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AcSEC UPDATE

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AcSEC ISSUES NEW SOP

AcSEC recently issued Statement of Position (SOP) 00-2, *Accounting by Producers or Distributors of Films*. The SOP replaces FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films* (which is rescinded by FASB Statement No. 139) and is effective for financial statements for fiscal years beginning after December 15, 2000. Earlier application is encouraged.

The SOP defines films 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. Certain of the SOP's requirements differ from those in FASB Statement No. 53 or practice.

To order a copy of SOP 00-2, please call the AICPA Order Department at (888) 777–7077.

RECENT AcSEC ACTIVITIES

SOP 95-2 Amendment. On August 15, 2000, AcSEC will issue an exposure draft of the proposed SOP, *Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, to Include Commodity Pools*, with a 90-day comment period. See page 7 for details on the project.

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 were made and positive clearance obtained. A meeting with the FASB is planned for August 9, 2000. See page 8 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 issue the SOP during the fourth quarter of 2000. See page 3 for details on the project.

Accounting by Certain Financial Institutions and Entities That Lend to or Finance the Activities of Others. AcSEC issued an exposure draft of the proposed SOP on May 30, 2000 with a 90-day comment period. AcSEC expects to issue the SOP during the fourth quarter of 2000. See page 4 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. AcSEC expects to issue the SOP during the fourth quarter of 2000. 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 was issued with a 60-day exposure period that ended on June 5, 2000. Currently, eleven comment letters have been received and the task force is in the process of discussing the responses and any needed changes to the SOP. See page 7 for details on the project.

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RECENT AcSEC ACTIVITIES *continued from page 1*

Life and Health Insurance Entities. In September 1998, the AICPA released for public comment a proposed Audit and Accounting Guide *Life and Health Insurance Entities*. The 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. The Guide was cleared by the FASB on May 31, 2000 and is currently in production for issuance this summer.

The 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 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 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 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 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. At its September 1999 meeting, AcSEC approved a completely revised Audit and Accounting Guide *Audits of Investment Companies*, subject to FASB clearance. On May 31, 2000, the FASB cleared the issuance of the Guide, subject to certain changes. The proposed Guide, that will replace the 1987 AICPA Audit and Accounting Guide *Audits of Investment Companies*, is expected to be issued in August 2000.

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 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 Guide will be effective for fiscal years beginning after December 15, 2000.

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 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.

SOP 00-2, *Accounting by Producers or Distributors of Films*, for fiscal years beginning after December 15, 2000, with earlier application encouraged.

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

	2000				2001	
As of June 30, 2000	1Q	2Q	3Q	4Q	1Q	2Q
Lending Institutions						
Certain Purchased Loans — SOP (page 3)				F		
Certain Financial Institutions — SOP (page 4)		E		F		
Allowance for Loan Losses — SOP (page 5)						
Employee Benefit Plans						
Health and Welfare Benefit Plans — SOP (page 6)	E			F		
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 2)			F			
Nontraditional Contracts — SOP (page 7)				E		
Mutual Company Reorganizations — SOP (page 7)	E			F		
Motion Picture Industry						
Motion Pictures — SOP (page 1)		F				
Real Estate Industry						
Real Estate Investments — SOP (page 8)			E			
Real Estate Time-Sharing Transactions — SOP (page 9)					E	
Cost Capitalization–PP&E — SOP (page 10)				E		

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

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

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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, *Accounting by Debtors and Creditors for 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
  - ♦ 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 AcSEC's positive clearance of certain revisions and FASB clearance. AcSEC expects to issue the SOP in the fourth 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

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

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. In May 2000, AcSEC issued an exposure draft of the proposed SOP. Comments are due August 31, 2000. A copy can be obtained at *www.aicpa.org/members/div/acctstd/edo/index.htm*. AcSEC expects to issue the SOP in the fourth 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 is reviewing existing GAAP and identifying aspects that may need clarification. 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*.
- 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 cred-

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it 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.

Current developments and plans. The task force will meet again with AcSEC in July 2000.

Staff: Fred Gill

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. AcSEC expects to issue the SOP in the fourth quarter of 2000.

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*. When clearing the exposure draft for the revised investment companies Guide (see page 2), the FASB expressed concern that the scope of the proposed Guide may be unclear. (The scope provisions of the exposure draft are unchanged from the current Guide.) 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 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 tentative conclusions:

- ❖ For purposes of the separate financial statements of an entity, the Guide would be applicable to entities that are regulated as investment companies and other entities whose primary business activity involves investing in investees that function as separate autonomous businesses. The SOP would include conditions that should be evaluated to determine whether the entity's primary business activity is investment activity and whether investees function as separate autonomous businesses. Entities that meet the investment company conditions would be required to apply the provisions of the Guide in presenting their financial statements. Entities that do not meet those conditions would be prohibited from applying the provisions of the Guide.
- ❖ The SOP also would include conditions that must be evaluated to determine whether the specialized industry accounting principles of the Guide applied by a subsidiary or equity method investee should be retained in the financial statements of the parent company or an investor that applies the equity method of accounting to its investments in the entity. Those conditions are intended to evaluate relationships between the parent company or equity method investor and investees that may indicate that investees are not separate autonomous businesses from the parent company or equity method investor. If those conditions are not met, the specialized industry accounting principles of the Guide would not be retained in the financial statements of the parent company or equity method investor and the financial information of the investment company would be adjusted to reflect the accounting

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principles that would apply to the entity assuming it did not qualify as an investment company within the scope of the Guide.

Current developments and plans. AcSEC will continue its discussion of the draft SOP at a future meeting. AcSEC plans to issue an exposure draft (subject to FASB clearance) in the first quarter of 2001.

Staff: Joel Tanenbaum

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*. In April 2000, AcSEC approved an exposure draft, *Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, to Include Commodity Pools*. The exposure draft proposes that paragraph 5(b) of SOP 95-2 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.

Current developments and plans. In July 2000, the FASB did not object to issuance of the exposure draft. The exposure draft will be issued on August 15, 2000 with a 90-day comment period. A copy can be obtained at *www.aicpa.org/members/div/acctstd/edo/index.htm*.

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. At its June 2000 Meeting, AcSEC discussed account balance definition and liability valuation and concluded the following (see the April 2000 *AcSEC Update* for AcSEC's earlier conclusions):

For products with multiple benefit features, such as variable annuities with minimum guaranteed death benefits (MGDB) features:

- ❖ For purposes of contract classification, it is necessary to determine if the mortality risk associated with the MGDB feature is "significant." If insignificant or remote, the contract should be classified as an investment contract. If significant, the contract should be classified as an insurance contract.

- ❖ The significance of the death benefit should be measured based on a comparison of the present value of expected payments to be made under the MGDB provision (death benefit amounts in excess of the account value) to the present value of all amounts assessed against the policyholder (revenues). Insurers should consider a range of reasonably possible scenarios rather than simply a best estimate using one set of assumptions.

- ❖ The direct writer of a variable annuity contract with a MGDB feature should view this as a single contract, accounted for under existing guidance 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*, with an additional liability established for the MGDB feature (applying the provisions of paragraph 17b regarding unearned revenue to the MGDB element of the contract). Paragraph 17d should also be applied with respect to premium deficiency. If the contract is classified as an investment contract, no additional liability is needed for the MGDB feature. If the contract is classified as an insurance contract, a MGDB liability should be recorded in addition to the account value.

- ❖ If the contract transfers significant reinsurance risk to the reinsurer, the reinsurer of the MGDB feature of that contract would account for the reinsurance contract by recording an additional MGDB liability. In other words, the treatment is the same as under a direct writer.

For products with multiple account balances, such as market-value annuities, AcSEC held a discussion but did not reach any conclusions. AcSEC asked the task force to further analyze two views and to come up with examples of each view. Those views are:

- ❖ Liability valuation at the higher of book or market-adjusted value, reflecting the probability of withdrawals

- ❖ Liability valuation at the higher of the value that the policyholder could currently receive in cash or the value of other benefits (annuitization value)

Current developments and plans. AcSEC plans to begin discussing a draft SOP by the fourth quarter of 2000.

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

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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 not be considered an 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. The exposure draft for the proposed SOP was issued in April 2000 with a 60-day exposure period that ended June 5, 2000. AcSEC is planning to discuss responses to the exposure draft, and any proposed revisions, at its July 2000 meeting.

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 were received, with the majority stating that guidance is needed.

Current developments and plans. The task force will present the prospectus to AcSEC's Planning Subcommittee at its July meeting.

Staff: Kim Hekker

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):

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

- ❖ 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 positive clearance of certain revisions and FASB clearance. Those revisions were made and positive clearance obtained. A meeting with the FASB is planned for August 9, 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 nonreversionary 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

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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.

Current developments and plans. AcSEC will continue to discuss key issues at its September 2000 meeting, with the intention to issue an exposure draft (subject to FASB clearance) in the first quarter of 2001.

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 expanded the scope of the project so that all property, plant, and equipment (PP&E) is included and the "accrue in advance" method of accounting for overhaul costs is addressed. The FASB has approved a revised prospectus for the project.

Tentative conclusions. At its June 2000 meeting, AcSEC began discussing the first draft of an SOP and concluded the following (see the April 2000 *AcSEC Update* for AcSEC conclusions from its January 2000 meeting):

- Prior to acquisition of specific PP&E being probable, an entity should expense all costs related to that PP&E. Those costs include a payment for an option to acquire that PP&E. If acquisition of specific PP&E is probable, a payment to acquire an option to obtain that PP&E should be capitalized. If the option expires unexercised or if it becomes no longer probable that the option will be exercised, any previously capitalized cost of the option should be charged to expense, net of probable recoveries from the sale of the option.

- The SOP would utilize a "project stage" framework, whereby to facilitate presentation and understanding, guidance would be provided in terms of each of the various stages of a PP&E project. The stages would include *preliminary* (occurring prior to acquisition of specific PP&E being probable), *preacquisition* (occurring subsequent to acquisition of specific PP&E being probable but prior to acquisition or construction), *acquisition or construction*, and *operations* (when the PP&E is substantially complete and ready for its intended use).

- The SOP would broadly describe kinds of activities occurring within each project stage, with examples provided as appropriate. The SOP would then provide capitalization-versus-expensing guidance for the various kinds of costs relating to those activities—for example, third-party costs, payroll-related costs, and overhead and administrative costs.

- The capitalization-versus-expensing guidance would be based on the same accounting model for all project stages. That model would be based on paragraphs 6 and 7 of FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, and similar guidance in SOP 98-1, *Accounting for Costs of Computer Software for Internal Use*.

- In the case of real estate, during the time that activities are being performed in the acquisition/construction stage, incremental costs of property taxes, insurance, and ground rentals (land leasing costs) should be capitalized. This would apply both to property that an entity has just acquired for purposes of starting construction and property that an entity has held for a longer period of time and on which it has just started construction.

- When demolition costs are incurred in conjunction with the acquisition of land, and the demolition of existing structures on that land is contemplated as part of the acquisition, the demolition costs should be capitalized as part of the land costs. Demolition costs incurred related to land currently held by an entity should be expensed.

- Costs incurred to extend the expected useful life of PP&E should be capitalized provided the costs extend the life beyond that originally expected assuming the entity performs normal, ongoing maintenance on that PP&E.

- AcSEC discussed that PP&E replacements involve three costs—the replaced PP&E, the labor to remove the old PP&E, and the labor to install the new PP&E. While acknowledging that there

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

may be practical difficulties in separating out removal and installation costs, AcSEC concluded that costs of the PP&E and installation should be capitalized whereas removal costs should be expensed.

- Planned major maintenance activities such as "overhauls" should be capitalized only to the extent of the costs of specific PP&E items replaced.

Current developments and plans. AcSEC will continue its discussion of a draft SOP at its July 2000 meeting. AcSEC plans to issue an exposure draft, subject to FASB clearance, in the fourth quarter of 2000.

Staff: Marc Simon

OTHER AcSEC ACTIVITIES

At its April 2000 meeting, AcSEC—

- Met with the FASB to discuss the following topics: AcSEC projects on cost capitalization and the scope of the Investment Company Guide; FASB Concepts Statement No. 7 and how it will be considered by standard setters; AcSEC comment letters on FASB's fair value document and the SEC's Concept Release on International Accounting Standards (IAS); and the process for adding projects to the agendas of EITF, AcSEC, and FASB.
- Approved a comment letter on the FASB's *Preliminary Views on major issues related to Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value*, subject to substantive revisions.
- Approved a comment letter on the FASB's exposure draft, *Accounting for Obligations Associated with the Retirement of Long-Lived Assets*. AcSEC's letter supported a cost accumulation model for obligations that an entity plans to settle itself.
- Discussed a draft AICPA letter to the SEC on the SEC's Concept Release on IAS.

On April 27, 2000, AcSEC's Planning Subcommittee met with the Association for Investment Management and Research (AIMR) Financial Accounting Policy Committee (FAPC) to discuss AcSEC projects and FAPC projects.

At its June 2000 AcSEC meeting, AcSEC discussed and approved a redrafted comment letter on the FASB's *Preliminary Views on major issues related to Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value*. AcSEC's letter was supportive of the FASB's efforts to address the subject of fair value accounting for financial instruments and encouraged the Board to continue to move forward with the project. However, it recommended that a more strict definition of financial instruments be applied. That approach would not preclude companion projects or future projects addressing topics such as insurance accounting.

POTENTIAL FUTURE AcSEC PROJECT

Accounting for Customer Acquisition Costs SOP. AcSEC's Planning Subcommittee added to AcSEC's agenda a project to provide guidance on accounting for customer acquisition costs. The issue to be addressed is under what circumstances an entity should defer and amortize versus charge directly to expense amounts incurred for customer acquisition costs. Currently there is diversity in practice across industries. The project would not address areas that are specifically covered by higher level GAAP, including FASB Statement Nos. 60, *Accounting and Reporting by Insurance Enterprises*, and 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. Other AcSEC standards that include guidance for customer acquisition costs may be amended. A task force is being formed to draft a prospectus seeking FASB clearance to undertake the project.

To Order Copies of AcSEC Pronouncements

Call 888-777-7077 (option #1), ask for operator NQ; **order via fax**, 800-362-5066; or **write** AICPA Order Department, NQ, P.O. Box 2209, Jersey City, NJ 07303–2209. Orders for exposure drafts must be written or faxed. Exposure drafts may also be obtained through the AICPA web site; see "AcSEC ON AICPA WEB SITE" on page 13.

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.

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

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. Expert Panels covering Financial Services, Government/Not-for-Profit Organizations, and Employee Benefit Plans have been established. Additional panels dealing with issues in High Technology, Biotechnology/Pharmaceuticals, Computer Auditing/Electronic Delivery, and Health Care will be established later this year.

For more information on the Expert Panels or to apply, visit AICPA Volunteer Central at *www.skillscape.com/aicpaonline*. Staff contacts for Expert Panels are as follows:

Financial Services (Sydney Garmong; *sgarmong@aicpa.org*)

Government/Not-for-Profit Organizations (Mary Foelster; *mfoelster@aicpa.org*)

Employee Benefit Plans (Wendy Frederick; wfrederick@aicpa.org)

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 and is nearing completion of the initial drafting stage of the project. 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 force determines that there is a need for new accounting requirements as a result of Statement No. 34's revisions to the Guide. A final revised guide is expected to be issued during the second quarter of 2001.

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.

Technical Practice Aids

Staff of the Accounting Standards Team recently released a third set of nonauthoritative questions and answers (Q&As), commonly referred to as Technical Practice Aids (TPAs), pertaining to software revenue recognition.

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

AICPA Appoints New Representative to IASC

Effective July 1, 2000, John Smith of Deloitte & Touche was appointed as the AICPA's representative to the IASC. John is very knowledgeable about IAS, he has been serving on the IASC's Standing Interpretations Committee, and he is well-versed in financial instrument accounting, under both US and IAS standards. We are fortunate that John will be serving in this important capacity. Through June 30, Mike Crooch had been the AICPA representative. However, Mike's move from Arthur Andersen to the FASB called for his resignation as IASC representative. We appreciate Mike's significant contribution to the AICPA and the IASC over the past 3 years as part of the US delegation to the IASC. ❖

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. ❖

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." ❖

Upcoming AcSEC Meetings

AcSEC meetings are open to the public.

July 25–26, 2000	Seattle, WA
September 12–13, 2000	New York, NY
October 24–25, 2000	New York, NY
December 11–12, 2000	Orlando, FL
February 1–2, 2001	New York, NY
March 6–7, 2001	New York, NY

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