4-2000

AcSec Update, Volume 4, Number 3 April 2000

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

VOL. 4 • NO. 3 ~ APRIL 2000

AcSEC UPDATE

A publication of the Accounting Standards Executive Committee and the Accounting Standards Team of the AICPA

AICPA

American Institute of Certified Public Accountants

AICPA ESTABLISHING EXPERT PANELS

As part of its effort to revamp the Institute's volunteer structure (see the January 2000 *AcSEC Update*), the AICPA is establishing Expert Panels that focus on identifying industry-specific business reporting issues with an emphasis on audit and accounting. We will begin with Expert Panels covering Employee Benefit Plans, Financial Services, and Government/Not-for-Profit Organizations rolled out first and we are in the process of nominating the Panel Chairs and the Panel members. Additional panels dealing with issues in High Technology, Biotechnology/Pharmaceuticals, Computer Auditing/Electronic Delivery, and Health Care will be established after the initial roll-out. Applications for Panels will be accepted at *www.skillscape.com/aicpaonline*.

For more information, contact Joel Tanenbaum, Technical Manager, Accounting Standards (212–596–6164, *jtanenbaum@aicpa.org*).

RECENT AcSEC ACTIVITIES

Interests in Unconsolidated Real Estate Investments. At its January 2000 meeting, AcSEC cleared for exposure, pending AcSEC's positive clearance of certain revisions and FASB clearance, the draft SOP *Accounting for Investors' Interests in Unconsolidated Real Estate Investments*. Those revisions are in the process of being made and a meeting with the FASB is expected in the third quarter of 2000. See page 9 for details on the project.

Certain Purchased Loans (formerly known as Discounts Related to Credit Quality). In March 2000, AcSEC approved a final SOP, *Accounting for Certain Purchased Loans*, pending AcSEC's positive clearance of certain revisions and FASB clearance. AcSEC expects to meet with FASB during the second quarter of 2000. See page 4 for details on the project.

Motion Pictures. In March 2000, AcSEC approved key changes to the final SOP, *Accounting by Producers and Distributors of Films*, subject to AcSEC's negative clearance and FASB clearance. AcSEC expects to meet with the FASB during the second quarter of 2000. See page 9 for details on the project.

Employee Benefit Plans. In February 2000, AcSEC obtained clearance from the FASB to expose a draft SOP *Accounting and Reporting of Certain Health and Welfare Benefit Plan Transactions*. The exposure draft was issued on March 22, 2000 with a 90-day comment period. See page 6 for details on the project.

Mutual Company Reorganizations. In February 2000, AcSEC obtained clearance from the FASB to expose a draft SOP *Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts*. The exposure draft is scheduled for issuance at the end of March with a 60-day exposure period. See page 8 for details on the project.

Life and Health Insurance Entities. On September 4, 1998, the AICPA released for public comment a proposed Audit and Accounting Guide *Life and Health Insurance Entities*. The proposed Guide would supersede the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*, which was issued in 1972 and updated only for conforming changes. AcSEC discussed the comment letters received on the exposure draft at its March 1999 meeting.

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RECENT AcSEC ACTIVITIES *continued from page 1*

AcSEC voted to issue a final Guide to reflect AcSEC's consideration of the comment letters, subject to clearance by the chair of AcSEC, a subcommittee of AcSEC, and the FASB. A meeting with the FASB is expected in the second quarter and AcSEC expects to issue the final Guide in the third quarter of 2000.

The proposed Guide discusses those aspects of accounting and auditing unique to life and health insurance entities and was developed to assist life and health insurance entities in preparing financial statements in conformity with GAAP and to assist independent auditors in auditing and reporting on those financial statements. In addition, the proposed Guide contains significant discussions of statutory accounting practices (SAP), which comprise laws, regulations, and administrative rulings adopted by various states that govern the operations and reporting requirements of life insurance entities. The proposed Guide will reflect SAP under the National Association of Insurance Commissioners codification project.

The proposed Guide incorporates accounting and financial reporting requirements issued by the FASB and AcSEC since the issuance of the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*. Also incorporated in this proposed Guide are new auditing standards issued by the AICPA Auditing Standards Board since the issuance of the pronouncements that the proposed Guide would supersede.

The proposed Guide is not intended to establish any new accounting standards or interpret any existing accounting standards, except for the inclusion of an SEC staff announcement regarding the effects of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, made at the July 12, 1994 EITF meeting, on certain assets and liabilities.

Investment Companies. On September 22, 1998, AcSEC issued an exposure draft of a completely revised Audit and Accounting Guide *Audits of Investment Companies*. The proposed Guide will replace the AICPA Audit and Accounting Guide *Audits of Investment Companies*, which was issued in 1987 and updated only for conforming changes. AcSEC discussed the comment letters received on the exposure draft at its April 1999 meeting. At its September 1999 meeting, AcSEC approved a final Guide that reflects AcSEC's consideration of the comment letters. AcSEC expects to issue the final Guide in the second quarter of 2000, subject to FASB clearance.

EFFECTIVE DATES

SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*, for fiscal years beginning after June 15, 1999, with earlier adoption encouraged.

SOP 98-9, *Modification of SOP 97-2, "Software Revenue Recognition," With Respect to Certain Transactions*, extends the deferral of the application of certain passages of SOP 97-2 provided by SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2, "Software Revenue Recognition,"* effective December 15, 1998 to March 15, 1999; all other provisions 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 have not been issued.

SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, for plan years beginning after December 15, 1998, with earlier application encouraged.

SOP 99-3, *Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters*, for plan years ending after December 15, 1999, with earlier application encouraged in fiscal years for which annual financial statements have not been issued.

The Guide discusses those aspects of accounting and auditing unique to investment companies and was developed to assist investment companies in preparing financial statements in conformity with GAAP and to assist independent auditors in auditing and reporting on those financial statements. The proposed Guide will provide new guidance on accounting for offering costs, amortization of premium or discount on bonds, liabilities for excess expense plans, reporting complex capital structures, payments by affiliates, and financial statement presentation and disclosures for investment companies and nonpublic investment partnerships. The proposed revised Guide will be effective for fiscal years beginning after December 15, 2000.

Editor: **Marc Simon**

Administrative Editor: **Sharon Macey**

AcSEC Update, the newsletter of the AICPA Accounting Standards Executive Committee and the AICPA Accounting Standards Team, is published three to four times a year.

AcSEC AGENDA PROJECTS

As of March 31, 2000	2000 1Q	2000 2Q	2000 3Q	2000 4Q	2001 1Q
Lending Institutions					
Certain Purchased Loans — SOP (page 4)			F		
Certain Financial Institutions — SOP (page 5)		E			
Allowance for Loan Losses — SOP (page 5)					
Employee Benefit Plans					
Health and Welfare Benefit Plans — SOP (page 6)	E				
Investment Industry					
Investment Companies — Guide (page 2)		F			
Scope Clarification, Investment Companies Guide — SOP (page 6)				E	
SOP 95-2 Amendment — SOP (page 7)			E		
Insurance Industry					
Life and Health Insurance Entities — Guide (page 1)			F		
Nontraditional Contracts — SOP (page 7)				E	
Mutual Company Reorganizations — SOP (page 8)	E				
Motion Picture Industry					
Motion Pictures — SOP (page 9)		F			
Real Estate Industry					
Real Estate Investments — SOP (page 9)			E		
Real Estate Time-Sharing Transactions — SOP (page 10)				E	
Cost Capitalization–PP&E — SOP (page 11)				E	

Codes: E – Exposure Draft anticipated or actual issuance date
F – Final Pronouncement anticipated or actual issuance date

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AcSEC's CURRENT SOP PROJECTS

Accounting for Certain Purchased Loans (formerly known as Discounts Related to Credit Quality)

Description and background. FASB Statement 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 a loan's life. Practice Bulletin (PB) 6, *Amortization of Discounts on Certain Acquired Loans*, further addresses amortization of discounts on certain acquired loans, which involves intertwining issues of amortization of discount, measurement of credit losses, and recognition of interest income. This project considers whether PB 6's objectives and guidance continue to be relevant given a number of FASB pronouncements issued subsequent to PB 6 to address various related issues.

Tentative conclusions. AcSEC has reached the following conclusions for loans and debt securities purchased with credit quality concerns:

- Investors should display purchased loans at the initial investment amount on the balance sheet. Investors should not display discounts on purchased loans in the balance sheet and should not carry over the allowance for loan losses established by the seller.
- Investors should estimate expected cash flows on the loan at inception and periodically over the life. The excess of expected cash flows over the initial investment (purchase price) should be recognized as the yield. The excess of contractual cash flows over expected cash flows (referred to as nonaccretable difference) should not be recognized as yield.
- PB 6's treatment of changes in estimates of cash flows after acquisition is preserved. Probable subsequent decreases in expected cash flows result in recognition of an impairment (and not recognized as an adjustment over the life of the loan). Probable subsequent increases in expected cash flows should be recognized prospectively.
- If a new, higher yield on a loan is established (due to a probable increase in expected future cash flows), that higher yield should be used as the effective interest rate in any later test for impairment.
- Loans purchased at a discount related to credit quality should not be considered impaired at acquisition for either measurement or disclosure purposes.
- The SOP explicitly excludes originated loans from its scope. FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, provides criteria for distinguishing between purchased and originated loans.
- The SOP does not apply to revolving credit accounts where the customer has revolving privileges at the purchase date (but will apply to accounts where the customer has lost revolving privileges).
- Retained interests are excluded from the scope of the SOP.
- The scope includes loans acquired in purchase business combinations. AcSEC found no reason to exclude such loans while at the same time including individual or "bulk" loan purchases.
- Only those mortgage loans that are held for sale (which are covered under FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*) are excluded from the scope of the SOP.
- Receivables from leases are excluded from the scope of the SOP.
- The SOP prohibits loans within its scope that are refinanced or restructured after acquisition from being accounted for as new loans, other than through a troubled debt restructuring (such loans are already covered by FASB Statement Nos. 15, *Troubled Debt Restructurings*, 114, *Accounting by Creditors for Impairment of a Loan*, and 115, *Accounting for Certain Investments in Debt and Equity Securities*).
- The scope also includes aggregations of loans purchased from multiple or single sellers. Such aggregation is available to loans purchased individually or in pools. Aggregation is only available, however, to smaller-balance homogeneous loans. To be aggregated loans must have a common credit risk (such as past due status, credit score) and have a common predominant risk characteristic (such as type of loan, date of origination). Aggregation is limited to loans purchased in the same fiscal quarter.
- Guidance on recognition of income from loans within the scope will not be provided because that guidance does not exist for originated loans.
- Variable loans with index rate decreases, contractual cash flow decreases, and expected cash flow decreases should be evaluated based on the change in expected cash flows attributable to the decrease in index rates. Those changes should be recognized prospectively rather than as an impairment. The investor must determine the decrease in expected cash flows due to index rate decreases and evaluate those changes against the loan's contractual payments receivable which must be calculated based on the index rate as it changes over the life of the loan.
- The SOP requires new disclosures for purchased loans within its scope, in addition to those already required by other accounting literature, including FASB Statement Nos. 5, *Accounting for Contingencies*, 114, 115, and 118, *Accounting by Creditors for Impairment of a Loan — Income Recognition and Disclosures*. The following disclosures apply whether or not the loans are considered impaired:
  - Beginning and ending carrying amount
  - A reconciliation of the beginning and ending accretable yield balances, including additions, reclassifications, deletions, accretion, and sales

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- Beginning and ending nonaccretable difference balances
- For loans other than debt securities, loss accruals recorded and reversed.

- Effective date for financial statements issued for fiscal years beginning after June 15, 2001.

Current developments and plans. At its March 2000 meeting, AcSEC approved the issuance of a final SOP subject to certain revisions and FASB clearance. AcSEC expects to issue the SOP in the third quarter of 2000.

Staff: Sydney Garmong

Accounting by Certain Financial Institutions and Entities Which Lend to or Finance the Activities of Others

Description and background. This SOP project is to reconcile the specialized accounting and financial reporting guidance established in the existing Guides *Banks and Savings Institutions*, *Audits of Credit Unions*, and *Audits of Finance Companies*. The final provisions would be incorporated in a final combined Guide, applicable to entities that lend to or finance the activities of others. This includes, but is not limited to, banks, savings institutions, credit unions, finance companies, corporate credit unions, and mortgage companies.

The proposed SOP eliminates differences in accounting and disclosure established by the respective Guides and carries forward accounting guidance for transactions determined to be unique to certain financial institutions. It is not intended to create new accounting guidance.

Tentative conclusions.

Some of the tentative conclusions reached by AcSEC are as follows:

- Mortgage companies and corporate credit unions will be explicitly included in the scope of the combined Guide.
- Regulatory capital disclosures will be required for mortgage companies, credit unions, banks, and thrifts.
- Credit unions report amounts placed in their deposit insurance fund as an asset if such amounts are fully refundable, due to unique legal and operational aspects of the credit union share insurance fund. Banks and thrifts expense payments to their deposit insurance fund as incurred. Under the SOP, both practices are expected to be preserved because of differences in how the funds operate.
- Finance companies record purchases and sales of securities on the settlement date, whereas banks, thrifts, and credit unions follow trade date accounting. Under the SOP, finance companies will follow trade date accounting.
- FASB Statement Nos. 114, *Accounting by Creditors for Impairment of a Loan*, and 118, *Accounting by Creditors for Impairment of a Loan — Income Recognition and Disclosures*, address loan impairment measurement and disclosure requirements, but they do not specify how to recognize income on impaired loans. The Guide for finance companies gives specific guidance on the recognition of interest income on impaired loans. Under the SOP, such guidance for finance companies will be eliminated.
- Certain disclosures for credit unions will be eliminated. These disclosures include, for example, additional information about repurchase agreements, servicing assets, and deposit liabilities.

Current developments and plans. AcSEC cleared the exposure draft of the proposed SOP at its December 1998 meeting. In July 1999, the FASB did not object to AcSEC issuing the proposed SOP for exposure, subject to certain revisions. AcSEC expects to issue the exposure draft in the second quarter of 2000.

Staff: Sydney Garmong

Allowance For Loan Losses

Description and background. AcSEC has established a task force whose primary objective is to provide additional guidance on the application of GAAP as it relates to the allowance for loan losses. In this context, the task force intends to review existing GAAP with a view toward identifying aspects that may need clarification. The initial expectations are that the task force will develop an SOP that will provide additional guidance on periodic loan loss allowances and the related allowance for loan losses. The project may result in amendment of the AICPA Audit and Accounting Guide *Banks and Savings Institutions*.

Tentative conclusions.

Some of the tentative conclusions reached by AcSEC are as follows:

- Allowances for loan losses should be established only when available information about past and current events indicates that it is probable that an asset has been impaired or that a loss has been incurred as of the balance sheet date.
- The allowance for loan losses reported on a creditor's balance sheet should consist of two components:
  - a component for specifically identified loans that have been evaluated individually for impairment, considered to be individually impaired, with impairment measured in accordance with FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, and
  - a component for impairment of pools of loans determined in accordance with FASB Statement No. 5, *Accounting for Contingencies*.

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AcSEC's CURRENT SOP PROJECTS *continued from page 5*

- A creditor should not assume that there always would be a single, distinct event that can be identified as the cause of an impairment. Instead, there may be a series of events that have occurred resulting in the impairment of an individual loan or a pool of loans.

Among the significant unresolved issues are:

- Whether information about current events would be required to be held constant, or "flat-lined," both when evaluating whether it is probable that a loss has been incurred and in estimating the amount of the loss.
- Whether, in reviewing an individual loan as part of its normal loan review procedures in order to evaluate the underlying credit risk, a creditor has identified the loan for evaluation within the meaning of FASB Statement No. 114.
- The application of FASB Statement No. 5 to pools of commercial loans. Many commercial loans might be considered individually unimpaired, but a pool that includes those same loans might be considered impaired.

AcSEC directed the task force to better define a past versus a future event, to consider using examples to distinguish between an expected loss and an incurred loss, and to further pursue guidance on loss discovery periods and discovery factors.

Current developments and plans. In March 2000, AcSEC discussed some of the preliminary conclusions reached by the task force. The task force expects to meet again with AcSEC in June 2000.

Staff: Sydney Garmong

Accounting and Reporting For Certain Health and Welfare Benefit Plan Transactions

Description and background. This proposed SOP would amend chapter 4 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* and SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*. This project was undertaken because, in recent years, many employers have amended their plans to reduce benefits provided, to introduce cost-sharing arrangements, or both. To the extent that cost sharing has been introduced or increased, the total cost of the benefits has remained essentially the same, while the portion of the total cost paid by the plan sponsor has decreased. Such benefit reductions and cost-sharing arrangements were not prevalent when SOP 92-6 was issued, and thus they were not addressed in SOP 92-6. In addition, since SOP 92-6 was issued, there has been confusion among preparers and auditors in understanding and implementing some of its requirements.

Tentative conclusions.

This proposed SOP:

- Revises the standards for measuring, reporting, and disclosing estimated future postretirement benefit payments that are to be funded partially or entirely by plan participants
- Specifies the presentation requirements for benefit obligation information
- Establishes standards of financial accounting and reporting for certain postemployment benefits provided by health and welfare benefit plans
- Clarifies the measurement date for benefit obligations
- Requires the identification of investments that are 5% of the net assets available for benefits.

Current developments and plans. The FASB cleared the document for exposure at its February 23, 2000 meeting. The exposure draft was issued on March 22, 2000 with a 90-day comment period.

Staff: Wendy Frederick

Clarification of the Scope of the Investment Companies Guide

Description and background. In February 1999, the FASB approved a prospectus for a project to develop an SOP to address the scope of the AICPA Audit and Accounting Guide *Audits of Investment Companies*, which was issued in 1987 and updated only for conforming changes. In 1998 AcSEC issued an exposure draft proposing revisions to that Guide. The scope provisions of the exposure draft are unchanged from the current Guide, and the FASB, at its July 1998 meeting to clear the exposure draft of the Guide, expressed concern that the scope of the proposed Guide may be unclear. This project will address whether more specific attributes of an investment company can be identified to determine if an entity is within the scope of the Guide. Until this project 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.

Tentative conclusions. At its December 1999 meeting, AcSEC discussed a draft of a proposed SOP and reached the following conclusions:

The SOP will prescribe a two-tiered approach for deciding which activities or characteristics should result in application of the Guide. The first tier would consider entities registered under either the Investment Company Act of 1940 or the Small Business Investment Company Act of 1958, foreign registered mutual funds, investment partnerships, common (collective) funds, and other investment fund entities (such as venture capital funds and private equity funds).

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The Guide would apply to those entities if no more than 20% of the entity is owned by related parties and if certain other criteria regarding the purpose of the entity are met.

The second tier would include entities not meeting the first tier requirements, but that invest for appreciation of investments or for current income from individual investees, represent themselves to be an investment company, hold investments in multiple investees, and have an exit strategy for their investments. The Guide would apply to those entities if the investor also does not participate in certain prohibited activities such as participating in the day-to-day management of investees, providing significant administrative or support services to investors, providing financial guarantees or collateral for investees, benefiting directly from the products or processes of investees, or linking investee management compensation to the performance of the investor.

Current developments and plans. At its March 2000 meeting, AcSEC discussed whether the proposed SOP should allow certain entities, such as companies registered under the 1940 Act, that are required to report for regulatory purposes as an investment company to apply the provisions of the Guide in their separate financial statements if those entities do not meet the conditions specified in the proposed SOP. AcSEC also discussed whether the accounting by certain subsidiaries or equity method investees of another entity should carry over to the consolidated financial statements of the parent or equity method investor based on the guidance in EITF Issue 85-12, *Retention of Specialized Accounting for Investments in Consolidation*, or be reversed in the preparation of consolidated financial statements of the parent or equity method investor. In previous discussions, AcSEC advised the task force that the guidance in EITF Issue 85-12 should apply to these situations.

AcSEC tentatively concluded that that the task force should reconsider whether there may be situations in which EITF 85-12 should not be applied. If AcSEC accepts this alternative approach, a parent or equity method investor in an investment company would be required to meet certain conditions in order to carry over the specialized accounting of the investment company subsidiary or investee. This direction would also require that the task force reconsider the conditions an entity must meet in order to be an investment company.

AcSEC will continue its discussion of the draft SOP at a future meeting.

Staff: Fred Gill

SOP 95-2 Amendment

Description and background. In March 2000, AcSEC's Planning Subcommittee approved a prospectus for a project to develop an SOP to consider amending the scope of SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*. The project will explore whether paragraph 5(b) of SOP 95-2 should be deleted, with the result that SOP 95-2 would apply to investment partnerships that are commodity pools subject to regulation under the Commodity Exchange Act of 1974. The prospectus is still subject to FASB clearance.

Current developments and plans. A meeting with the FASB will be scheduled. Subject to FASB clearance of the prospectus and an exposure draft, AcSEC expects to issue an exposure draft in the third quarter of 2000.

Staff: Dan Noll

Nontraditional Long-Duration Contracts

Description and background. In February 1998, the FASB cleared a prospectus for the development of an SOP on accounting by insurance companies for certain nontraditional long-duration contracts and for separate accounts. The SOP will address the classification and valuation of liabilities as well as disclosures for nontraditional annuity and life insurance contracts issued by insurance enterprises. The former AICPA Insurance Companies Committee identified this project because of the growing trend in insurers offering such contracts.

Tentative conclusions. Some of the more important tentative conclusions reached by AcSEC are as follows:

Sales inducements — Sales inducements that are earned by the customer immediately, such as "day-one bonuses," should be expensed immediately. Sale inducements that are earned over a period of time, such as persistency bonuses or enhanced yields, should be expensed over time.

Definition of a separate account — Separate accounts should be recorded in the financial statements of the insurance enterprise that owns them. Separate account assets and liabilities should be reported as single line items on the respective sides of the balance sheet ("one-line" presentation) if all of the following criteria are met:

- assets reside in a legally recognized separate account;
- the separate account is bankruptcy remote from the insurance enterprise;
- the policyholder directs allocation of investments;
- all investment performance (net of contract fees) is passed through to the policyholder (including contracts with minimum guarantees, but excluding contracts with caps or ceilings).

The guaranteed portion of separate accounts with minimum guarantees should be recorded as a liability in the general account, consistent with the bifurcation approach for embedded derivatives in

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FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Seed money and other insurance company funds invested in separate accounts should be classified and valued as any other general account asset.

Current developments and plans. AcSEC discussed key issues at its December 1999 meeting and is scheduled to continue the discussion at its June 2000 meeting. AcSEC plans to begin discussing a draft SOP by the third quarter of 2000. AcSEC expects to issue an exposure draft in the fourth quarter of 2000, subject to FASB clearance.

Staff: Kim Hekker

Mutual Company Reorganizations

Description and background. In February 1999, the FASB cleared a prospectus for the development of an SOP on accounting by insurance enterprises for demutualizations and formations of mutual insurance holding companies (MIHCs). The former AICPA Insurance Companies Committee identified this project because of the growing trend for mutual insurers to form mutual holding companies or to demutualize.

Tentative conclusions. Some of the more important tentative conclusions reached by AcSEC are as follows:

Accounting for expenses related to a demutualization and the formation of an MIHC — AcSEC determined that the classification of expenses related to a demutualization and the formation of an MIHC should be considered an other than extraordinary expense.

Presentation of the closed block — AcSEC concluded that closed block assets and liabilities should be included with the corresponding financial statement items of the insurance enterprise.

Accounting for pre-demutualization participating contracts after the demutualization date or formation of an MIHC — SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, established accounting principles to be applied by a mutual life insurance company to certain participating policies. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, provides only limited guidance on the accounting to be applied to stock life insurance company participating policies. Accounting guidance on whether a mutual life insurance company that converts to a stock company should continue to apply the provisions of SOP 95-1 or could apply the provisions of FASB Statement No. 60 to its participating policies needed to be determined. AcSEC concluded that SOP 95-1 should continue to be applied. However, provisions of paragraph 42 of FASB Statement No. 60 relating to dividends on participating contracts should apply to such contracts whether sold before or after the date of demutualization or date of formation of the MIHC.

Deferral of excess earnings — AcSEC discussed that the maximum future contribution of the closed block to the earnings of the company is typically the excess of the GAAP liabilities over the GAAP assets at the date of demutualization. Under FASB Statement No. 60, paragraph 42, a dividend liability should be established for current earnings that will be paid to policyholders through future benefits. From a shareholder perspective, excess earnings of the closed block that will never inure to the shareholders should be set up as a liability. AcSEC decided upon establishment of a dividend liability for excess earnings due to policyholders that cannot inure to shareholders.

Accounting for retained earnings — At the date of formation of an MIHC or demutualization, shares of capital stock will be issued. AcSEC concluded that, for a distribution-form demutualization, an insurance enterprise should reclassify all of its retained earnings as of the date of demutualization to capital stock and additional paid-in capital accounts (the capital accounts). AcSEC concluded that a subscription-form demutualization should not in and of itself result in reclassification of retained earnings. AcSEC concluded that the equity accounts of the 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.

Current developments and plans. At its October 1999 meeting, AcSEC voted to expose a proposed SOP subject to FASB clearance. AcSEC obtained clearance from the FASB, with no substantial changes, in February 2000. The exposure draft will be issued at the end of March 2000, with an exposure period of 60 days.

Staff: Kim Hekker

DAC on Internal Replacements

Description and background. A task force has been formed to determine if authoritative guidance is feasible on accounting by life insurance enterprises for deferred acquisition costs (DAC) on internal replacements other than those covered by 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*.

In June 1999, the former Insurance Companies Committee issued a Discussion Paper on the accounting by insurance enterprises for deferred acquisition costs on internal replacements. The intent of this paper was to determine if diversity exists with regard to accounting by life insurance enterprises for internal replacements other than those covered by FASB Statement No. 97 and, if so, whether accounting guidance should be provided. Eleven comment letters have been received to date, with the majority stating that guidance is needed.

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AcSEC's CURRENT SOP PROJECTS *continued from page 8*

Current developments and plans. The task force will have its first meeting in April 2000. The task force will recommend whether AcSEC should add a project to its agenda.

Staff: Kim Hekker

Motion Pictures

Description and background. This project was undertaken by AcSEC at the request of the FASB, and the resulting SOP will replace FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*.

Tentative conclusions. Major changes to the October 16, 1998 exposure draft SOP include:

Changes to the film required of the producer after delivery — Significant changes to a film would be defined as those changes that are additive, which involves creation by entities of new or additional content after delivery. Changes such as dubbing and adding subtitles would therefore not be considered significant changes that preclude revenue recognition.

Participations and residuals — Participations and residuals would be accounted for under current practice, that is, costs should be accrued as revenue is earned, similar to accounting for royalties. If the recorded participation costs liability exceeds the estimated ultimate unpaid participation costs for an individual film, the excess recorded liability would be reduced by a credit to film costs.

Exploitation costs — All exploitation costs would be accounted for under SOP 93-7, *Reporting on Advertising Costs*.

Statement of cash flows — Cash outflows for film costs, participation costs, exploitation costs, and manufacturing costs would be reported as operating activities in the statement of cash flows.

Revenue recognition — The requirement that licensees transfer substantially all risks and rewards of ownership (capital lease analogy, paragraph 7) in order for film entities to initially recognize revenue would be deleted.

Fee allocations in multiple film licensing arrangements — Flat fee allocations to individual films would be based on the fair value of the films; AcSEC deleted the "entity-specific" and "product-specific" requirements discussed in the exposure draft.

Minimum guarantees — Nonrefundable minimum guarantees in variable fee arrangements on multiple films would be recognized as revenue similar to how an entity accounts for flat fees on single film arrangements. However, when the films are cross-collateralized, the guarantee fee would be recognized as revenue similar to how an entity accounts for variable fees, with any excess guarantee fee over variable fee being recognized as revenue at the end of the license period.

Reporting accounts receivable — The specific accounting requirement to not report a receivable prior to meeting the revenue recognition conditions of the SOP would be deleted, as the issue is not unique to the film industry. Transfers of amounts (to a third party) due from a customer under an arrangement that does not meet the revenue recognition conditions of the SOP would not result in recognition of the revenue yet to be earned in the arrangement.

Ultimate revenue — Ultimate revenue would include estimates of a 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 exhibition or exploitation of a particular film.

Transition — The effective date will be extended for one year, making the SOP effective for fiscal years beginning after December 15, 2000.

Current developments and plans. In March 2000, AcSEC approved a revised final SOP, *Accounting by Producers and Distributors of Films*, subject to negative clearance. A meeting with the FASB will be scheduled for final clearance.

Staff: Dan Noll

Interests in Unconsolidated Real Estate Investments

Description and background. This proposed SOP would supersede SOP 78-9, *Accounting for Investments in Real Estate Ventures*. AcSEC added this project to its agenda in 1991 in response to inconsistent practice, especially in the area of loss recognition, and a lack of guidance on reporting on unincorporated entities.

Tentative conclusions. At its January 2000 meeting, AcSEC reached the following conclusions (see the October 1999 and January 2000 issues of *AcSEC Update* for AcSEC's other conclusions):

- The guidance in the SOP on basis differences would indicate why the "two component" approach is the approach generally observed in practice and why this approach cannot be applied in certain circumstances. It would also (1) clarify that basis adjustments should always be recorded if they arise upon initial investment by the investor, (2) clarify that basis adjustments, including revaluations, should be considered upon subsequent investments by the investor, and (3) note that AcSEC is following current practice in this regard.
- The presentation guidance in the SOP, which discusses the investor combining, in its balance sheet, loans to the investee, receivables from the investee, and similar items with its investment in equity securities of the investee, would be non-prescriptive.

Current development and plans. At its January 2000 meeting, AcSEC cleared the draft SOP for exposure, pending AcSEC's

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positive clearance of certain revisions and FASB clearance. Those revisions are in the process of being made and a discussion with FASB for purposes of clearance for exposure is expected in the third quarter of 2000.

Staff: Marc Simon

Real Estate Time-Sharing Transactions

Description and background. AcSEC added this project to its agenda at the request of the former AICPA Real Estate Committee because of diversity in practice caused by a lack of guidance specific to real estate time-sharing transactions. The SOP would attempt to reduce the diversity in practice.

Issues to be addressed in this proposed SOP include:

- Which profit recognition method should be used?
- How should allowances for uncollectible receivables be determined?
- What kinds of selling costs may be deferred?

Tentative conclusions. At its January 2000 meeting, AcSEC concluded the following (see the January 2000 *AcSEC Update* for AcSEC conclusions from its December 1999 meeting):

- A sales incentive given to a time-share buyer regardless of whether a sale is consummated would be accounted for by the seller as a selling cost. If a sales incentive is given to a buyer only upon consummation of a sale, both the sales price of the time-share and the amount of the buyer's initial investment would be reduced by the fair value of the incentive and the seller would record that fair value as a separate revenue item. An amount received by the seller for a "sampler program" would be deferred until either the seller has satisfied its obligations associated with the program or the time limit for utilizing the stay offered in the program has expired. If the program results in a sale, then the amount paid for the program by the buyer cannot be included in the initial investment requirement.
- AcSEC discussed the 10% initial investment requirement for full accrual sales accounting in the case of (1) "reloads," in which an existing customer purchases an additional interval without relinquishing the first, and (2) upgrades, whereby an existing customer pays for a more expensive interval while relinquishing the first. In the case of a reload, AcSEC reaffirmed a previous tentative conclusion that the buyer's equity in the first interval would not be counted toward the initial investment criterion for the second, and an additional cash payment of 10% of the sales price of the second would be required to satisfy the initial investment criterion. For an upgrade, an additional cash payment of 10% of the difference between the sales prices of the second and the first intervals would be required to meet the initial investment criterion.
- The proposed SOP would direct the reader to FASB Statement Nos. 13 and 98, *Accounting for Leases*, for right-to-use and similar transactions not involving passage by the seller of non-reversionary title. The proposed SOP would be silent as to the appropriate guidance for time-sharing transactions not involving real estate (such as cruise ships and corporate jets), that are outside its scope.
- Noting that all of its conclusions to-date assumed the most basic time-sharing transaction of a fixed week in a fixed unit, AcSEC began discussing more complex structures. The first was the deeded floating week, floating unit with exchange privileges, in which exchange privileges could either be through an independent exchange program or the seller's own internal exchange network. AcSEC considered this structure as a type of "multiple-element" arrangement with the elements including the time-sharing interval, the exchange privilege, and anything else passed from seller to buyer (for example, health club memberships and amusement park tickets) as part of the sales transaction. Sales involving this structure would be accounted for similar to sales in the basic model, but with the sales price reduced by the fair value of elements other than the time-sharing interval itself. Those other elements would be recorded as deferred revenue and amortized over periods corresponding to the lives of the elements. AcSEC asked the task force to obtain more information about multiple elements and consider methods for determining fair values for them—including, for example, up-front initiation fees and the exchange privilege.
- AcSEC discussed a special purpose entity (SPE) structure in which the seller transfers deeded title to the real estate to a trust or third party corporation (the SPE) in exchange for stock or other interests in the SPE which the seller then sells to the time-share buyers. AcSEC agreed that in accordance with the partial sales guidance in paragraphs 33 and 34 of FASB Statement No. 66, *Accounting for Sales of Real Estate*, and paragraph 21 of APB 29, *Accounting for Nonmonetary Transactions*, sales should only be recorded upon the sale of the stock or interests to the time-share buyer, not upon transfer of title to the SPE.
- With respect to the above SPE structure, AcSEC discussed the issue of whether the seller, while in possession of over 50% of the stock or interests of the SPE or otherwise considered to be in control of the SPE, should consolidate the SPE. While tentatively concluding that the seller should consolidate, AcSEC requested that the task force (1) obtain more information on current accounting practice in this area, and (2) present at a future meeting an example of the seller's balance sheet accounting (consolidation, equity method, cost method, etc.) for an SPE as the seller's ownership percentage in the SPE decreases from 100% to 0% during the sell-out of a project.

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AcSEC's CURRENT SOP PROJECTS *continued from page 10*

Current developments and plans. AcSEC will continue to discuss key issues at its June 2000 meeting, with the intention to issue an exposure draft (subject to FASB clearance) in the fourth quarter of 2000.

Staff: Marc Simon

Cost Capitalization — Property, Plant, and Equipment

Background and description. Diversity in practice concerning the recording of costs for improvements, replacements, betterments, additions (and terms synonymous with these such as redevelopments, refurbishments, renovations, and rehabilitations), and repairs and maintenance is one of the most prevalent problems in the real estate industry at this time. The AcSEC task force is working on an SOP to address accounting and disclosure issues related to determining which costs related to real estate assets should be capitalized as improvements and which should be expensed as repairs and maintenance. The SOP will also address capitalization of indirect and overhead costs and componentization of real estate assets for depreciation purposes.

As of March 2000, pursuant to communications with the SEC, AcSEC agreed to amend the prospectus for the project so that all property, plant, and equipment is included within its scope and the "accrue in advance" method of accounting for overhaul costs is addressed. AcSEC also has requested that the FASB approve a revised prospectus.

Tentative conclusions. AcSEC held an initial issues discussion of the project at its January 2000 meeting (prior to the planned scope expansion), at which it reached the following tentative conclusions:

- AcSEC discussed the concept of "componentization," in which certain capitalizable real estate costs can and should be separated into components that each may have different estimated useful lives. Each separate component would be accounted for as a separate asset and depreciated or amortized separately over its estimated economic useful life. AcSEC agreed with guidance proposed by the task force stating that as a practical matter, an enterprise will have to consider that there is a level of componentization below which the costs of recordkeeping exceed the benefits. However, AcSEC asked that the guidance for componentization be expanded to include (1) an entity should have to componentize to some extent if the cost of the separate component is significant and its life differs from the rest of the asset; (2) if the estimated useful economic life of certain components is short (for example, one year) those components should be expensed; (3) componentization would have to begin at the time of construction or acquisition, not later; (4) the basis for componentization (for example, relative fair values); and (5) the appropriate level of component aggregation in the balance sheet and disclosure in the footnotes.

AcSEC agreed that any componentization guidance in a proposed SOP would apply to all real estate assets whether purchased or constructed, whether the costs are initial or subsequent real estate costs, and whether the costs are for real estate assets for internal use or for sale or lease. That is, the guidance would apply regardless of whether the assets are included within the scope of FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, which does not address the subject of componentization.

- "Subsequent" real estate costs, defined as costs for repairs and maintenance or improvements to real estate assets owned or leased under a capital lease by an enterprise, would be charged to expense unless one of the following criteria is met:

  1. The costs are incurred for an expansion or enlargement of real estate assets
  2. The costs are incurred for a replacement of an originally capitalized component or major part of a real estate asset
  3. The costs are incurred to alter the functionality, extend the life, or improve the safety or efficiency of the real estate, whereby the condition of the real estate after the costs are incurred would have to be improved as compared with its initial condition
  4. The costs relate to a contractual agreement for the sale of real estate as described in paragraph 16 of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*.

In addition, if existing real estate assets or components thereof are replaced or otherwise removed from service, their net book values (or a reasonable estimate if net book value is not readily available) would be charged to expense.

- The SOP would provide guidance only for capitalization of fixed assets or expensing of costs as repairs and maintenance. It would not permit treatment of those costs as prepaid expenses.

- Noting that Statement 67 prescribes the accounting for acquisition, development, and construction (ADC) costs, including indirect and overhead costs, that are considered initial costs of real estate assets for sale or lease, AcSEC discussed the task force's proposed guidance for ADC costs related to initial "internal use" real estate costs (costs of real estate developed by an enterprise for use in its own operations) and subsequent real estate costs. AcSEC requested that the task force propose guidance for the types of costs for activities that should

AcSEC's CURRENT SOP PROJECTS *continued from page 11*

be capitalized without regard to the provisions of Statement 67. AcSEC noted that it may ask the FASB to amend Statement 67 after considering the issue fully. For example, with respect to the accounting for indirect and overhead costs, AcSEC directed the task force to propose guidance closely resembling that of SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, and to specify kinds of employee activities that would be considered "directly associated" with a real estate project for purposes of capitalization.

- The scope of the SOP would include lessee accounting for real estate under a capital lease but not under an operating lease, with the exception of costs incurred within the tenant's leased space (leasehold improvements).

Current developments and plans. A follow-up discussion of key issues and presentation of a draft SOP, incorporating the scope expansion noted above, are planned for AcSEC's June 2000 meeting, with the intention to issue an exposure draft (subject to FASB clearance) in the fourth quarter of 2000.

Staff: Marc Simon

OTHER AcSEC ACTIVITIES

Mark Sever of Ernst & Young LLP was appointed as successor to AcSEC Chair Dave Kaplan, effective October 1, 2000.

At its January 2000 meeting, AcSEC approved a comment letter to the IASC on its proposed accounting for agriculture. AcSEC was generally not supportive of a fair value model (with changes recognized in income) for all biological assets, although AcSEC did propose that fair value would be appropriate in certain limited circumstances.

The comment letter is available on the AICPA web site.

AcSEC ON AICPA WEB SITE

Look for information about AcSEC activities on the AICPA web site, "AICPA Online." The AICPA web site address is http://www.aicpa.org, and the area containing information pertaining to AcSEC activities is entitled "Accounting Standards Team." This area can be accessed by clicking in the "choose a topic" section underneath "Information Solutions," selecting "Accounting/Financial Reporting," and clicking on "Go." To view minutes of recent AcSEC meetings, click next on "Technical Status Updates" and then "Highlights of Recent AcSEC Meetings." Or, to obtain a copy of an exposure draft, after clicking on "Go" click on "Technical Documents."

OTHER ACTIVITIES OF THE ACCOUNTING STANDARDS TEAM OF THE AICPA (NON-AcSEC ACTIVITIES)

GASB's New Financial Reporting Model Affects AICPA Audit and Accounting Guides

On June 30, 1999, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. This standard greatly changes the financial reporting model that governments have been following. The standard is effective in three phases. Large governments (total annual revenues of $100 million or more) will have to implement the standard for periods beginning after June 15, 2001. Medium-sized governments (total annual revenues of $10 million or more but less than $100 million) have until periods beginning after June 15, 2002 to implement the standard. Smaller governments (total annual revenues of less than $10 million) have until periods beginning after June 15, 2003 to implement the standard.

As a result of these changes, the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* (the Guide) will require significant revisions to reflect the new accounting requirements as well as to address a number of related audit issues. An AICPA task force was established in mid-1999 to work on this project. At present the task force does not anticipate a need to develop new accounting requirements as a result of the Guide revision. Instead, the plan is to conform the accounting guidance included in the Guide to reflect Statement No. 34's requirements. The Guide's auditing guidance will also be revised.

The task force is currently developing the necessary revisions to the Guide. Because it is not expected that new accounting requirements will be developed, there is no plan for full AcSEC deliberation and clearance. Instead, several AcSEC representatives will review the changes made to conform the Guide to Statement No. 34. However, that plan could change if the task

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Upcoming AcSEC Meetings

AcSEC meetings are open to the public.

April 25–26, 2000	New York, NY
June 13–14, 2000	New York, NY
July 25–26, 2000	Seattle, WA
September 12–13, 2000	New York, NY
October 24–25, 2000	New York, NY
December 12–13, 2000	To be decided

OTHER ACTIVITIES OF THE ACCOUNTING STANDARDS TEAM OF THE AICPA (NON-AcSEC ACTIVITIES)

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force determines that there is a need for new accounting requirements as a result of Statement No. 34's revisions to the Guide.

The AICPA Audit and Accounting Guide *Not-For-Profit Organizations*, which was issued in 1996, superseded the three AICPA Audit and Accounting Guides *Audits of Voluntary Health and Welfare Organizations*, *Audits of Colleges and Universities*, and *Audits of Certain Nonprofit Organizations* (Guides). These three Guides were last updated in 1994; however, they continue to be applicable to some governmental entities because current GASB literature references them. When using these last three Guides, consideration should be given as to whether guidance issued subsequent to the last update affects the guidance contained in the Guides. Once Statement No. 34 becomes effective, these three Guides will no longer have any authoritative standing and should no longer be referred to.

Staff: Mary Foelster

Acquired In-Process Research and Development (IPR&D)

The Accounting Standards Team is working with a cross section of experts from industry, public accounting firms, the financial analyst community, and appraisal firms to identify best practices related to definitions, accounting, disclosures, valuation, and auditing of acquired IPR&D. The IPR&D task force expects to release its findings in several months.

Technical Practice Aids

Staff of the Accounting Standards Team recently released a nonauthoritative question and answer (Q&A), commonly referred to as a Technical Practice Aid (TPA), pertaining to not-for-profit organizations.

The Q&A may be viewed on the AICPA web site at *http://www.aicpa.org/members/div/acctstd/general/nfptpa.htm*. The Q&A will be included in the next update of the AICPA's Technical Practice Aids. AICPA members with questions on the TPA should call the AICPA's Technical Hotline, which provides nonauthoritative guidance on accounting and attest issues, at (888) 777–7077.

Comments or Suggestions?

We welcome any comments or suggestions you may have concerning this publication. Please send to *msimon@aicpa.org*, fax to 212–596–6064, or write to Marc Simon at AICPA, 1211 Avenue of the Americas, New York, NY 10036–8775.

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To order final pronouncements through the AICPA web site, *www.aicpa.org*, go to the area on the web site containing information pertaining to AcSEC activities, entitled "Accounting Standards Team." This area can be accessed by clicking in the "choose a topic" section underneath "Information Solutions," selecting "Accounting/Financial Reporting," and clicking on "Go." Next click on "Technical Documents," and "Documents Available from AICPA Order Dept." Order the documents you need by clicking on the product numbers on the left.

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