business purpose may be supported by defined exit strategies, a limited life of the entity, distribution of proceeds on sales of investment properties, and other factors. Consideration of the express business purpose of an entity that holds direct ownership interests in real estate typically is similar to consideration of the express business purpose of an entity that holds investments other than real estate.

Entity's Activities, Assets, and Liabilities are Limited to Investment Activities, Assets, and Liabilities

C-3. Activities of real estate investment companies typically are limited to managing investments in real estate properties. Real estate investment companies typically have few or no employees and the activities of real estate investment companies typically are managed by a professional investment adviser in accordance with an advisory contract. In contrast, real estate operating companies typically have employees that perform the management and other activities of the entity and real estate properties.

Multiple Substantive Investments

C-4. Though the investment plans of real estate investment companies would include plans to invest in multiple substantive investments, the holding of multiple real estate properties does not necessarily provide evidence to distinguish real estate investment companies from real estate operating companies because real estate operating companies also sometimes hold multiple properties. Consideration of whether an entity that holds direct ownership interests in real estate invests in multiple substantive investments typically is similar to consideration of whether an entity that holds investments other than real estate invests in multiple substantive investments.

Exit Strategies

C-5. Real estate investment companies have defined exit strategies for the investments and those exit strategies sometimes are supported by a limited life of the entity. In addition, real estate investment companies typically are what is commonly referred to as *closed funds*, because new investors are prohibited after the initial capitalization and proceeds from property sales are distributed to the investors rather than reinvested in new properties.

Not for Strategic Operating Purposes

C-6. Real estate investment companies are not operated for strategic operating purposes and the operations of each property generally are segregated from the operations of the real estate investment company and other investment properties.

Other Factors

Pooling of Funds

C-7. Pooled funds provide significant evidence to support the objective of a real estate investment company as investing for current income, capital appreciation, or both. Due to the potential involvement in the operations of the investment properties as discussed further in the section below, "Involvement in Day-to-Day Management and Administrative and Support Services," evidence of pooled funds may be necessary to support a conclusion that an entity holding direct ownership interests in real estate meets the definition of an *investment company*. Consideration of whether an entity that holds direct ownership interests in real estate has pooled funds typically is similar to consideration of whether an entity that holds investments other than real estate has pooled funds.

Level of Ownership Interests in Investees

C-8. Real estate investment companies may hold partial interests or entire interests in real estate investment properties. Though holding no controlling interests in real estate properties may provide some evidence to support the investment objectives of the entity, ownership of controlling interests in real estate properties does not necessarily preclude the entity from meeting the definition of an *investment company*. Consideration of the level of ownership interests in investees for an entity that holds direct ownership interests in real estate is similar to consideration of the level of ownership interests in investees for an entity that holds investments other than real estate.

Nature of Investors

C-9. In addition to pooling of funds, the nature of the investors may provide significant evidence to support the objective of a real estate investment company as investing for current income, capital appreciation, or both. In particular, the existence of passive investors seeking professional investment management expertise may provide evidence to support that objective. In addition, the existence of pension fund investors may also provide evidence to support the determination that the entity meets the definition of an *investment company*. Consideration of the nature of investors in an entity that holds direct ownership interests in real estate typically is similar to consideration of the nature of investors of an entity that holds investments other than real estate.

Involvement in Day-to-Day Management and Administrative or Support Services

C-10. As noted previously, real estate investment companies typically do not have employees. Such real estate investment companies, therefore, typically hire property management companies[32] to perform day-to-day management of the investment properties, which typically require less strategic planning and development than do investments in other than real estate. In contrast, a real estate operating company typically has employees that are involved in the day-to-day property management functions of the real estate properties, as well as employees that are actively involved in directing and performing development activities at the entity's properties. Also, typically, management of properties held by a real estate investment company is dedicated to specific properties and little or no integration of management between properties exists.

Integration of Investees

C-11. Operations of investment properties of real estate investment companies typically would not be integrated with other properties. Consideration of integration of investees for an entity that holds direct ownership interests in real estate is similar to consideration of integration of investees for an entity that holds investments other than real estate.

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[32] Though property management typically is not performed directly by the real estate investment company, in certain circumstances, property management functions may be performed by entities that are affiliated with the real estate investment company. The involvement in property management of a majority-owned real estate investee by a real estate investment company or its affiliates, while a negative factor, is not necessarily inconsistent with the definition of an *investment company*, though it may provide evidence that the entity is investing for strategic operating purposes, depending on the facts and circumstances.

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Appendix D

Effects on Other Pronouncements

D-1. This Appendix discusses amended sections of American Institute of Certified Public Accountants (AICPA) pronouncements (other than the Audit and Accounting Guide *Investment Companies*) by showing changes made by this Statement of Position (SOP).

D-2. This SOP reconciles and conforms, as appropriate, the accounting and financial reporting provisions established by AICPA SOP 94–3, *Reporting of Related Entities by Not-for-Profit Organizations* [section 10,610].

The following is added as a footnote to the end of paragraph .05:

> AICPA SOP 07-1, *Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies*. For those entities that are investment companies under SOP 07-1, the SOP also addresses the retention of that specialized industry accounting by a parent company in consolidation. Not-for-profit organizations with a controlling financial interest in a for-profit entity (through direct or indirect ownership of a majority voting interest in that entity) that applies investment company accounting pursuant to SOP 07-1 should consider whether investment company accounting should be retained in the financial statements of the parent not-for-profit organization pursuant to SOP 07-1.

The following footnote is added to the end of the first sentence of paragraph .06:

> As discussed in footnote 6 of this SOP, AICPA SOP 07-1 provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies*. For those entities that are investment companies under SOP 07-1, the SOP also addresses the retention of that specialized industry accounting by an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the investment company. Not-for-profit organizations with investments in common stock of a for-profit entity that applies investment company accounting pursuant to SOP 07-1, wherein the not-for-profit organization's investment qualifies for the equity method of accounting in conformity with APB Opinion No. 18, should consider whether investment company accounting should be retained in the financial statements of the investor not-for-profit organization pursuant to SOP 07-1.

Paragraph .07 is revised to read as follows:

> Chapter 8 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* permits investment portfolios to be reported at fair value in certain circumstances. FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*,[33] permits common stock and "in-substance common stock" to be reported at fair value. Not-for-profit organizations are

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[33] FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157, *Fair Value Measurement*. [Footnote added, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159.]

permitted to report investment portfolios at fair value in conformity with that Guide or make an election to report investments in common stock or "in-substance common stock" at fair value pursuant to FASB Statement No. 159 instead of applying the equity method of accounting to investments covered by paragraph .06 of this SOP.

D-3. This SOP reconciles and conforms, as appropriate, the accounting and financial reporting provisions established by the AICPA Audit and Accounting Guide *Health Care Organizations*.

The following is added as a footnote to the end of the first sentence in paragraph 11.10:

> AICPA SOP 07-1, *Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies*. For those entities that are investment companies under SOP 07-1, the SOP also addresses the retention of that specialized industry accounting by a parent company in consolidation. Health care organizations with a controlling financial interest in a for-profit entity (through direct or indirect ownership of a majority voting interest in that entity) that applies investment company accounting pursuant to SOP 07-1 should consider whether investment company accounting should be retained in the financial statements of the parent health care organization pursuant to SOP 07-1.

The following footnote is added to the end of the first sentence of paragraph 11.17:

> As discussed in footnote X, AICPA SOP 07-1 provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies*. For those entities that are investment companies under SOP 07-1, the SOP also addresses the retention of that specialized industry accounting by an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the investment company. Health care organizations with investments in common stock of a for-profit entity that applies investment company accounting pursuant to SOP 07-1, wherein the health care organization's investment qualifies for the equity method of accounting in conformity with APB Opinion No. 18, should consider whether investment company accounting should be retained in the financial statements of the investor health care organization pursuant to SOP 07-1.

D-4. This SOP includes conditions that should be met for investment company accounting to be retained in the financial statements of the entity's parent company or an equity method investor. Accordingly, this SOP nullifies the guidance in Emerging Issues Task Force (EITF) Issue No. 85-12, *Retention of Specialized Accounting for Investments in Consolidation,* but only as it applies to investments in investment companies. AcSEC expects that the EITF will revise its literature to be consistent with this SOP.

D-5. This SOP provides guidance about which entities are included within the scope of the Audit and Accounting Guide *Investment Companies*. EITF Topic D-74 provides as follows:

> Until [AcSEC's project to develop this SOP] is finalized, an entity should consistently follow its current accounting policies for determining whether the provisions of the current Guide apply to investees of the entity or to subsidiaries

that are controlled by the entity. AcSEC will provide similar guidance in the scope section of the proposed Guide and in the transmittal letter accompanying it.

AcSEC expects that the EITF will revise its literature to be consistent with this SOP.

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Appendix E

Schedule of Paragraph Numbers in This SOP and how They Will Be Reflected in the Revised Guide

This SOP	Revised Guide
.01	Not applicable (NA)
.02	NA
.03	1.01
.04	1.02
.05	1.03
.06	1.04
.07	1.05
.08	1.06
.09	1.07
.10	1.08
.11	1.09
.12	1.10
.13	1.11
.14	1.12
.15	1.13
.16	1.14
.17	1.15
.18	1.16
.19	1.17
.20	1.18
.21	1.19
.22	1.20
.23	1.21
.24	1.22
.25	1.23
.26	1.24
.27	1.25
.28	1.26
.29	1.27
.30	9.01

This SOP	Revised Guide
.31	9.02
.32	9.03
.33	9.04
.34	9.05
.35	9.06
.36	9.07
.37	9.08
.38	9.09
.39	9.10
.40	9.11
.41	9.12
.42	9.13
.43	9.14
.44	9.15
.45	9.16
.46	9.17
.47	9.18
.48	1.28
.49	9.19
.50	9.20
.51	9.21
.52	7.79
.53	9.22
.54	Glossary
.55	Glossary
.56	Preface
.57	Preface
.58	Preface

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ACC TOPICAL INDEX

STATEMENTS OF POSITION

References are to section numbers.

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Archive—Practice Bulletins

The guidance included in this section has been codified into the Financial Accounting Standards Board (FASB) *Accounting Standard Codification*™ (ASC) effective July 1, 2009. However, these Practice Bulletins are included herein for archival purposes until further notice.

The Practice Bulletins in this section have not been updated for certain recently issued FASB Statements, including FASB Statement No. 157, *Fair Value Measurements*, and FASB Statement No. 165, *Subsequent Events*.

[The next page is 85,203.]

PB Section 12,000—Archive

PRACTICE BULLETINS

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Section 12,010

Practice Bulletin 1
Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance

November, 1987

NOTICE TO READERS

Practice bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under Rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

.01 The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants has decided to publish AcSEC Practice Bulletins to provide practitioners and preparers with guidance on narrow financial accounting and reporting issues. This bulletin presents background information on AcSEC Practice Bulletins and describes their purpose and scope and the procedures for issuing them.

Background

.02 In 1984, AcSEC established a task force to study its role. The task force recommended, among other things, that AcSEC adopt a procedure for issuing practice bulletins as a means to make its views on narrow financial and reporting issues more easily retrievable. AcSEC has previously stated its views on such issues in notices to practitioners published in the *CPA Letter* or in the *Journal of Accountancy*.

Purpose and Scope

.03 Practice bulletins are used to disseminate AcSEC's views for the purpose of providing guidance to AICPA members on narrow financial accounting and reporting issues. The guidance provided will be similar to that previously published as notices to practitioners.[1] The issues will be limited to those

[1] Previously issued notices to practitioners that continue to be relevant and applicable are listed and reprinted without change in the appendix [paragraph .09] to this practice bulletin. Other notices to practitioners are no longer relevant or applicable, as indicated in the appendix [paragraph .09].

that have not been and are not being considered by the Financial Accounting Standards Board (FASB) or the Governmental Accounting Standards Board (GASB). The purpose of practice bulletins is to enhance the quality and comparability of financial statements.

Procedures for Publication

.04 Drafts of practice bulletins are discussed in open meetings of AcSEC and are available to the public as part of the agenda papers for such meetings. Practice bulletins need not be exposed for comment and are not the subject of public hearings.

.05 A practice bulletin may be published only if—

a. Two-thirds of AcSEC approve publication.

b. The FASB and GASB have had the opportunity to review it, and each of those bodies has informed AcSEC that it has no current plans to consider the issue.

.06 The procedures for issuing amendments of practice bulletins are the same as the procedures for issuing original practice bulletins.

.07 Once a practice bulletin has been approved for issuance, it is distributed to all practice units and other interested parties. The bulletin includes a notice to readers that indicates that—

a. AcSEC is the issuing body.

b. The document is not covered by rule 203 of the AICPA Code of Conduct.

.08 Practice bulletins will be numbered to facilitate reference and retrievability.

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Appendix

The following notices to practitioners, first published in the *CPA Letter*, are still relevant and are reprinted in this appendix (exhibits A through I).

Title	*Date Published*	*Exhibit*
ACRS Lives and GAAP	11/23/81	A
Accounting by Colleges and Universities for Compensated Absences	9/13/82	B
ADC Arrangements	2/10/86	I

The following notices to practitioners published in the *CPA Letter* or in the *Journal of Accountancy* are no longer relevant or applicable.

Title	*Date Published*	*Comments*
Fee Regulations	3/10/80*	FASB Statement No. 91, *Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans,* now provides authoritative guidance.
Accounting for Combinations of Mutual Savings and Loan Associations or Mutual Savings Banks	1/11/82*	FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions,* now provides authoritative guidance.
Mortgage Banking Activities	6/27/83*	Superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions,* 1996.
Interest as a Holding Cost	10/10/83*	Superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions,* 1996.
Certain Real Estate Lending Activities of Financial Institutions	11/83†	Superseded by the 2/10/86 notice on accounting for real estate acquisition, development, and construction (ADC) arrangements.
Allowance for Loan Losses, Insider Loans, and Loan Participations	12/12/83*	The October 1986 Auditing Procedure Study, *Auditing the Allowance for Credit Losses of Banks,* now provides guidance.

* Published in the *CPA Letter.*

† Published in the *Journal of Accountancy.*

Title	*Date Published*	*Comments*
Bank Loan Disclosures	12/26/83‡	Superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions,* 1996.
Accounting and Disclosures for Reinsurance Transactions	1/23/84‡	Effectively superseded by FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.*
Accounting and Disclosure for Income Taxes of Stock Life Insurance Companies in 1983 Financial Statements	1/23/84‡	Applied only to financial statements in 1983.
Loan Origination Fees	9/24/84‡	FASB Statement No. 91, *Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans,* now provides authoritative guidance.
Deposit Float	9/24/84‡	Superseded by and incorporated into the AICPA Audit and Accounting Guide *Banks and Savings Institutions,* 1996.
ADC Loans	11/26/84‡	Superseded by the 2/10/86 notice on ADC arrangements.
Accounting for Foreign Loan Swaps	5/27/85‡	Superseded by and incorporated into the AICPA Audit and Accounting Guide *Banks and Savings Institutions,* 1996.

‡ Published in the *CPA Letter.*

Exhibit A

ACRS Lives and GAAP[||]

The Economic Recovery Tax Act of 1981 established the Accelerated Cost Recovery System (ACRS), which replaces the depreciation system for income tax purposes. ACRS eliminates for income taxes the need to select a depreciation method and to determine each asset's useful life and salvage value. Instead of depreciation deductions permitted by prior tax laws, enterprises must now use recovery deductions in determining taxable income. The recovery deductions are determined by applying percentages specified by the law to the tax basis of the asset for a specified number of years.

The Institute's accounting standards executive committee has been asked whether the recovery deductions used for income tax purposes also may be used as depreciation expense for financial reporting.

Generally accepted accounting principles require that the cost of depreciable assets be allocated to expense over the expected useful life of the asset in a systematic and rational manner. In contrast, the recovery deductions required under ACRS were designed to encourage investment in productive assets by allowing accelerated deduction of the tax basis of an asset.

If the number of years specified by ACRS for recovery deductions for an asset does not fall within a reasonable range of the asset's useful life, the recovery deductions should not be used as depreciation expense for financial reporting. Depreciation expense in financial statements for such an asset should be determined based on the asset's useful life.

If the recovery deductions for income tax purposes differ from depreciation expense for financial reporting, deferred income taxes should be provided in financial statements for the temporary differences that result, as required by FASB Statement No. 109, *Accounting for Income Taxes*. [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

[||] Reprinted from the *CPA Letter*, November 23, 1981.

Exhibit B

Accounting by Colleges and Universities for Compensated Absences#

FASB Statement of Financial Accounting Standards No. 43, *Accounting for Compensated Absences*, requires an employer to accrue a liability for employees' rights to receive compensation for future absences if certain conditions are met. The National Association of College and University Business Officers (NACUBO) asked the FASB to defer the applicability for Statement No. 43 to colleges and universities, which use fund accounting, until fund accounting questions have been resolved.

The board decided not to defer the applicability of Statement No. 43 to colleges and universities and indicated that the statement applies to institutions covered by the AICPA industry audit guide, *Audits of Colleges and Universities*. The audit guide states that it covers "nonprofit institutions of higher education including colleges, universities, community or junior colleges." Such an institution therefore should accrue a liability for compensated absences in accordance with Statement No. 43 following the guidance in this announcement.

AICPA members have recently asked several questions on how to apply Statement No. 43 to institutions covered by the audit guide, especially how to account for the charge when the liability is first recorded. Confusion has resulted from the publication of articles indicating that institutions were recording the liability directly in their plant funds. Research does not reveal any case in which that treatment has been followed.

Although the audit guide was published before Statement No. 43 was issued and therefore does not refer specifically to the application of the statement to those institutions, the audit guide can provide guidance on the questions.

The accounting standards executive committee recently discussed the problem and makes these observations to clarify the application of Statement No. 43 within the guidance provided by the audit guide:

- The liability and charge for compensated absences related to current and previous years should be recorded in the unrestricted current fund.
- Neither the liability nor the charge should be recorded in the plant funds.
- There has been some question as to whether a receivable and related revenue could be recorded for the portion of the liability expected to be paid from present or future state appropriations or grants and contracts for sponsored research and training programs. A receivable and related revenue should be recognized only if the receivable meets the definition of an asset in FASB Statement of Financial Accounting Concepts No. 3, *Elements of Financial Statements of Business Enterprises*. In applying the definition, the college or university should consider factors such as measurability, collectibility and legal rights and should look, for example, to entitlements under state constitutions or contracts with the federal government.

Reprinted from the *CPA Letter*, September 13, 1982.

- The effect of the charge on the unrestricted current fund balance caused by recognition of such a liability may be offset in whole or in part by interfund transfers resulting in a receivable in the unrestricted current fund only if (1) unrestricted assets are available for permanent transfer and (2) payment (or settlement by other means) to the unrestricted current fund is expected within a reasonable period of time.

Exhibit C

Mortgage Banking Activities[**]

[Superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

[**] [Footnote superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

Exhibit D

Interest as a Holding Cost[††]

[Superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

[††] [Footnote superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

Exhibit E

Bank Loan Disclosures[‡‡]

[Superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

[‡‡] [Footnote superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

Exhibit F

Accounting and Disclosures for Reinsurance Transactions[||||]

[Effectively superseded by FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, effective for fiscal years beginning after December 15, 1992.]

[||||] [Footnote effectively superseded by FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, effective for financial statements for fiscal years beginning after December 15, 1992.]

Exhibit G

Deposit Float[##]

[Superseded by and incorporated into the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

[##] [Footnote superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

Exhibit H

Accounting for Foreign Loan Swaps[***]

[Superseded by and incorporated into the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

[***] [Footnote deleted.]

Exhibit I

ADC Arrangement†††

The AICPA accounting standards executive committee (AcSEC) has prepared the following guidance on accounting for real estate acquisition, development, or construction (ADC) arrangements of financial institutions. This guidance is intended to clarify and expand upon the two Notices to Practitioners issued in November 1983 and November 1984 on this subject; accordingly, it supersedes those notices. Because practice and guidance on this matter have been the subject of debate and evolution over time, the guidance contained in this notice should be applied to ADC arrangements entered into after its issuance.

1. Financial institutions may enter into ADC arrangements in which they have virtually the same risks and potential rewards as those of owners or joint venturers. AcSEC believes that, in some instances, accounting for such arrangements as loans would not be appropriate and thus is providing this guidance in determining the proper accounting.

Scope

2. This notice applies only to those ADC arrangements in which the lender participates in *expected residual profit*, as further described below.

Expected Residual Profit

3. Expected residual profit is the amount of profit, whether called interest or another name, such as equity kicker, above a reasonable amount of interest and fees expected to be earned by the lender.

4. The extent of such profit participation and its forms may vary. An example of a simple form might be one in which the contractual interest and fees, if any, on a condominium project are considered to be at fair market rates; the expected sales prices are sufficient to cover at least principal, interest, and fees; and the lender shares in an agreed proportion, for example, 20 percent, 50 percent, or 90 percent, of any profit on sale of the units.

5. A slightly different form of arrangement may produce approximately the same result. For example, the interest rate and/or fees may be set at a level higher than in the preceding example, and the lender may receive a smaller percentage of any profit on sale of the units. Thus, a greater portion of the expected sales price is required to cover the contractual interest and/or fees, leaving a smaller amount to be allocated between the lender and the borrower. The lender's share of expected residual profit in such an arrangement may be approximately the same as in the preceding example. A different arrangement may cause the same result if the interest rate and/or fees are set at a sufficiently high level and the lender does not share in any proportion of profit on sale of the units. Another variation is one in which the lender shares in gross rents or net cash flow from a commercial project, for example, an office building or an apartment complex.

6. The profit participation agreement may or may not be part of the mortgage loan agreement. Consequently, the auditor should be aware of the

††† Reprinted from the *CPA Letter, Special Supplement*, February 10, 1986.

possibility that such agreements may exist and should design audit procedures accordingly. Those procedures could include inquiries to, and requests for written representation from, both the lender and the borrower.

7. The accounting guidance in paragraphs 16 and 17 is based on a consideration of the following characteristics of ADC arrangements. A particular ADC arrangement may have one or more of these characteristics.

Characteristics of ADC Arrangements Implying Investments in Real Estate or Joint Ventures

8. As stated in the "Scope" section, this notice applies to an ADC arrangement in which the lender participates in expected residual profit. In addition to the lender's participation in expected residual profit, the following characteristics suggest that the risks and rewards of an ADC arrangement are similar to those associated with an investment in real estate or joint venture:

- *a.* The financial institution agrees to provide all or substantially all necessary funds to acquire, develop, or construct the property. The borrower has title to but little or no equity in the underlying property.
- *b.* The financial institution funds the commitment or origination fees or both by including them in the amount of the loan.
- *c.* The financial institution funds all or substantially all interest and fees during the term of the loan by adding them to the loan balance.
- *d.* The financial institution's only security is the ADC project. The financial institution has no recourse to other assets of the borrower, and the borrower does not guarantee the debt.
- *e.* In order for the financial institution to recover the investment in the project, the property must be sold to independent third parties, the borrower must obtain refinancing from another source, or the property must be placed in service and generate sufficient net cash flow to service debt principal and interest.
- *f.* The arrangement is structured so that foreclosure during the project's development as a result of delinquency is unlikely because the borrower is not required to make any payments until the project is complete, and, therefore, the loan normally cannot become delinquent.

Characteristics of ADC Arrangements Implying Loans

9. Even though the lender participates in expected residual profit, the following characteristics suggest that the risks and rewards of an ADC arrangement are similar to those associated with a loan:

- *a.* The lender participates in less than a majority of the expected residual profit.
- *b.* The borrower has an equity investment, substantial to the project, not funded by the lender. The investment may be in the form of cash payments by the borrower or contribution by the borrower of land (without considering value expected to be added by future development or construction) or other assets. The value attributed to the land or other assets should be net of encumbrances. There may be little value to assets with substantial prior liens that make foreclosure to collect less likely. Recently acquired property generally should be valued at no higher than cost.

c. The lender has 1) recourse to substantial tangible, saleable assets of the borrower, with a determinable sales value, other than the ADC project that are not pledged as collateral under other loans; or 2) the borrower has provided an irrevocable letter of credit from a creditworthy, independent third party to the lender for a substantial amount of the loan over the entire term of the loan.

d. A take-out commitment for the full amount of the financial institution's loans has been obtained from a creditworthy, independent third party. Take-out commitments often are conditional. If so, the conditions should be reasonable and their attainment probable.

e. Noncancelable sales contracts or lease commitments from creditworthy, independent third parties are currently in effect that will provide sufficient net cash flow on completion of the project to service normal loan amortization, that is, principal and interest. Any associated conditions should be probable of attainment.

Personal Guarantees

10. Some ADC arrangements include personal guarantees of the borrower and/or a third party. AcSEC believes that the existence of a personal guarantee alone rarely provides a sufficient basis for concluding that an ADC arrangement should be accounted for as a loan. In instances where the substance of the guarantee and the ability of the guarantor to perform can be reliably measured, and the guarantee covers a substantial amount of the loan, concluding that an ADC arrangement supported by a personal guarantee should be accounted for as a loan may be justified.

11. The substance of a personal guarantee depends on a) the ability of the guarantor to perform under the guarantee, b) the practicality of enforcing the guarantee in the applicable jurisdiction, and c) a demonstrated intent to enforce the guarantee.

12. Examples of personal guarantees that have the ability to perform would include those supported by liquid assets placed in escrow, pledged marketable securities, or irrevocable letters of credit from a creditworthy, independent third party[ies] in amounts sufficient to provide necessary equity support for an ADC arrangement to be considered a loan. In the absence of such support for the guarantee, the financial statements and other information of the guarantor may be considered to determine the guarantor's ability to perform. Due to the high-risk nature of many ADC arrangements, AcSEC believes financial statements that are current, complete, and include appropriate disclosures and that are reviewed or audited by independent CPAs are the most helpful in this determination.

13. Particular emphasis should be placed on the following factors when considering the financial statements of the guarantor:

a. *Liquidity as well as net worth of the guarantor*—There should be evidence of sufficient liquidity to perform under the guarantee. There may be little substance to a personal guarantee if the guarantor's net worth consists primarily of assets pledged to secure other debt.

b. *Guarantees provided by the guarantor to other projects*—If the financial statements do not disclose and quantify such information, inquiries should be made as to other guarantees. Also, it may be appropriate to obtain written representation from the guarantor regarding other contingent liabilities.

14. The enforceability of the guarantee in the applicable jurisdiction should also be determined. Even if the guarantee is legally enforceable, business reasons that might preclude the financial institution from pursuing the guarantee should be assessed. Those business reasons could include the length of time required to enforce a personal guarantee, whether it is normal business practice in that jurisdiction to enforce guarantees on similar transactions, and whether the lender must choose between pursuing the guarantee or the project's assets, but cannot pursue both. The auditor should consider obtaining written representation from management regarding its intent to enforce personal guarantees.

Sweat Equity

15. Some ADC arrangements recognize value, not funded by the lender, for the builder's efforts after inception of the arrangement, sometimes referred to as *sweat equity*. AcSEC believes that sweat equity is not at risk by the borrower at the inception of an ADC project. Consequently, AcSEC believes sweat equity should not be considered a substantial equity investment on the part of the borrower in determining whether the ADC arrangement should be treated as a loan.

Accounting Guidance

16. In the interest of more uniformity in accounting for ADC arrangements, AcSEC believes the following guidance is appropriate:

a. If the lender is expected to receive over 50 percent of the expected residual profit, as previously defined, from the project, the lender should account for income or loss from the arrangement as a real estate investment as specified by Statement of Financial Accounting Standards (SFAS) No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*,[1] and SFAS No. 66, *Accounting for Sales of Real Estate.*[2]

b. If the lender is expected to receive 50 percent or less of the expected residual profit, the entire arrangement should be accounted for either as a loan or as a real estate joint venture, depending on the circumstances. At least one of the characteristics identified in paragraph 9, b through e, or a qualifying personal guarantee should be present for the arrangement to be accounted for as a loan. Otherwise, real estate joint venture accounting would be appropriate.

1. In the case of a loan, interest and fees may be appropriately recognized as income subject to recoverability. Statement of Position (SOP) No. 75-2, *Accounting Practices of Real Estate Investment Trusts*,[3] and the AICPA Audit and Accounting Guide en-

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[1] Statement of Financial Accounting Standards (SFAS) No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects* (Stamford: FASB, 1982).

[2] SFAS No. 66, *Accounting for Sales of Real Estate* (Stamford: FASB, 1982).

[3] Statement of Position (SOP) No. 75-2, *Accounting Practices of Real Estate Investment Trusts* (New York: AICPA, 1975).

titled, *Banks and Savings Institutions*,[4] provide guidance that may be relevant in those industries in assessing the recoverability of such loan amounts and accrued interest.

2. In the case of a real estate joint venture, the provisions of SOP No. 78-9, *Accounting for Investments in Real Estate Ventures*,[5] and SFAS No. 34, *Capitalization of Interest Cost*,[6] as amended by SFAS No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*,[7] provide guidance for such accounting. In particular, paragraph 34 of SOP No. 78-9 provides guidance on the circumstances under which interest income should not be recognized.

17. ADC arrangements accounted for as investments in real estate or joint ventures should be combined and reported in the balance sheet separately from those ADC arrangements accounted for as loans.

Other Considerations

18. Transactions have occurred in which the lender's share of the expected residual profit in a project is sold to the borrower or a third party for cash or other consideration. If the expected residual profit in an ADC arrangement accounted for as a loan is sold, AcSEC believes the proceeds from the sale should be recognized prospectively as additional interest over the remaining term of the loan. The expected residual profit is considered additional compensation to the lender, and the sale results in a quantification of the profit. When an ADC arrangement is accounted for as an investment in real estate or joint venture and the expected residual profit is sold, gain recognition, if any, is appropriate only if the criteria of SFAS No. 66 are met after giving consideration to the entire ADC arrangement including the continuing relationship between the financial institution and the project.

19. If the financial institution was the seller of the property at the initiation of the project, gain recognition, if any, should be determined by reference to SFAS No. 66.

20. The factors that were evaluated in determining the accounting treatment at inception subsequently change for some ADC arrangements, for example, as a result of a renegotiation of the terms. Consequently, the accounting treatment for an ADC arrangement should be periodically reassessed. An ADC arrangement originally classified as an investment or joint venture could subsequently be treated as a loan if the risk to the lender diminishes significantly, and the lender will not be receiving over 50 percent of the expected residual profit in the project. The lender must demonstrate a change in the facts relied upon when initially making the accounting decision, not just the absence of, or reduced participation in, the expected residual profit. For instance, risk may be reduced if a valid take-out commitment from another lender who has the capability to perform under the commitment is obtained and all conditions affecting the take-out have been met, thus assuring the primary lender recovery

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[4] [Footnote deleted, April 1996, to reflect conforming changes necessary due to the issuance of the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

[5] SOP No. 78-9, *Accounting for Investments in Real Estate Ventures* (New York: AICPA, 1978).

[6] SFAS No. 34, *Capitalization of Interest Cost* (Stamford: FASB, 1979).

[7] SFAS No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method* (Stamford: FASB, 1982).

of its funds. If the lender on the other hand assumes further risks and/or rewards in an ADC arrangement by, for example, releasing collateral supporting a guarantee and/or increasing its percentage of profit participation to over 50 percent, the lender's position may change to that of an investor in real estate. Neither an improvement in the economic prospects for the project or successful, on-going development of the project nor a deterioration in the economic prospects for the project justifies a change in classification of an ADC arrangement. A change in classification is expected to occur infrequently and should be supported by appropriate documentation. The change in factors in an ADC arrangement should be evaluated based on the guidance in this notice and accounted for prospectively.

21. If an ADC arrangement accounted for as a real estate joint venture continues into a permanent phase with the project generating a positive cash flow and paying debt service currently, income should be recognized in accordance with SOP No. 78-9.

22. Regardless of the accounting treatment for an ADC arrangement, management has a continuing responsibility to review the collectibility of uncollected principal, accrued interest, and fees and provide for appropriate allowances. The auditor should determine whether the allowances provided by management are adequate. In connection with this determination, the auditor should review relevant evidential matter including feasibility studies, appraisals, forecasts, non-cancelable sales contracts or lease commitments and information concerning the track record of the developer. In addition, ADC arrangements may involve related parties and the auditor should be aware of such a possibility and design procedures accordingly. Progress information may be less than desirable for the auditor's purpose and may require supplemental procedures. Additional procedures might include on-site inspection of projects or the independent use of experts such as property appraisers or construction consultants to assist in the assessment of the collateral value.

23. Many participations in loans or whole loans are bought and sold by other financial institutions. The accounting treatment for a purchase that involves ADC arrangements should be based on a review of the transaction at the time of purchase in accordance with the guidance in this notice. In applying this guidance, a participant would look to its individual percentage of expected residual profit; for example, a participant who will not share in any of the expected residual profit is not subject to this notice. However, the responsibility to review collectibility and provide allowances applies equally to purchased ADC arrangements. Any reciprocal transactions between institutions, including multi-party transactions, should be viewed in their entirety and accounted for in accordance with their combined effects.

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Section 12,020

Practice Bulletin 2
Elimination of Profits Resulting From Intercompany Transfers of LIFO Inventories

November, 1987

NOTICE TO READERS

Practice bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

.01 The Accounting Standards Executive Committee (AcSEC) believes it is desirable to issue a reminder concerning inventory transfers between or from LIFO (last in, first out) pools, either within a company or between subsidiaries or divisions of a reporting entity, particularly if a LIFO inventory liquidation has occurred in any transferring LIFO pool during the year.[1]

.02 A LIFO liquidation (also called a decrement) occurs when the number of units (or total base year cost if dollar value LIFO is used) in a LIFO pool at year end is less than that at the beginning of the year, causing prior years' costs, rather than current year's costs, to be charged to current year's income. For example, in periods of rising prices, prior years' costs are less than current year's costs and, in such periods, charging prior years' costs to current year's income results in reporting current year's net income higher than it would be reported without a liquidation.

.03 Accounting for a LIFO liquidation is more complex with intercompany transfers of inventories. Accounting Research Bulletin (ARB) 51, *Consolidated Financial Statements*, states that "the purpose of consolidated financial statements is to present . . . the results of operations and the financial position of the parent company and its subsidiaries essentially as if the group were a single company with one or more branches." Under ARB 51, intercompany pro-

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[1] This subject was identified in paragraph 3-2 of AcSEC's November 30, 1984, issues paper, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories*.

fit on assets remaining within the group should be eliminated.[2] Results of operations and financial position, therefore, should not be affected solely because of inventory transfers within a reporting entity. Inventory transferred between or from LIFO pools may cause LIFO inventory liquidations which could affect the amount of intercompany profit to be eliminated.

.04 Many different approaches are used by entities in eliminating such profit. AcSEC believes that each reporting entity should adopt an approach that, if consistently applied, defers reporting intercompany profits from transfers within a reporting entity until such profits are realized by the reporting entity through dispositions outside the consolidated group. The approach should be suited to the entity's individual circumstances.

[2] APB Opinion 18, *The Equity Method of Accounting for Investments in Common Stock*, also requires elimination of a portion of intercompany profit.

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Section 12,040

Practice Bulletin 4
Accounting for Foreign Debt/Equity Swaps

Issue date, unless otherwise indicated: May, 1988

NOTICE TO READERS

Practice Bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under Rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

.01 The Accounting Standards Executive Committee and the Banking Committee of the American Institute of Certified Public Accountants (AICPA) have considered the accounting treatment by financial institutions for exchanges of their public or private sector loans to debtors in financially troubled countries for equity investments in companies in the same countries. These transactions are generally referred to as *debt/equity swaps*. As a result of these deliberations, the committees have prepared the following guidance, based on existing authoritative accounting literature, for financial institutions and independent auditors.

.02 Debt/equity swap programs are in place in several financially troubled countries. Although the programs differ somewhat among the countries, the principal elements of each program generally are as follows. Holders of U.S. dollar-denominated debt of these countries can choose to convert that debt into approved local equity investments. The holders are credited with local currency, at the official exchange rate, approximately equal to the U.S. dollar debt. A discount from the official exchange rate is usually imposed as a transaction fee. The local currency credited to the holder must be used for an approved equity investment. The local currency is not available to the holders for any other purpose. Dividends on the equity investment can generally be paid annually, although there may be restrictions on the amounts of the dividends or on payment of dividends in the early years of the investment. Capital usually cannot be repatriated for several years, and although some countries permit the investment to be sold, the proceeds from any such sale are generally subject to similar repatriation restrictions.

.03 A debt/equity swap is an exchange transaction of a monetary for a nonmonetary asset, which should be measured at fair value at the date the transaction is agreed to by both parties. (See paragraph .11 for a discussion of loss recoveries or gains.)

.04 There is a significant amount of precedent in the accounting for exchange transactions to consider both the fair value of the consideration given up as well as the fair value of the assets received in arriving at the most informed valuation—especially if the value of the consideration given up is not readily determinable or may not be a good indicator of the value received. For example, in acquisitions involving consideration in the form of stock, an examination of the value of the net assets received is often considered necessary if the stock is thinly traded or restricted.

.05 FASB Statement No 141, *Business Combinations*, deals with the acquisition of assets (paragraphs 4 to 8) and with determining the cost of an acquired company (paragraphs 20 to 34). FASB Statement No. 141 provides that assets acquired should be recorded based on the fair value of assets surrendered, liabilities incurred, or equity interests issued, unless the fair value of the assets acquired received is more clearly determinable ("cost may be determined either by the fair value of consideration given up or by the fair value of assets acquired, whichever is the more clearly evident"). Paragraph 20 states that the same accounting principles apply to determining the cost of assets acquired individually, those acquired in a group, and those acquired in business combinations.[*] APB Opinion 29, *Accounting for Nonmonetary Transactions*, paragraph 18, provides similar guidance. [Revised, July 2004, to reflect the conforming changes necessary due to the issuance of FASB Statement No. 141.[†]]

.06 FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended by FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, deals with the receipt of assets in satisfaction of a loan and, in paragraph 28 as amended, states that a creditor shall account for assets received (including an equity interest) at their fair value at the time of the restructuring, unless the fair value of the receivable satisfied is more clearly evident. A creditor that receives long-lived assets from a debtor that will be sold in full satisfaction of a receivable shall account for those assets at their fair value less cost to sell, as that term is used in paragraph 34 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. [Revised, July 2004, to reflect the conforming changes necessary due to the issuance of FASB Statement No. 144.]

.07 Debt/equity swaps have characteristics similar to both the acquisition of assets contemplated by FASB Statement No. 141[‡] and APB Opinion No. 29 and the receipt of assets in satisfaction of a loan contemplated by FASB

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[*] Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141 (revised 2007), *Business Combinations*, should be applied. FASB Statement No. 141(R) provides guidance for the acquisition of assets. [Footnote added, May 2008, due to the issuance of FASB Statement No. 141(R).]

[†] FASB Statement No. 141 supersedes APB Opinion No. 16, *Business Combinations*. [Footnote renumbered due to the issuance of FASB Statement No. 141(R), May 2008.]

[‡] Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141(R) should be applied. [Footnote added, May 2008, due to the issuance of FASB Statement No. 141(R).]

Statement No. 15, as amended by FASB Statement 144. Since the secondary market for debt of financially troubled countries is presently considered to be thin, it may not be the best indicator of the value of the equity investment or of net assets received. In light of this thin secondary market and of the unique nature of the transaction, it is also necessary to examine the value of the equity investment or net assets received. The committees therefore believe that in arriving at the fair value of a debt/equity swap, both the secondary market price of the loan given up and the fair value of the equity investment or net assets received should be considered. It is the responsibility of management to make the valuation considering all of the circumstances. It is the responsibility of independent auditors to become satisfied that the valuation is based on reasonable methods and assumptions, including, as needed, information from independent appraisals. Factors to consider in determining current fair values include the following:

- Similar transactions for cash
- Estimated cash flows from the equity investment or net assets received
- Market value, if any, of similar equity investments
- Currency restrictions, if any, affecting dividends, the sale of the investment, or the repatriation of capital

[Revised, July 2004, to reflect the conforming changes necessary due to the issuance of FASB Statements No. 141† and No. 144.]

.08 In accordance with generally accepted accounting principles, a financial institution's loan portfolio should be carried at amortized historical cost less both loan write-offs and the allowance for loan losses, as long as the financial institution has the ability and intent to hold the loans until their maturity. Management may decide to dispose (by sale of swap) of loans prior to maturity for a number of reasons, including liquidity needs, tax considerations, portfolio diversification objectives, and management practices of generating loans specifically for disposition, in which case the loans should be carried at the lower of cost (amortized historical cost less loan write-offs) or fair value.

.09 If the fair value of the equity investment or net assets received in a debt/equity swap is less than the recorded investment in the loan, the committees believe that a loss should be recognized and recorded at the date the transaction is agreed to by both parties. Although some portion of the swap loss may result from factors such as a change in the interest rate environment for similar loans, the committees believe that the loss results principally from a concern as to the ultimate collectibility of the loan. Therefore, the swap loss generally should be charged to the allowance for loan losses and should include any discounts from the official exchange rate that are imposed as a transaction fee.

.10 All other fees and transaction costs involved in a debt/equity swap should not be capitalized but should be charged to expense as incurred.

.11 Loss recoveries or even gains might be indicated in a swap transaction as a result of the valuation process. However, due to the subjective nature of the valuation process, the committees believe that such loss recoveries or gains ordinarily should not be recorded until the equity investment or net assets received in the swap transaction are realized in unrestricted cash or cash equivalents.

.12 In addition to recording specific transactions during an accounting period, a financial institution, in the course of preparing its financial statements, should review its loan portfolio in order to assess the adequacy of the allowance for loan losses. Allowances are established and write-offs taken based on management's judgment regarding ultimate collectibility of the loans in the normal course of business. Recognition of a debt/equity swap loss should be among the factors to be considered by management in its periodic assessment of the adequacy of the allowance for loan losses with respect to its remaining portfolio of loans to debtors in financially troubled countries.

.13 The committees recommend that the guidance in this practice bulletin be adopted upon issuance.

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Technical Manager

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Section 12,050

Practice Bulletin 5
Income Recognition on Loans to Financially Troubled Countries

July, 1988

NOTICE TO READERS

Practice Bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under Rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

.01 Loans to financially troubled countries (LDC loans) of many banks currently meet the conditions in paragraph 8 of FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, for accrual of loss contingencies. As a result, those banks should have established loan loss allowances for their LDC loans by charges to income.

.02 A financially troubled country may suspend the payment of interest on its loans. Banks with outstanding loans from such a country have also suspended accrual of interest income (placed them on nonaccrual status).

.03 A country that has suspended payment of interest may later resume payment. Guidance on accounting by a creditor for the receipt of interest payments from a debtor that had previously suspended payment, on pages 51 and 52 in the industry audit guide *Audits of Banks* (2nd ed. [1983]) published by the Institute, is as follows:

> Many banks suspend accrual of interest income on loans when the payment of interest has become delinquent or collection of the principal has become doubtful. Such action is prudent and appropriate. Regulatory reporting guidelines for nonaccrual loans have been established by federal supervisory agencies.
>
> Although placing a loan in a nonaccrual status, including loans accruing at a reduced rate, does not necessarily indicate that the principal of the loan is uncollectible in whole or in part, it generally warrants reevaluation of collectibility of principal and previously accrued interest. If amounts are received on a loan on which the accrual of interest has been suspended, a determination should be made about whether the payment received should be recorded as a reduction of the principal balance or as interest income.

> If the ultimate collectibility of principal, wholly or partially, is in doubt, any payment received on a loan on which the accrual of interest has been suspended should be applied to reduce principal to the extent necessary to eliminate such doubt.

.04 At issue is whether this guidance means that the creditor should credit receipt of renewed interest payments to the principal balance of the loan or to income.

Interpretation

.05 The Accounting Standards Executive Committee and the Committee on Banking agree on the interpretation of that section of the guide as set forth in paragraph .07 of this practice bulletin.

[.06] [Effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, effective for financial statements for fiscal years beginning after December 15, 1994.]

.07 When a country becomes current as to principal and interest payments and has normalized relations with the international financial community including, as appropriate, having in place an understanding with the International Monetary Fund regarding its economic stabilization program, and assuming that the allowance for loan losses is adequate, the creditor may recognize receipt of interest payments as income.

.08 Although a country has met the conditions described in paragraph .07, that should not automatically lead to the conclusion that the loans should be returned to accrual status. Some period of payment performance generally is necessary in order to make an assessment of collectibility that would permit returning the loans to accrual status.

Accounting Standards Executive Committee (1987-1988)

Banking Committee (1987-1988)

[The next page is 85,291.]

Section 12,060

Practice Bulletin 6
Amortization of Discounts on Certain Acquired Loans

August, 1989

NOTICE TO READERS

Practice Bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under Rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

.01 The Accounting Standards Executive Committee (AcSEC) has prepared the following guidance, based on existing authoritative literature, regarding amortization of discounts on certain acquired loans for which there is uncertainty as to the amounts or timing of future cash flows.

Scope

.02 This practice bulletin addresses the accounting and reporting by purchasers of loans in fiscal years beginning on or before December 15, 2004 (1) that are acquired in a purchase business combination,* bought at a discount from face value in a transaction other than a business combination, or transferred to a newly created subsidiary after having been written down to fair value with the intent of transferring the stock of the subsidiary as a dividend to the shareholders of the parent company and (2) for which it is not probable that the undiscounted future cash collections will be sufficient to recover the face amount of the loan and contractual interest. [As amended, effective for loans purchased in fiscal years beginning on or before December 15, 2004, by Statement of Position 03-3.]

* Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141 (revised 2007), *Business Combinations*, should be applied and accounted for under the acquisition method. [Footnote added, May 2008, due to the issuance of FASB Statement No. 141(R).]

.03 This practice bulletin applies to loans and other debt securities, such as corporate or governmental bonds, notes, and loan-backed securities, such as pass-through certificates, collateralized mortgage obligations, and other so-called securitized loans. For convenience, those other debt securities are hereinafter referred to as *loans*. It does not apply to loans that are carried at market values or at the lower of cost or market, nor does it apply to loans held by liquidating banks.[1] Enterprises that acquire loans primarily for the rewards of ownership of the underlying nonmonetary collateral should record the collateral rather than the loan. Accordingly, this practice bulletin does not apply to such transactions. SEC Financial Reporting Release No. 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities*, and the February 10, 1986, notice to practitioners on ADC arrangements, reprinted in AcSEC Practice Bulletin 1 [section 12,010], may be helpful in determining whether a loan was acquired for that purpose.

Background

.04 Loans may be acquired at discounts from their face amounts. The discounts normally are amortized with corresponding increases in income over the estimated or contractual lives of the loans. APB Opinion 21, *Interest on Receivables and Payables*, describes the accounting for originated loans:

> *Note received or issued for cash.* The total amount of interest during the entire period of a cash loan is generally measured by the difference between the actual amount of cash received by the borrower and the total amount agreed to be repaid to the lender. Frequently, the stated or coupon interest rate differs from the prevailing rate applicable to similar notes, and the proceeds of the note differ from its face amount. As the Appendix to this Opinion demonstrates, such differences are related to differences between the present value upon issuance and the face amount of the note. The difference between the face amount and the proceeds upon issuance is shown as either discount or premium, which is amortized over the life of the note. (paragraph 6)

.05 APB Opinion 16, *Business Combinations*, gives general guidance for assigning amounts to loans acquired in a purchase business combination:

> Receivables [should be recorded] at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary. (paragraph 88[b])

.06 FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, describes the accounting for loans purchased at discounts:

> The initial investment in a purchased loan or group of loans shall include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. (paragraph 15)
>
> Deferred net fees or costs shall not be amortized during periods in which interest income on a loan is not being recognized because of concerns about the realization of loan principal or interest. (paragraph 17)

[1] Financial reporting by liquidating banks is dealt with in the minutes of the FASB's Emerging Issues Task Force for Issue 88-25, "Ongoing Accounting and Reporting for a Newly Created Liquidating Bank."

> Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in paragraph 20. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization. (paragraph 18)

.07 The FASB's Emerging Issues Task Force's minutes for Issue 87-17 addressed accounting for spin-offs and other distributions of loans receivable to shareholders and relied in part on APB Opinion 29, *Accounting for Nonmonetary Transactions*:

> Other nonreciprocal transfers of nonmonetary assets to owners should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution. (paragraph 23)

The Emerging Issues Task Force minutes state:

> An enterprise distributes loans receivable to its owners by forming a subsidiary and transferring those loans receivable to the subsidiary and then distributing the stock of that subsidiary to shareholders of the parent. If the book value of the loans receivable, which may be either the "recorded investment in the receivable" or the "carrying amount of the receivable," is in excess of their fair value, the accounting issue is whether the enterprise should report the distribution at book value as a spin-off or at fair value as a dividend-in-kind and how the recipient should record the transaction.
>
> The Task Force reached a consensus that the assets should be reported at fair value by the enterprise and the recipient. Task Force members noted that the transaction is not a spin-off because the subsidiary is not an operating company. Rather, the transaction may be considered a dividend-in-kind. Under paragraph 23 of APB Opinion 29, *Accounting for Nonmonetary Transactions*, dividends-in-kind are nonreciprocal transfers of nonmonetary assets to owners that should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would clearly be realizable to the distributing entity in an outright sale at or near the time of distribution.

.08 SEC Staff Accounting Bulletin (SAB) No. 61, *Adjustments of Allowances for Business Combination Loan Losses—Purchase Method Accounting*, states that the allowance for credit losses related to loans acquired by a bank in a purchase business combination should be the same as the allowance provided for those loans by the acquired bank unless the acquiring bank's plans for the ultimate recovery of those loans differ from the plans that served as the basis for the acquired bank's estimation of losses on those loans.

.09 SAB No. 61 states that if the acquired bank's financial statements as of the acquisition date are not fairly stated because of an unreasonable allowance for credit losses, the acquired bank's preacquisition financial statements should be restated to reflect a reasonable allowance, with the resulting adjustment applied to the restated preacquisition income statement of the acquired bank; the allowance for credit losses may not be changed through a purchase accounting adjustment.

.10 *Audits of Banks* (2nd ed. [1983], pp. 51 and 52), an AICPA industry audit guide, includes guidance on the suspension of the accrual of interest income on loans and the subsequent treatment of amounts received on those loans:

> Many banks suspend accrual of interest income on loans when the payment of interest has become delinquent or collection of the principal has become doubtful. Such action is prudent and appropriate. Regulatory reporting guidelines for nonaccrual loans have been established by federal supervisory agencies.
>
> Although placing a loan in nonaccrual status, including loans accruing at a reduced rate, does not necessarily indicate that the principal of the loan is uncollectible in whole or in part, it generally warrants reevaluation of collectibility of principal and previously accrued interest. If amounts are received on a loan on which the accrual of interest has been suspended, a determination should be made about whether the payment received should be recorded as a reduction of the principal balance or as interest income.
>
> If the ultimate collectibility of principal, wholly or partially, is in doubt, any payment received on a loan on which the accrual of interest has been suspended should be applied to reduce principal to the extent necessary to eliminate such doubt.

.11 *Audits of Finance Companies* (Including Independent and Captive Financing Activities of Other Companies), an AICPA industry audit and accounting guide, also includes guidance on the suspension of the accrual of interest income on loans:

> A finance company's revenues from loans should be accrued over time in accordance with the terms of the contracts using the interest (actuarial) method. Even if collections are not timely, the amounts at which assets are recorded in the form of receivables generally should continue to increase. If collection is not probable, however, continuing to accrue income would not reflect economic substance. Accruals or amortization of discount and, in accordance with FASB Statement No. 91, paragraph 17, amortization of deferred net fees or costs should therefore be suspended if collectibility of interest or principal is not probable. The following are examples of events that could cause such uncertainty on consumer loans:
>
> *a.* The borrower is in default under the terms of the loan agreement, and interest or principal payments are past due (often a stipulated number of days past due as established in company policies).
>
> *b.* The ability of the borrower to repay is in doubt because of events such as a loss of employment or bankruptcy.
>
> *c.* The loan terms have been renegotiated.
>
> Identifying commercial loans on which interest should be suspended is, at least mechanically, more difficult because, unlike consumer loans, commercial loans usually lack homogeneous characteristics. In addition to the factors described above, considerations may include whether—
>
> *a.* Significant unsecured balances are due from debtors suffering continued operating losses.
>
> *b.* The financial condition of the debtor is weak.
>
> *c.* The outlook for the debtor's industry is unfavorable.
>
> *d.* The ratio of collateral values to loans has decreased because of changes in market conditions.

e. A portion of the unpaid principal or accrued interest has been written off.

When recognition of interest has been suspended, interest income that has accrued on such loans should not be reversed even though receipt of those amounts may not be forthcoming. The potential uncollectibility of such amounts should be taken into consideration in the computation of the allowance for losses.

Accrual of interest generally should not be resumed until future collectibility of the loan and accrued interest becomes probable. Determining future collectibility is a matter of judgment that depends on considerations such as—

- Whether the customer has resumed making regular payments for a certain number of installments.
- Whether the reason for the customer's delinquency has been eliminated (such as reemployment of a consumer borrower or an improved economic outlook for a commercial borrower) or was an isolated circumstance unlikely to recur.
- Whether there are any other substantive indications of the customer's regaining an ability to repay the loan. (2d ed., rev., pp. 14-15)

.12 Some entities have amortized the discounts, or portions of the discounts, on certain acquired loans, with corresponding increases in income, over the estimated or contractual lives of the loans. The effect of such amortization has been to produce higher reported rates of return on loans that, before acquisition, yielded lower reported rates of return or no reported returns, despite the fact that the acquisition had no effect on the quality of the loans. AcSEC has concluded that it should examine the accounting in such circumstances.

Accounting Guidance

Date of Acquisition

.13 At the time of acquisition, the sum of the acquisition amount of the loan and the discount to be amortized should not exceed the undiscounted future cash collections that are both reasonably estimable and probable.[2] The discount on an acquired loan should be amortized over the period in which the payments are probable of collection only if the amounts and timing of collections, whether characterized as interest or principal, are reasonably estimable and the ultimate collectibility of the acquisition amount of the loan and the discount is probable. If these criteria are not satisfied, the loan should be accounted for using the cost-recovery method (see paragraphs .16 and .17).

.14 If at the date of acquisition it is known that interest income on a particular loan is not being recognized by the seller because of concerns about the collectibility of the loan principal or interest, it should be presumed that the loan does not meet the criteria in paragraph .13. That presumption may be

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[2] FASB Statement No. 91 states that the difference between the acquisition amount of the loan and the principal amount should be recognized as an adjustment of yield over the life of the loan. Statement No. 91 provides accounting guidance for loans acquired at a discount because of net origination fees and costs and differences between prevailing interest rates on the date of origination and the date of acquisition. This practice bulletin addresses amortization of discounts on acquired loans that reflect impairment of the borrowers' credit.

overcome if the acquirer's assessment of factors affecting collectibility, such as those discussed in paragraph .18, strongly indicate that collection of the acquisition amount and the discount is probable and the amounts and timing of collections are reasonably estimable. In accordance with FASB Statement No. 91, discounts should be amortized using the interest method.

Subsequent to the Date of Acquisition

.15 Collectibility should continue to be evaluated throughout the life of the acquired loan. If, upon subsequent evaluation—

- The estimate of the total probable collections is increased, the amount of the discount to be amortized should be adjusted accordingly. The adjustment should be accounted for as a change in estimate in accordance with APB Opinion 20, *Accounting Changes*, and the amount of periodic amortization adjusted over the remaining life of the loan.
- For a loan not accounted for as a debt security, the estimate of amounts probable of collection is reduced and considered impaired for purposes of applying the measurement and other provisions of FASB Statement No. 5, *Accounting for Contingencies*, or, if applicable, FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*.
- For a loan accounted for as a debt security, the fair value of the debt security has declined below its amortized cost basis, the acquirer should determine whether the decline is other than temporary. An acquirer should apply the impairment of securities guidance in paragraph 16 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.
- It is not possible to estimate the amount and timing of collection, amortization should cease, and the cost-recovery method should be used as described in paragraph .17 below.
- It is determined that collection is less than probable, amortization should cease, either the loan should be written down or an allowance for uncollectibility related to that loan should be recognized, and the cost-recovery method should be used as described in paragraph .17 below.
- It is determined that the loan is held primarily for the rewards of ownership of the underlying nonmonetary collateral, the collateral should be accounted for in accordance with the guidance on ADC arrangements in AcSEC Practice Bulletin 1 [section 12,010].

[As amended, effective for loans purchased in fiscal years beginning on or before December 15, 2004, by Statement of Position 03-3.]

Cost-Recovery Method

.16 Application of the cost-recovery method requires that any amounts received be applied first against the recorded amount of the loan; when that amount has been reduced to zero, any additional amounts received are recognized as income.

.17 The cost-recovery method should be used until it is determined that the amount and timing of collections are reasonably estimable and collection is probable. If the remaining amount that is probable of collection is less than the sum of the acquisition amount less collections and the discount amortized to date, then either the loan should be written down or an allowance for uncollectibility related to that loan should be recognized. If the remaining amount that is probable of collection is greater than that sum, then the difference between that sum and the revised amount that is probable of collection should be amortized on a prospective basis over the remaining life of the loan.

Collectibility

.18 Whether the acquisition amount of an acquired loan less collections and the discount amortized to date are collectible is a matter of judgment. Some of the factors that should be considered in assessing collectibility include—

a. The financial condition of the borrower.

b. A substantial equity of the borrower in the collateral underlying the loan that is *not* funded by the lender. This may reflect, to some extent, the borrower's commitment to pay the loan.

c. Historical cash flows from the acquired loan.

d. The prospect of near-term cash flows from the acquired loan.

e. Irrevocable letters of credit, enforceable personal guarantees, or take-out commitments from creditworthy parties. (The guidance on ADC arrangements in AcSEC Practice Bulletin 1 [section 12,010], may be useful in evaluating these items.)

f. The nature of any asset underlying the loan and the probability that it will generate sufficient future cash flows to cover future principal and interest payments when due (for example, the forecasted earnings of a commercial property that are expected to cover future principal and interest payments on a loan).

Transition and Effective Date

.19 This Practice Bulletin is amended by SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* [section 10,880], for decreases in estimated cash flows. The amendments should be applied prospectively for fiscal years beginning after December 15, 2004. [Paragraph added, effective for loans purchased in fiscal years beginning on or before December 15, 2004, by Statement of Position 03-3.]

.20 This Practice Bulletin is effective for loans purchased in fiscal years beginning on or before December 15, 2004. Loans acquired in fiscal years beginning after December 15, 2004, should be accounted for in accordance with SOP 03-3 [section 10,880]. For loans purchased in fiscal years beginning on or before December 15, 2004, all guidance in this practice bulletin is applicable, as amended, for fiscal years beginning after December 15, 2004. [Paragraph added, effective for loans purchased in fiscal years beginning on or before December 15, 2004, by Statement of Position 03-3.]

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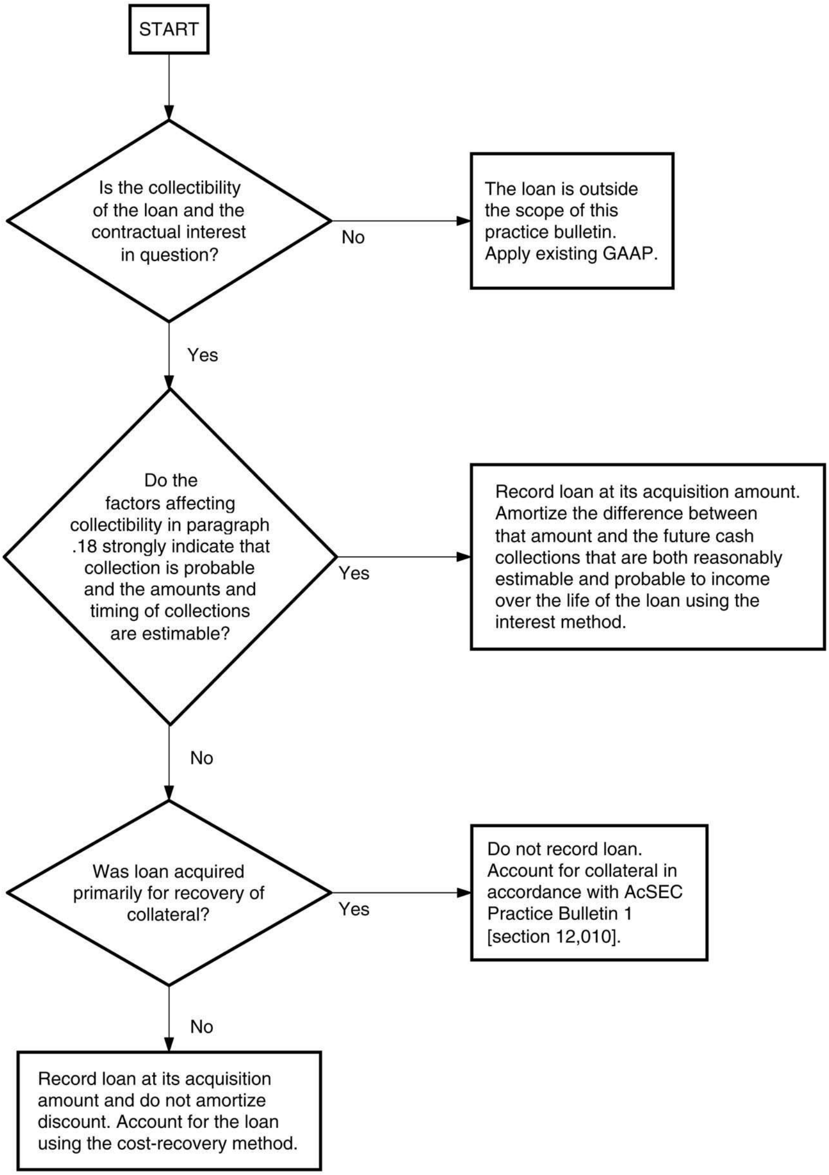
Appendix A

Accounting at the Date of Acquisition



[Paragraph renumbered by the issuance of Statement of Position 03-3, December 2003.]

.22

Appendix B

Illustrations of the Application of the Practice Bulletin

These illustrations are provided to assist in the interpretation of the principles set forth in this practice bulletin. They are not intended to provide guidance on whether the transactions should be accounted for as in-substance foreclosures.

Illustration 1

Z acquires a loan that is thirty days past due. Shortly after acquisition, the loan becomes current; collection of principal and interest is probable and the amounts and timing are reasonably estimable.

Task Force's Conclusion:

The discount should be amortized.

Illustration 2

Z acquires a loan that is thirty days past due. The loan is restructured with no loss recognized on the restructuring.

Additional Assumptions—A

The loan was restructured to pay no interest. Principal is to be paid in periodic installments, and it is probable that all of the principal will be collected.

Task Force's Conclusion:

The discount should be amortized, because the amount and timing of the cash flows that are probable of collection suggest that the presumption in paragraph .14 that the loan does not meet the criteria for amortization of discounts has been overcome.

Additional Assumptions—B

The loan was restructured to pay 4 percent interest, an amount less than the market rate and the original contractual rate. The original contractual principal payments continue to be made. The loan is not fully amortizing; that is, a substantial balloon payment will be required at maturity.

Task Force's Conclusion:

Due to the significance of the balloon payment, sole reliance on the payment as a basis for overcoming the presumption in paragraph .14 that the loan does not meet the criteria for amortization of discounts is not appropriate. Other evidence that supports the probability of collection would have to be assessed.

Additional Assumptions—C

Same assumptions as in B, except that the original contractual principal payments have been reduced and, consequently, a larger balloon payment will be required at maturity. (The new periodic payment is based on an amortization schedule longer than the term of the loan.)

Task Force's Conclusion:

The discount should not be amortized.

Additional Assumptions—D

The loan was restructured to pay no interest; principal is to be paid in a single amount at maturity.

Task Force's Conclusion:

The discount should not be amortized.

Illustration 3

Z acquires a loan that is thirty days past due at acquisition and begins to accrue interest income receivable and amortize the discount. The loan becomes ninety days past due, and Z stops accruing interest.

Task Force's Conclusion:

Amortization of the discount should stop.

Illustration 4

Z acquires a loan that is thirty days past due at acquisition. The amount and timing of the future payments are reasonably estimable, and the amount is probable of collection. Z begins to accrue interest income receivable and amortize the discount. The borrower makes all subsequent required payments but does not bring the loan current—that is, the borrower does not make the missed payment.

Task Force's Conclusion:

The discount should continue to be amortized.

Illustration 5

Z acquires a loan on which the borrower is making the contractual interest payments when due. The entire principal is due in a lump sum at maturity. Z believes repayment of some of the principal is probable, but repayment of the remainder is less than probable.

Task Force's Conclusion:

The discount, that is, the difference between the acquisition amount and the sum of the part of the principal and interest payments that are reasonably estimable and probable of collection, should be amortized to income over the life of the loan using the interest method. If the estimate of the amount that is probable of collection is revised, the periodic amortization should be adjusted accordingly.

Illustration 6

Y, an acquired bank, had a loan that originally paid 12-percent interest and that was secured by cash flows from a producing oil well. The well had proven reserves and the collateral coverage was 125 percent of the loan based on net cash flows ([oil produced x market price of oil]— cost to produce).

The price of oil subsequently decreased. Y agreed to accept reduced interest payments in a troubled debt restructuring, because estimates of cash flows at that time indicated that the loan principal plus 4-percent interest would be repaid. The borrower will continue to operate the well, and it is reasonably possible that cash flows of the borrower from additional sources would become available to the bank.

Z acquired Y in a purchase business combination and, in accordance with APB Opinion 16, recorded the loan "at present values of amounts to be received determined at appropriate current interest rates." Z believes that the amount and timing of the cash flows are reasonably estimable and the amount is probable of collection.

Task Force's Conclusion:

Z should amortize the discount because the cash flows are probable. However, amortization of the discount should stop if the price of oil drops further such that the probability of collection becomes uncertain.

Illustration 7

Acquiree bank has a $1,000,000 construction loan at 10-percent interest that was due on September 30, 1988. A takeout commitment on the loan was not honored, and the borrower continues to seek refinancing. The current market rate considering the creditworthiness of the borrower is 12 percent for a mortgage loan. Acquirer bank is acquiring Acquiree bank on December 31, 1988, at which time the loan is ninety days past due and interest is not being accrued. Acquirer bank is willing to renegotiate the loan so that it pays out. The borrower will operate the property, and it is reasonably possible that cash flows of the borrower from additional sources would become available to Acquirer bank.

Additional Assumptions—A

The property is leased under long-term leases. It is probable that the borrower will pay $10,000 a month from cash flow from the property. Over eighteen years and nine months that amount would repay all principal and contractual interest on the loan (approximately $2,250,000).

Task Force's Conclusion:

Acquirer bank should discount $2,250,000 at 12 percent and amortize the resulting discount to income, because the future cash collections are both reasonably estimable and probable.

Additional Assumptions—B

The property is 25 percent leased under long-term leases. It is probable that the borrower will pay $5,000 a month from cash flow from the property. Over twenty-five years (the estimated useful life of the property) that amount ($1,500,000) would not repay all principal and interest on the loan.

Task Force's Conclusion:

Acquirer bank should discount $1,500,000 at 12 percent and amortize the resulting discount to income, because the future cash collections totaling that amount are both reasonably estimable and probable.

Additional Assumptions—C

The property is not leased, and the borrower is unable to determine when payments can be made.

Task Force's Conclusion:

Acquirer bank would record the loan at the fair value of the note and account for it using the cost-recovery method. (If the Acquirer bank expects to obtain repayment of the loan through foreclosure of the underlying collateral, the collateral should be accounted for in accordance with AcSEC Practice Bulletin 1 [section 12,010].)

[Paragraph renumbered by the issuance of Statement of Position 03-3, December 2003.]

Accounting Standards Executive Committee (1987-1988)

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Section 12,080

Practice Bulletin 8
Application of 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, to Insurance Enterprises

November, 1990

NOTICE TO READERS

Practice bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

.01 This practice bulletin provides guidance, in the form of questions and answers, for insurance enterprises regarding the application of Financial Accounting Standards Board (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*.

Acquisition Costs

.02 *Question 1:* Is the definition of capitalized acquisition costs for investment contracts and universal life-type contracts under FASB Statement No. 97 the same as the definition under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*?

.03 FASB Statement No. 60, paragraph 28, defines acquisition costs as "those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts."

.04 *Answer 1:* Yes. However, FASB Statement No. 97, paragraph 24, specifies that certain acquisition costs should not be capitalized, but instead should be considered as maintenance and other period costs that are expensed as incurred, as follows:

Acquisition costs that vary in a constant relationship to premiums or insurance in force, are recurring in nature, or tend to be incurred in a level amount from period to period, shall be charged to expense in the period incurred.

.05 Certain acquisition costs have been excluded because, under FASB Statement No. 97, capitalized acquisition costs for universal life-type contracts and investment contracts ordinarily are amortized in relation to estimated gross profits, whereas under FASB Statement No. 60, capitalized acquisition costs are amortized in proportion to premium revenue recognized. Costs such as recurring premium taxes and ultimate level commissions, which vary with premium revenue, are effectively charged to expense in the periods incurred.

.06 *Question 2:* What method should be used for amortizing deferred policy acquisition costs (DPAC) incurred on investment contracts?

.07 *Answer 2:* The amortization method described in FASB Statement No. 97 for universal life-type contracts should be used for investment contracts that include significant surrender charges or that yield significant revenues from sources other than the investment of contract holders' funds. This method matches the amortization of DPAC with the recognition of gross profits. Otherwise, DPAC on investment contracts should be amortized using an accounting method that recognizes acquisition and interest costs as expenses at a constant rate applied to net policy liabilities and that is consistent with the interest method under FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases* (interest method).

.08 Under both the FASB Statement No. 97 amortization method and the interest method, assumptions used should be updated to be consistent with the concepts underlying the method used:

- Under the FASB Statement No. 97 amortization method, assumptions should be updated in compliance with paragraph 25 of FASB Statement No. 97, which states that "estimates of expected gross profit used as a basis for amortization shall be evaluated regularly, and the total amortization recorded to date shall be adjusted by a charge or credit to the statement of earnings if actual experience or other evidence suggests that earlier estimates should be revised."
- Under the interest method, the incidence of surrenders (if they are probable and can be reasonably estimated) can be anticipated for purposes of determining the amortization period. The rate of DPAC amortization should be adjusted for changes in the incidence of surrenders to be consistent with the handling of principal prepayments under FASB Statement No. 91.
- DPAC related to investment contracts should be reported as an asset to be consistent with the reporting of DPAC on insurance products covered by FASB Statement No. 97. Under some reserving methods, the insurance reserve may be calculated net of DPAC. In that event, the amounts of DPAC and reserves have to be determined separately.

Limited-Payment Contracts

.09 *Question 3:* Should the deferred profit liability (excess of gross premiums over net premiums), if any, on limited-payment contracts be amortized in relation to the discounted amount of insurance in force (or expected future benefit), and should interest accrue to the unamortized deferred profit liability balance?

.10 *Answer 3:* Yes. The deferred profit liability should be amortized in relation to the discounted amount of the insurance in force or expected future benefit payments, and interest should accrue to the unamortized balance. The use of interest in the amortization is consistent with the determination of the deferred profit using discounting.

.11 *Question 4:* Should costs related to the acquisition of new and renewal business that are not capitalized (because, for example, the costs do not vary with the acquisition of the business) be included in the calculation of net premium used in determining the profit to be deferred on limited-payment contracts?

.12 *Answer 4:* No. Those costs are period costs, which should be recognized when incurred. The inclusion of such costs in the calculation of net premium would result in their deferral.

.13 Costs that would be included in the determination of net premium under FASB Statement No. 97 and for purposes of determining the deferred profit for limited-payment contracts are policy-related costs that are not primarily related to the acquisition of business (such as policy administration, maintenance, and settlement costs) and acquisition costs that are capitalized under FASB Statement No. 97.

.14 *Question 5:* Does the method of amortizing DPAC on limited-payment contracts under FASB Statement No. 97 differ from the method required under FASB Statement No. 60?

.15 *Answer 5:* No. DPAC should continue to be amortized in proportion to premium revenue recognized, as required under FASB Statement No. 60, paragraph 29. Premium revenue used in the calculation should be the gross premium recorded, that is, the amount before adjustment for excess of gross over net premiums (the deferred profit liability).

.16 *Question 6:* Does paragraph 16 of FASB Statement No. 97, which addresses limited-payment contracts, apply to limited-payment participating and limited-payment nonguaranteed-premium contracts that are not, in substance, universal life-type contracts?

.17 *Answer 6:* Yes. These contracts are limited-payment contracts under paragraph 9 of FASB Statement No. 97 and are not excluded under paragraph 11 because they are not conventional forms of participating or nonguaranteed-premium contracts.

Internal Replacements

.18 *Question 7:* Does the accounting specified by FASB Statement No. 97, paragraph 26, for internal replacement transactions apply only to the replacement of traditional insurance contracts by universal life-type contracts?

.19 *Answer 7:* Yes. FASB Statement No. 97 addresses only replacements of traditional insurance contracts by universal life-type contracts. The accounting for other internal replacements should be based on the circumstances of the transaction. Paragraphs 70 to 72 of FASB Statement No. 97 discuss the Board's rationale for requiring recognition of loss on the termination of the replaced contract.

.20 *Question 8:* How should insurance enterprises report changes in accounting practices for internal replacements other than replacements by universal life-type contracts?

.21 *Answer 8:* If the accounting practice for internal replacements other than replacement by a universal life-type contract is changed, and if the effect is material, insurance enterprises should disclose the change in their reports to shareholders as a change in accounting principle, as described in paragraphs 18 to 26 of APB Opinion No. 20, *Accounting Changes*.

Scope of FASB Statement No. 97

.22 *Question 9:* According to paragraph 14 of FASB Statement No. 97, the statement does not apply to certain long-duration insurance contracts, such as those that provide benefits related only to illness, physical injury, or disability. Should FASB Statement No. 97 be applied to contracts that provide those kinds of benefits but that also have characteristics and benefits falling under FASB Statement No. 97, such as significant cash surrender benefits and limited-payment or universal-type provisions?

.23 *Answer 9:* Yes. If insurance contracts have characteristics significant to the contracts that are covered by FASB Statement No. 97—for example, limited-payment or universal life-type contracts—the accounting for the contracts should be guided by the concepts of FASB Statement No. 97. For example, universal disability contracts that have many of the same characteristics as universal life-type contracts, with the exception of providing disability benefits instead of life insurance benefits, should be accounted for in a manner consistent with universal life-type contracts.

Estimated Gross Profits—Universal Life-Type Contracts

.24 *Question 10:* FASB Statement No. 97, paragraph 23b, states that estimated gross profits (EGP) used to determine DPAC amortization for universal life-type contracts should include estimates of costs expected to be incurred for contract administration, including acquisition costs not included in capitalized acquisition costs. What kinds of costs should be included in contract administration costs, and should non-policy-related costs and costs that are not capitalized under FASB Statement No. 60, paragraph 28, because they do not vary with the acquisition of new and renewal insurance contracts be included?

.25 *Answer 10:* Contract administration costs included in the calculation of EGP should consist of the following:

- Policy-related costs that are not primarily related to the acquisition of business, such as policy administration, settlement, and maintenance costs
- Policy-related acquisition costs that are not capitalized under FASB Statement No. 97, paragraph 24, such as ultimate renewal commission and recurring premium taxes

.26 Non-policy-related expenses, such as certain overhead costs, and costs that are related to the acquisition of business that are not capitalized under FASB Statement No. 60, such as certain advertising costs, should not be included in EGP.

.27 *Question 11:* Should gains and losses from sales of investments be included in amounts expected to be earned from the investment of policyholder balances used to determine EGP?

.28 *Answer 11:* Yes. Expected gains and losses from sales of investments related to universal life contracts should be included in the determination of EGP, because earned investment income should be based on the expected total yield of the investments. If the timing and amount of realized gains and losses from the sales of investments change from those expected and materially affect the expected total yield and the estimated gross profits, DPAC amortization should be reevaluated.

Transition

.29 *Question 12:* Accounting changes resulting from the adoption of FASB Statement No. 97 are required to be applied retroactively through restatement of all previously issued financial statements that are being presented. FASB Statement No. 97 requires that if restatement of all years presented is not practicable, the cumulative effect of the accounting changes be reported in net income in the year the statement is adopted. If a company is adopting FASB Statement No. 97 through a cumulative-effect adjustment because restatement is not practicable, should the company nevertheless restate prior years' income statements for the change in reporting realized investment gains and losses under FASB Statement No. 97?

.30 *Answer 12:* Yes. A company should adopt FASB Statement No. 97's change in reporting realized investment gains and losses through restatement of prior years' income statements even if other provisions of the standard are adopted through a cumulative-effect adjustment. A company should adopt all provisions of FASB Statement No. 97 in the same period.

.31 *Question 13:* When adopting FASB Statement No. 97 retroactively through restatement of prior years' financial statements, should companies use the original accounting assumptions, such as assumptions regarding estimated gross profits, that they would have used in those prior periods, or may hindsight be used so that experience subsequent to those periods may be substituted for original assumptions?

.32 *Answer 13:* Assumptions used in restating prior years' financial statements should not include significant subsequent fluctuations in experience that could not reasonably have been foreseen—for example, a significant unexpected change in lapse experience resulting from specific circumstances occurring in a subsequent period, restructuring of policy charges, or a major change in investment strategy. The effects of such changes should be included in the restated results of the period in which the changes occurred, which may require the adjustment of total DPAC amortization recorded to date as specified in paragraph 25 of FASB Statement No. 97.

Recoverability and Loss Recognition—Investment Contracts

.33 *Question 14:* Should DPAC related to investment contracts defined under FASB Statement No. 97 be written off if it is determined that the amount at which the asset is stated is probably not recoverable?

.34 *Answer 14:* Yes. As stated in paragraph 87 in FASB Statement of Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, "[a]n expense or loss is recognized if it becomes evident that previously recognized future economic benefits of an asset have been reduced or eliminated, or that a liability has been incurred or increased, without associated economic benefits." The DPAC asset should be reduced to the level that can be recovered. Further guidance is provided in paragraphs .35 and .36 of this practice bulletin.

.35 *Question 15:* Should the provisions of FASB Statement No. 60 concerning loss recognition (premium deficiency), by which an additional liability is established for anticipated losses on contracts, apply to investment contracts defined in FASB Statement No. 97?

.36 *Answer 15:* No. Such loss recognition, as described in paragraph .34 above, is not permitted for investment contracts under FASB Statement No. 97.

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Section 12,110

Practice Bulletin 11 Accounting for Preconfirmation Contingencies in Fresh-Start Reporting

Issue date, unless otherwise indicated: March, 1994

NOTICE TO READERS

Practice bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under Rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

Introduction

.01 This practice bulletin interprets certain provisions of AICPA Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code* [section 10,460]. SOP 90-7 [section 10,460] provides guidance for financial reporting by entities that file petitions with the Bankruptcy Court and expect to reorganize as going concerns under Chapter 11 of title 11 of the United States Code. The SOP was issued on November 19, 1990, and is effective for financial statements of enterprises that filed petitions under the Bankruptcy Code after December 31, 1990.

.02 SOP 90-7 [section 10,460] states that an entity should adopt fresh-start reporting upon emergence from Chapter 11 reorganization if the reorganization value of assets immediately before the date of confirmation is less than the total of all postpetition liabilities and allowed claims, and if holders of existing voting shares immediately before confirmation receive less than 50 percent of the voting shares of the emerging entity. Reorganization value generally approximates fair value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after restructuring. The reorganization value of an entity is the amount of resources available and to become available for the satisfaction of postpetition liabilities and allowed claims and interest, as negotiated or litigated between the debtor-in-possession or trustee, the creditors, and the holders of equity interests.

.03 SOP 90-7 [section 10,460] identifies the principles to be applied in adopting fresh-start reporting, which include the following:

- Reorganization value of the entity should be allocated to the entity's assets in conformity with the procedures specified by Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*, for transactions recorded on the basis of the purchase method. Any reorganization value in excess of amounts allocable to identifiable assets should be amortized in conformity with APB Opinion 17, *Intangible Assets*.
- Each liability existing at the plan confirmation date, other than deferred taxes, should be stated at the present values of amounts to be paid.

.04 SOP 90-7 [section 10,460] does not provide specific guidance on accounting for contingencies existing at the date fresh-start reporting is adopted.[1] Some believe that the effects of adjusting or resolving all such contingencies should be included in postconfirmation earnings. Others believe that accounting similar to that in FASB Statement of Financial Accounting Standards No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*, should be applied. Such accounting could result in adjustments to reorganization value in excess of amounts allocable to identifiable assets. The Accounting Standards Executive Committee (AcSEC) has been asked to clarify the issue.

Interpretation

.05 Certain uncertainties that were not resolved during the Chapter 11 proceedings may continue to exist at the confirmation date. For purposes of applying SOP 90-7 [section 10,460], such uncertainties are referred to as *preconfirmation contingencies*, defined as contingencies[2] of an entity that emerges from Chapter 11 reorganization and applies fresh-start reporting, and that exist at the date of confirmation of the plan. A preconfirmation contingency can be a contingent asset, a contingent liability, or a contingent impairment of an asset.

.06 Preconfirmation contingencies include uncertainties concerning

- Amounts ultimately to be realized upon the disposition of assets designated for sale by the confirmed plan; proceeds upon disposition may vary from values estimated at confirmation.
- Nondischargeable claims (for example, environmental issues).
- Claims that are disputed, unliquidated, or contingent and that are unresolved at confirmation; these claims may be estimated for purposes of voting on the plan. The confirmed plan may provide for issuance of shares (or release of shares from escrow) in resolution of certain claims.

.07 Preconfirmation contingencies do not include—

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[1] See paragraphs .35 and .55 of SOP 90-7 [section 10,460.35 and .55].

[2] FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, defines a contingency as an existing condition, situation, or set of circumstances involving uncertainty concerning possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.

- Allocation of reorganization value to the entity's assets. The initial allocation of the value of the reconstituted entity to individual assets in conformity with the procedures specified by FASB Statement No. 141, *Business Combinations* may require the use of estimates. Those estimates may change when information the entity has arranged to obtain has been received—for example, once appraisals of certain assets of the reconstituted business have been received.
- Deductible temporary differences or net operating loss and tax-credit carryforwards that exist at confirmation. FASB Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*, and paragraph .38 of SOP 90-7 [section 10,460.38], specify the accounting for those items.

[Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 141.[*]]

.08 After the adoption of fresh-start reporting, adjustments that result from a preconfirmation contingency shall be included in the determination of net income in the period in which the adjustment is determined. Such adjustments can result from resolution of a contingency or changes in estimates of amounts initially recorded at emergence from Chapter 11 (see paragraph .05 herein).

.09 Adjustment of preconfirmation contingencies should be included in income or loss from continuing operations of the emerged entity and should be separately disclosed.

.10 This practice bulletin is effective for adjustments of preconfirmation contingencies made after March 31, 1994. Earlier application is encouraged.

Basis for Conclusions

.11 Paragraph .58 of SOP 90-7 [section 10,460.58] states, in part, ". . . in the reorganization process, extensive information available to the parties in interest, the adversarial negotiation process, the involvement of the Bankruptcy Court, the use of specialists by one or more of the parties in interest, and the fact that all elements of the determination are focused solely on the economic viability of the emerging entity result in an objective and reliable determination of reorganization value." Thus, all contingencies that are significant to the reorganization proceedings are identified and generally estimated by the confirmation date.

.12 FASB Statement No. 38 describes an allocation period as the time required by a purchaser of a business to identify and quantify the assets acquired and the liabilities assumed. The allocation period ends when the acquiring entity is no longer waiting for information that it has arranged to obtain and that is known to be available or obtainable. Any adjustment after the end of the allocation period that results from a preacquisition contingency is included in earnings. AcSEC believes that in reorganization proceedings the analogous allocation period for contingencies is the reorganization period, which ends at the confirmation date. Therefore, adjustments to the amounts initially recorded for preconfirmation contingencies at the adoption of fresh-start accounting should be reflected in earnings.

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[*] FASB Statement No. 141 supersedes APB Opinion No. 16, *Business Combinations*.

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Section 12,130

Practice Bulletin 13
Direct-Response Advertising and Probable Future Benefits

December, 1994

NOTICE TO READERS

Practice Bulletins are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice Bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Practice Bulletins as a source of established accounting principles generally accepted in the United States that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. If relevant to the circumstances of the transaction or event, the accounting treatment specified by this Practice Bulletin should be used, or the member should be prepared to justify the departure.

Introduction

.01 In December 1993, the AICPA's Accounting Standards Executive Committee (AcSEC) issued Statement of Position (SOP) 93-7, *Reporting on Advertising Costs* [section 10,590]. SOP 93-7 [section 10,590] provides guidance on financial reporting on advertising costs and requires that an entity report the costs of all advertising as expenses either in the periods in which those costs are incurred, or the first time the advertising takes place, except for certain direct-response advertising. The costs of direct-response advertising that result in probable future benefits should be capitalized and amortized over the estimated period of the future benefits.

Direct-Response Advertising

.02 Paragraph 33 of SOP 93-7 [section 10,590.33] states that the costs of direct-response advertising should be capitalized if both of the following conditions are met:

a. The primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising. (Paragraph 34 of SOP 93-7 [section 10,590.34] discusses the conditions that must exist in order to conclude that the advertising's purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising.)

b. The direct-response advertising results in probable future benefits. (Paragraph 37 of SOP 93-7 [section 10,590.37] discusses the conditions that must exist in order to conclude that direct-response advertising results in probable future benefits.)

.03 Paragraph 36 of SOP 93-7 [section 10,590.36] states that "probable future benefits of direct-response advertising activities are probable future revenues arising from that advertising in excess of future costs to be incurred in realizing those revenues." Practice has interpreted *probable future revenues* in different ways. Some believe that future revenues should be limited to revenue received from sales to customers receiving and responding to the direct-response advertisement. Others believe that future revenues should include revenue indirectly related to the advertisement. SOP 93-7 [section 10,590] does not explicitly address this issue.

.04 This practice bulletin interprets paragraphs 33, 36, and 46 through 48 of SOP 93-7 [section 10,590.33, .36, .46–.48] by clarifying that only revenue from sales to customers receiving and responding to the direct-response advertisement should be considered when determining probable future revenues.

Probable Future Revenues

.05 Revenues associated with direct-response advertising are as follows:

a. *Primary:* Revenues from sales to customers receiving and responding to the direct-response advertising

b. *Secondary:* Revenues other than revenues from sales to customers receiving and responding to the direct-response advertising

For example, most publishers receive revenue from customers that subscribe to the publications; these subscription revenues are primary revenues. Publishers also receive secondary revenues such as advertisements in the publications (referred to as *placement fees*). Placement fee revenues are affected by several factors, including the total number of subscribers to the publication and the selling efforts devoted to obtaining the placement fees.

Conclusion

.06 When determining *probable future revenues*, those revenues should be limited to revenues from sales to customers receiving and responding to the direct-response advertising (primary revenues).

.07 When evaluating whether the direct-response advertising results in probable future benefits (paragraph 33*b* of SOP 93-7 [section 10,590.33*b*]), probable future benefits should include only primary revenues. When amortizing and assessing the realizability of the direct-response advertising reported as assets, future revenues should be limited to primary revenues (paragraphs 46 through 48 of SOP 93-7 [section 10,590.46–.48]).

Effective Date and Transition

.08 This practice bulletin is effective for advertising costs incurred after December 31, 1994, or upon the adoption of SOP 93-7 [section 10,590], if later.

.09 Entities that adopt SOP 93-7 [section 10,590] on or prior to December 31, 1994, and that report the costs of direct-response advertising as assets based on the inclusion of secondary revenues in determining probable future revenues, may report advertising costs incurred on or prior to December 31, 1994, using one of the following alternatives:

a. Continue to include secondary revenues in determining probable future revenues for purposes of amortizing and assessing the realizability of direct-response advertising reported as assets at December 31, 1994.

b. For entities that have issued annual financial statements reflecting the adoption of SOP 93-7 [section 10,590], use only primary revenues for purposes of reporting the costs of direct-response advertising reported as assets and report the change in accounting as the cumulative effect of a change in accounting principle as prescribed by paragraph 20 of Accounting Principles Board Opinion No. 20, *Accounting Changes.*

c. For entities that have not issued annual financial statements, use only primary revenues for purposes of reporting the costs of direct-response advertising as assets.

Discussion of Conclusion

Probable Future Revenues

.10 SOP 93-7 [section 10,590] establishes narrow conditions for reporting the costs of advertising as an asset beyond the first time the advertising takes place. Those conditions are based, in part, on future benefits resulting from the advertising. Some entities have interpreted SOP 93-7 [section 10,590] to allow the inclusion of secondary sources of revenue when determining probable future benefits. That practice extends, beyond AcSEC's intent, the link between the customers responding to the direct-response advertising and the probable future revenues resulting from the advertising. This practice bulletin clarifies that AcSEC intended that only primary revenues should be included in the determination of probable future revenues.

Transition

.11 SOP 93-7 [section 10,590] was issued in December 1993 and is effective for financial statements for years beginning after June 15, 1994, with earlier application encouraged in fiscal years for which financial statements previously have not been issued. SOP 93-7 [section 10,590] did not explicitly address the issue of whether secondary revenues should be included in probable future benefits. Therefore, some entities that early adopted SOP 93-7 [section 10,590] included secondary revenues in determining probable future revenues, and as a result reported direct-response advertising costs as assets that would not be reported as assets under this practice bulletin.

.12 AcSEC acknowledges that transition, to a significant extent, is a practical matter. A major objective of transition is to mitigate disruption to the extent possible without unduly compromising the objectives of the accounting guidance in this practice bulletin and consistency among reporting entities.

AcSEC believes that those entities that adopted SOP 93-7 [section 10,590] prior to its effective date did so in good faith and should not be required to restate annual financial statements previously issued. AcSEC further believes that few entities both adopted SOP 93-7 [section 10,590] prior to its effective date and included secondary revenues when determining probable future revenues. Therefore, consistency among reporting entities has not been compromised significantly.

Accounting Standards Executive Committee (1993-1994)

AICPA Staff

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Section 12,140

Practice Bulletin 14
Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships

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NOTICE TO READERS

Practice Bulletins are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice Bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

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Introduction

.01 The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) prepared the following guidance regarding the application of existing authoritative literature to limited liability companies and limited liability partnerships.

.02 U.S. limited liability companies and limited liability partnerships (hereinafter referred to as *limited liability companies or LLCs*) are formed in accordance with the laws of the state in which such entities are organized. Because those laws are not uniform, the characteristics of LLCs vary from state to state. However, LLCs generally have the following characteristics:[1]

- An LLC is an unincorporated association of two or more "persons."
- Its members have limited personal liability for the obligations or debts of the entity.
- It is classified as a partnership for federal income tax purposes.

[1] The characteristics listed in this paragraph are not intended to be representative of characteristics in the statutes of each state. Preparers of an LLC's financial statements should be cognizant of the LLC legislation enacted in the jurisdiction in which the LLC is organized.

.03 Under the rules in existence as of the date of this practice bulletin, to be classified as a partnership for federal income tax purposes, a limited liability company must lack at least two of the following corporate characteristics:[2]

- Limited liability
- Free transferability of interests
- Centralized management
- Continuity of life

Scope

.04 This practice bulletin provides reporting guidance for limited liability companies organized in the United States that prepare financial statements in accordance with generally accepted accounting principles. The practice bulletin also provides guidance on certain accounting issues for LLCs organized in the United States. For accounting issues not addressed in this practice bulletin, an LLC should comply with the existing requirements of generally accepted accounting principles.

Conclusions

Accounting Issues

Accounting for Assets and Liabilities Previously Owned by Predecessor Entities

.05 An LLC formed by combining entities under common control or by conversion from another type of entity initially should state its assets and liabilities at amounts at which they were stated in the financial statements of the predecessor entity or entities as indicated in paragraphs D-11–D-12 of FASB Statement No. 141, *Business Combinations*.[*] [Revised, June 2004, to reflect the conforming changes necessary due to the issuance of FASB Statement No. 141.[†]]

Accounting for Income Taxes

.06 As discussed in paragraph .02 of this practice bulletin, LLCs generally are classified as partnerships for federal income tax purposes. An LLC that is subject to federal (U.S.), foreign, state, or local (including franchise) taxes based on income should account for such taxes in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 109, *Accounting for IncomeTaxes*. Paragraph 17 of FASB Statement No. 109 requires a jurisdiction-by-jurisdiction computation.

.07 In accordance with paragraph 28 of FASB Statement No. 109, an entity whose tax status in a jurisdiction changes from taxable to nontaxable

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[2] Many states have adopted similar requirements for limited liability companies to be classified as partnerships for state income or franchise tax purposes. However, certain states have enacted LLC legislation that includes income tax requirements. Additionally, if an LLC operates in a jurisdiction where either LLC legislation has not been enacted or LLCs are subject to income taxation, it may be subject to income tax requirements on income derived from operations in those jurisdictions.

[*] Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141 (revised 2007), *Business Combinations*, should be applied. [Footnote added, May 2008, due to the issuance of FASB Statement No. 141(R).]

[†] FASB Statement No. 141 supersedes APB Opinion No. 16, *Business Combinations*. [Footnote renumbered due to the issuance of FASB Statement No. 141(R), May 2008.]

should eliminate any deferred tax assets or liabilities related to that jurisdiction as of the date the entity ceases to be a taxable entity. Paragraph 45 of FASB Statement No. 109 requires disclosure of significant components of income tax expense attributable to continuing operations including "adjustments of a deferred tax liability or asset for . . . a change in the tax status of the enterprise."

Financial Statement Display Issues

.08 A complete set of LLC financial statements should include a statement of financial position as of the end of the reporting period, a statement of operations for the period, a statement of cash flows for the period, and accompanying notes to financial statements. Additionally, the LLC should present information related to changes in members' equity for the period. This information may be presented as a separate statement, combined with the statement of operations, or in the notes to the financial statements.

.09 The headings of a limited liability company's financial statements should identify clearly the financial statements as those of a limited liability company.

Presentation of the Equity Section of the Statement of Financial Position

.10 The financial statements of a limited liability company should be similar in presentation to those of a partnership. The LLC owners are referred to as "members"; therefore, the equity section in the statement of financial position should be titled "members' equity." If more than one class of members exists, each having varying rights, preferences, and privileges, the LLC is encouraged to report the equity of each class separately within the equity section. If the LLC does not report the amount of each class separately within the equity section, it should disclose those amounts in the notes to the financial statements (see paragraph .15).

.11 Even though a member's liability may be limited, if the total balance of the members' equity account or accounts described in the preceding paragraph is less than zero, a deficit should be reported in the statement of financial position.

.12 If the LLC maintains separate accounts for components of members' equity (for example, undistributed earnings, earnings available for withdrawal, or unallocated capital), disclosure of those components, either on the face of the statement of financial position or in the notes to the financial statements, is permitted.

.13 If the LLC records amounts due from members for capital contributions, such amounts should be presented as deductions from members' equity. Presenting such amounts as assets is inappropriate except in very limited circumstances when there is substantial evidence of ability and intent to pay within a reasonably short period of time, as described in Emerging Issues Task Force (EITF) Issue No. 85-1, *Classifying Notes Received for Capital Stock*.

Comparative Financial Statements

.14 Presentation of comparative financial statements is encouraged, but not required, by Chapter 2A, "Comparative Financial Statements," of Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*. If comparative financial statements are presented, amounts shown for comparative purposes must be in fact comparable with those shown for the most recent period, or any exceptions to comparability must be disclosed in the notes to the financial statements. Situations may exist in which financial statements of the same reporting entity for periods prior to the period of conversion are not comparable with those for the most recent period presented, for example, if transactions such as spin-offs or other distributions of assets occurred prior to or as part of the LLC's formation. In such situations, sufficient disclosure should be made so the comparative financial statements are not misleading. If the formation of the LLC results in a new reporting entity, the guidance in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, paragraphs 34 and 35, should be followed and financial statements for all prior periods presented should be restated.

Financial Statement Disclosure Issues

.15 The following disclosures should be made in the financial statements of a limited liability company:

- A description of any limitation of its members' liability
- The different classes of members' interests and the respective rights, preferences, and privileges of each class. Additionally, as discussed in paragraph .10, if the LLC does not report separately the amount of each class in the equity section of the statement of financial position, those amounts should be disclosed.

If the LLC has a finite life, the date the LLC will cease to exist should be disclosed.

.16 For limited liability companies formed by combining entities under common control or by conversion from another type of entity, the notes to the financial statements for the year of formation should disclose that the assets and liabilities previously were held by a predecessor entity or entities. LLCs formed by combining entities under common control are required to make the disclosures in paragraph D-18 of FASB Statement No. 141.[*] [Revised, June 2004, to reflect the conforming changes necessary due to the issuance of FASB Statement No. 141.[†]]

.17 FASB Statement No. 109 requires specific disclosures relating to accounting for income taxes. LLCs subject to income tax in any jurisdiction should make the relevant FASB Statement No. 109 disclosures.

.18 As discussed in paragraph .14, if comparative financial statements are presented, additional disclosures may be required.

Effective Date

.19 This practice bulletin is effective for financial statements issued after May 31, 1995.

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[*] Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 31, 2008, the guidance in FASB Statement No. 141 (revised 2007), *Business Combinations*, should be applied. [Footnote added, May 2008, due to the issuance of FASB Statement No. 141(R).]

[†] FASB Statement No. 141 supersedes APB Opinion No. 16, *Business Combinations*. [Footnote renumbered due to the issuance of FASB Statement No. 141(R), May 2008.]

Discussion of Conclusions

Accounting Issues

.20 If an LLC is formed by combining entities under common control or by conversion from another form of entity, the assets and liabilities transferred to the LLC from the predecessor entity or entities should be recorded at historical cost in a manner similar to a pooling of interests. This position is supported by the following authoritative pronouncements:

- AICPA Accounting Interpretation No. 39 to APB Opinion 16, "Transfers and Exchanges Between Companies Under Common Control," which discusses transfers of net assets and exchanges of shares be tween companies under common control. The Interpretation states that assets and liabilities transferred between entities under common control would be accounted for in a manner similar to a pooling of interests.
- EITF Issue No. 88-16, *Basis in Leveraged Buyout Transactions*, which provides guidance as to when a new basis of accounting is appropriate in a leveraged buyout. Section 1 of Issue No. 88-16 states that a partial or complete change in accounting basis is appropriate only when there has been a change in control of voting interest (that is, a new controlling shareholder or group of shareholders must be established).

Financial Statement Display Issues

.21 AcSEC believes that the financial statements required by paragraph .08 of this practice bulletin are necessary to provide the information needed to meet the financial reporting objectives of a limited liability company and to report that information in a manner that is both comprehensive and understandable. The required financial statements are consistent with paragraph 13 of FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.

.22 AcSEC believes that, because the members' liability is limited, the headings of the financial statements should state prominently that the entity is a limited liability company, even in jurisdictions where LLCs are not required by law to include the LLC designation in its name.

.23 In corporate financial statements, the amounts initially invested (capital stock) are kept separate from subsequent income and distribution amounts. In a partnership, such separation is not maintained. AcSEC believes that such a separation is not needed for LLCs. Consequently, AcSEC believes that the presentation of the equity section of the statement of financial position should be similar to that of a partnership rather than to that of a corporation.

.24 ARB 43, chapter 2A, recommends presentation of comparative financial statements. It states, however, that "it is necessary that prior-year figures shown for comparative purposes be in fact comparable with those shown for the most recent period, or that any exceptions to comparability be clearly brought out." Formation of a limited liability company by conversion from another type of entity (such as a partnership or corporation) generally does not result in a different reporting entity; formation of an LLC by combining entities under common control should result in a change in reporting entity, unless the entities were presented previously in combined financial statements.

.25 EITF Issue No. 85-1 addresses a situation in which an enterprise receives a note, rather than cash, as a contribution to equity. The task force reached a consensus that reporting the note as an asset generally is not appropriate, except in very limited circumstances when there is substantial evidence of ability and intent to pay within a reasonably short period of time.

Financial Statement Disclosure Issues

.26 As discussed in paragraph .03 of this practice bulletin, a limited liability company must lack at least two corporate characteristics to avoid being classified as an association for federal income tax purposes, and most limited liability companies do lack at least two of those characteristics. If one of the characteristics that the LLC lacks is "continuity of life," AcSEC believes that fact should be disclosed since it may be of significant interest to financial statement users that enter into transactions with the LLC. For example, a limited life would be significant information to a lender lending funds to an entity on a long-term basis.

.27 If an LLC is formed by a combination of entities under common control, the LLC is encouraged to make the relevant disclosures required by paragraph 64 of APB Opinion 16, because those transactions are considered to be similar to poolings of interests.

.28 AcSEC believes that the relationship between preferences of the classes may be of major significance to users of financial statements of those companies. Therefore, disclosure of the different classes and their respective rights, preferences, and privileges is encouraged.

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Section 12,150

Practice Bulletin 15
Accounting by the Issuer of Surplus Notes

Issue date, unless otherwise indicated: January, 1997

NOTICE TO READERS

Practice Bulletins are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice Bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Practice Bulletins as a source of established accounting principles generally accepted in the United States that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. If relevant to the circumstances of the transaction or event, the accounting treatment specified by this Practice Bulletin should be used, or the member should be prepared to justify the departure.

Introduction and Background

.01 Surplus notes[1] are financial instruments issued by insurance enterprises that are includable in surplus for statutory accounting purposes as prescribed or permitted by state laws and regulations.

.02 The following are some general characteristics of surplus notes:

- Approval of the issuance by the domiciliary state insurance commissioner (commissioner)
- Stated maturity date in most but not all cases
- Scheduled interest payments
- Approval of the payment of principal and interest by the commissioner
- Nonvoting
- Subordinate to all claims except those of shareholders for stock companies

[1] The term surplus notes is the most common term applied to these financial instruments. Some jurisdictions refer to these financial instruments as certificates of contribution, surplus debentures, or capital notes.

- Subordinate to all claims except policyholder residuals for mutual companies (after policyholder liabilities are settled)
- No or limited acceleration rights other than for rehabilitation, liquidation, or reorganization of the insurer by a governmental agency
- Proceeds from issuance in the form of cash, cash equivalent, or some other asset with a readily determinable fair value satisfactory to the commissioner

.03 Mutual insurance enterprises are owned by their policyholders and cannot raise capital by issuing shares of common or preferred stock; thus, many mutual insurance enterprises have issued surplus notes. Early issuances of surplus notes were generally by financially troubled mutual insurance enterprises in need of raising capital with limited alternatives to do so. More recently, mutual life insurance enterprises which do not have access to traditional equity capital markets, have viewed these instruments as a viable method of raising capital and improving risk-based capital ratios.

.04 Mutual life insurance enterprises currently account for surplus notes under statutory accounting practices almost universally as equity capital or surplus. Surplus treatment is allowed for statutory accounting purposes because of the regulatory control over an insurance enterprise's ability to repay interest and principal that is maintained through required approval of payment by the commissioner.

.05 The accounting for and presentation of surplus notes under generally accepted accounting principles (GAAP) is a significant issue to mutual life insurance enterprises when implementing FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, and FASB Statement of Financial Accounting Standards No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*. According to FASB Interpretation No. 40 as amended by FASB Statement No. 120, mutual life insurance enterprises that issue financial statements for fiscal years beginning after December 15, 1995, that are described as prepared "in conformity with generally accepted accounting principles" are required to apply all applicable authoritative accounting pronouncements in preparing those statements. Current authoritative accounting pronouncements are silent as to the accounting for surplus notes. Due to the prevalence and increasing use of these instruments by all kinds of insurance enterprises in the marketplace, GAAP guidance is necessary.

Scope

.06 This Practice Bulletin applies to life and health insurance enterprises (including mutual life insurance enterprises), property and casualty insurance enterprises, reinsurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, financial guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies that issue surplus notes. It provides guidance on accounting, financial statement presentation, and disclosure by the issuers of surplus notes in their GAAP financial statements. This Practice Bulletin does not apply to investors in surplus notes.

Conclusions

Balance-Sheet Classification of Outstanding Surplus Notes

.07 Surplus notes should be accounted for as debt instruments and presented as liabilities in the financial statements of the issuer. Equity treatment for surplus notes is inappropriate. This Practice Bulletin does not establish new guidance for accounting for debt instruments by the issuer.

.08 Consistent with paragraph 16 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, *A Replacement of FASB Statement No. 125*, a debtor shall derecognize a surplus note if and only if it has been extinguished. According to paragraph 16 of FASB Statement No. 140,[2] a liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

b. The debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. [*Footnote omitted*]

[Revised, June 2004, to reflect conforming changes due to the issuance of FASB Statement No. 140.]

Accrual of Interest

.09 Interest should be accrued over the life of the surplus note, irrespective of the approval of interest and principal payments by the insurance commissioner, and recognized as an expense in the same manner as other debt.

Disclosure

.10 Issuers of surplus notes should comply with existing disclosure requirements for debt instruments. In addition, disclosure is required regarding the commissioner's role and ability to approve or disapprove any interest and principal payments.

Effective Date and Transition

.11 This Practice Bulletin is effective for financial statements for fiscal years beginning after December 15, 1995. The effect of initially applying this Practice Bulletin shall be reported retroactively through restatement of all previously issued financial statements presented for comparative purposes. The cumulative effect of adopting this Practice Bulletin, including the accrual of interest, if any, shall be included in the earliest year restated.

The provisions of this Practice Bulletin need not be applied to immaterial items.

Basis for Conclusions

.12 This section discusses considerations that were deemed significant by members of AcSEC in reaching the conclusions in this Practice Bulletin. It includes reasons for accepting certain views and rejecting others.

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[2] [Footnote deleted, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 140.]

Balance-Sheet Classification of Outstanding Surplus Notes

.13 AcSEC considered the characteristics of surplus notes and deemed them liabilities in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statements.*

.14 FASB Concepts Statement No. 6 defines both liabilities and equity and describes their essential characteristics. Paragraph 35 of the Concepts Statement defines liabilities as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."

.15 Paragraph 36 of FASB Concepts Statement No. 6 describes the following three essential characteristics of a liability.

> (*a*) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (*b*) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (*c*) the transaction or other event obligating the entity has already happened.

.16 Surplus notes represent a present duty to the holders of the notes that entails settlement by probable future transfers of cash. The future transfers of cash are normally on specified dates, subject to the approval of the commissioner. If the commissioner does not grant approval for payment on a specified date, the future transfer of cash takes place on occurrence of a specified event, which is the ultimate approval of the commissioner. Therefore, surplus notes meet the first characteristic of a liability. In addition, AcSEC observed that declaration of bankruptcy by an enterprise and the role of the court in determining when and in what amounts an obligation will be settled do not affect whether the debt instrument continues to qualify as a liability.

.17 Should the commissioner not grant approval for an interest or principal payment, the issuer cannot make the payment and the holders of the notes have no recourse. The commissioner will grant approval only if it is consistent with his or her responsibility and objective to maintain the solvency and financial stability of the insurer. Although the commissioner has discretion, AcSEC concluded that the commissioner is not part of the organization. The discretion described in FASB Concepts Statement No. 6 is not delegable outside the enterprise. The entity has little or no discretion to avoid the future sacrifice and thus surplus notes do meet the second characteristic of a liability.

.18 AcSEC concluded that the previous transfer of cash to enterprises from the noteholder in return for the issuance of the surplus note is the event needed to obligate the entity and therefore surplus notes meet the third characteristic of a liability.

.19 Equity of a business enterprise is defined in paragraph 60 of FASB Concepts Statement No. 6 simply as a residual interest—the difference between an enterprise's assets and its liabilities. Equity of a business enterprise stems from ownership rights or the equivalent, and it involves a relationship between an enterprise and its owners as owners rather than as employees, suppliers, lenders, or in other nonowner roles.

.20 FASB Concepts Statement No. 6 explains that the essential characteristics of equity center on the conditions for transferring enterprise assets to the holders of equity interests. Distributions to owners are at the discretion and volition of the owners or their representatives after satisfying restrictions imposed by law, regulation, or agreements with other entities. In most circumstances, an enterprise is not obligated to transfer assets to owners except in the event of the enterprise's liquidation unless it formally acts to do so, such as by declaring a dividend. An enterprise's liabilities and equity are mutually exclusive claims to or interests in its assets by other entities, and liabilities take precedence over ownership interests.

.21 Surplus note payments require the approval of the commissioner. The commissioner's responsibilities and objectives include maintaining the solvency and financial stability of the insurer. AcSEC concluded that although the commissioner has the ability to restrict payments of interest and principal, the issuer continues to have the obligation even though the timing may be uncertain. Actions by the commissioner do not formally discharge the issuer's obligation to pay the principal or interest. Therefore, the characteristics of surplus notes are not consistent with the characteristics of equity as described in FASB Concepts Statement No. 6.

Surplus Notes—Statutory Basis

.22 Statutory accounting practices for surplus notes generally are consistent among all the states. Once approved by the commissioner, these instruments are classified as surplus on the balance sheet. Interest is reported as an expense and a liability only after payment has been approved by the commissioner. Interest that has not yet been approved for payment is not accrued as an expense and liability but rather disclosed in the notes to the financial statements. AcSEC observed that the objectives of regulatory accounting requirements are not always consistent with GAAP, and differences in accounting for other transactions currently exist.

Other Instruments With Similar Characteristics

.23 AcSEC considered other instruments with similar characteristics to surplus notes. Subordinated liabilities of broker/dealers, mandatorily redeemable preferred stock, and hybrid preferred securities such as monthly/quarterly income preferred stock (MIPS/QUIPS) have characteristics of both liabilities and equity and are generally presented on the balance sheet as a separate component between liabilities and equity.

Subordinated Liabilities of Broker/Dealers

.24 Insurance enterprise surplus notes have many of the same characteristics as subordinated liabilities of brokers and dealers in securities. Both kinds of instruments qualify as capital for regulatory purposes, are subordinated to all other claims except those of owners, and require regulatory approval or meeting of prescribed regulatory conditions before repayment. The revised AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* does not permit reporting combined subordinated liabilities with stockholders' equity in the statement of financial condition, which was acceptable under the superseded guide. The superseded presentation was believed to be misleading because it implied that subordinated liabilities are a component of stockholders' equity, unencumbered by the right of the creditor to be repaid. Liabilities frequently have repayment limitations of one sort or another, but nevertheless remain liabilities. AcSEC concluded that accounting for surplus notes as a liability is consistent with the accounting for subordinated liabilities of brokers and dealers.

Mandatorily Redeemable Preferred Stocks and Hybrid Preferred Securities

.25 Surplus notes and mandatorily redeemable preferred stocks are similar in that both are subordinated to other claims and because of the terms of the redemption as prescribed by the instrument; once issued, redemption is outside the control of the issuer. AcSEC concluded that although practice is to show mandatorily redeemable preferred stock in a separate category between liabilities and equity, to treat surplus notes in the same manner would be inappropriate. AcSEC was not persuaded that surplus notes, an instrument that meets all the characteristics of a liability, should be required or permitted to be displayed other than as a liability.

.26 Hybrid preferred securities such as monthly and quarterly income preferred securities (MIPS/QUIPS) are securities issued by a special-purpose entity that lends the proceeds to its controlling company. AcSEC concluded that although the practice is to show hybrid preferred securities in a separate category between liabilities and equity, to treat surplus notes in the same manner would be inappropriate. AcSEC concluded that surplus notes meet all of the characteristics of a liability and to record surplus notes in a separate category between liabilities and equity outside of liabilities would not provide users with as relevant information.

Income Statement Presentation

.27 Because surplus notes are presented on the balance sheet as liabilities, interest payments on surplus notes should be recorded as interest expense through operations. This treatment is consistent with current accounting practice for interest expense on debt.

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