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AcSEC UPDATE

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

AcSEC ISSUES AUDIT AND ACCOUNTING GUIDE ON INVESTMENT COMPANIES, NEW SOP ON MUTUAL INSURANCE COMPANY REORGANIZATIONS

Investment Companies On November 21, 2000, AcSEC issued a revised Audit and Accounting Guide *Audits of Investment Companies* (product no. 012364). The Guide replaces the 1987 AICPA Audit and Accounting Guide *Audits of Investment Companies*.

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 provides 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 is effective for fiscal years beginning after December 15, 2000.

AcSEC has a related project on its agenda to develop an SOP, *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investments Companies, to clarify the scope of the Guide. AcSEC has also formed a task force that is in the process of drafting a prospectus for another related project to address the issue of whether an entity within the scope of the Guide should use a blockage factor to estimate the fair value of an unrestricted investment that has a quoted market price in an active market. The Guide provides that if an entity's accounting policy, in investment company financial statements issued for fiscal years ending on or before May 31, 2000, was to apply a blockage factor in estimating the fair value of certain unrestricted investments that have a quoted market price in an active market, that entity may continue to apply that policy, with disclosure, to those and similar investments. Otherwise, an entity may not elect to adopt such a policy pending completion of the AcSEC project on this matter or the FASB's project on measuring financial instruments at fair value.

Mutual Insurance Company Reorganizations AcSEC issued SOP 00-3, *Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts* (product no. 014928), on December 15, 2000. The SOP provides guidance on accounting by insurance enterprises for demutualizations and the formation of mutual insurance holding companies (MIHCs). The SOP also applies to stock life insurance enterprises that apply SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, to account for participating policies that meet the criteria of paragraph 5 of SOP 95-1.

The SOP applies to past and future demutualizations or formations of an MIHC, with specific transition provisions as described in the SOP. Entities must apply the SOP to financial statements no later than the end of the fiscal year that begins after December 15, 2000.

RECENT AcSEC ACTIVITIES

Accounting by 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. The original comment period closed August 31, 2000. Several comment letters said that the scope, particularly relating to the inclusion of insurance companies, was unclear. AcSEC agreed and has extended the comment period to October 31, 2000. AcSEC expects to issue the SOP during the second quarter of 2001.

SOP 95-2 Amendment On December 11, 2000, AcSEC approved a final SOP, *Amendment to Scope of Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships*, to Include Commodity Pools*, pending AcSEC's negative clearance of certain revisions and FASB clearance. AcSEC expects to issue the SOP during the first quarter of 2001.

Interests in Unconsolidated Real Estate Investments On November 21, 2000, AcSEC issued an exposure draft of the proposed SOP, *Accounting for Investors' Interests in Unconsolidated Real Estate Investments*. Comments are due by April 15, 2001. Because the proposed SOP will replace SOP 78-9, *Accounting for Investments in Real Estate Ventures*, and SOP 78-9 has been applied to other industries besides real estate, AcSEC encourages non-real estate investors interested in accounting for unconsolidated interests to comment on the proposed SOP.

Certain Purchased Loans and Securities (formerly known as Discounts Related to Credit Quality) In March 2000, AcSEC approved a final SOP, *Accounting for Certain Purchased Loans and Debt Securities*, pending AcSEC's positive clearance of certain revisions and FASB clearance. AcSEC's positive clearance has been obtained and a clearance meeting with the FASB has been scheduled. AcSEC expects to issue the SOP during the second quarter of 2001.

Health & Welfare Benefit Plans In September 2000, AcSEC approved the final SOP, *Accounting and Reporting of Certain Health and Welfare Benefit Plan Transactions*. Subject to the AcSEC Chair's clearance of certain revisions and FASB clearance, AcSEC expects to issue the SOP during the first quarter of 2001.

Costs and Activities Related to PP&E At its September 2000 meeting, AcSEC cleared for exposure, pending AcSEC's positive clearance of certain revisions and FASB clearance, the draft SOP *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*. AcSEC's positive clearance has been obtained and a clearance meeting with the FASB is being scheduled.

EFFECTIVE DATES

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.

SOP 00-3, *Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts*; entities must apply the SOP to financial statements no later than the end of the fiscal year that begins after December 15, 2000. Earlier adoption is encouraged.

Audit and Accounting Guide, *Audits of Investment Companies*, for annual financial statements issued for fiscal years beginning after December 15, 2000, and for interim financial statements issued after initial application. Earlier application is permitted.

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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" later in this issue.

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.

AcSEC AGENDA PROJECTS

-2000- ---------------2001-------------------

As of December 31, 2000

	4Q		1Q		2Q		3Q		4Q
Financing and Lending Activities									
Certain Purchased Loans and Securities — SOP					**F**				
Certain Entities that Lend or Finance — SOP					**F**				
Allowance for Loan Losses — SOP (see discussion)							**E**		
Employee Benefit Plans									
Health and Welfare Benefit Plans — SOP			**F**						
Investment Industry									
Investment Companies — Guide	**F**								
Scope Clarification, Investment Companies Guide — SOP			**E**						
SOP 95-2 Amendment — SOP			**F**						
Insurance Industry									
Certain Entities that Lend or Finance — SOP					**F**				
Nontraditional Contracts — SOP							**E**		
Mutual Company Reorganizations — SOP	**F**								
Real Estate Industry									
Real Estate Investments — SOP	**E**								
Real Estate Time-Sharing Transactions — SOP					**E**				
Other Projects									
Costs and Activities Related to PP&E — SOP			**E**				**F**		

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 and Debt Securities (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 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. Expected cash flows in excess of the initial investment (purchase price) should be recognized as the yield. Contractual cash flows in excess of 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 retained. Probable subsequent decreases in expected cash flows result in recognition of an impairment (and should not be 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. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of FASB Statement No. 125*, 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 does 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 those 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 Statements No. 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 or credit score) and have a common predominant risk characteristic (such as type of loan or 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 Statements No. 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.

- The SOP will be effective for loans acquired in fiscal years beginning after June 15, 2001.

Current developments and plans. At its March 2000 meeting, AcSEC approved issuance of a final SOP subject to AcSEC's positive clearance of certain revisions and FASB clearance. AcSEC's positive clearance has been obtained and a meeting with the FASB has been scheduled. AcSEC expects to issue the SOP in the second quarter of 2001.

Staff: Sydney Garmong

Accounting by Certain Entities That Lend to or Finance the Activities of Others

Description and background. This proposed SOP would apply to entities that lend to or finance the activities of others. In addition to banks, savings institutions, credit unions, finance companies, corporate credit unions, and mortgage companies, the SOP would also apply to manufacturers, retailers, wholesalers, and other business enterprises that provide financing for products and services.

All entities (except those such as investment companies, broker-dealers, and employee benefit plans, that carry loans receivable at fair value and include gains and losses in earnings) that lend to or finance the activities of others are subject to the provisions of *Audits of Finance Companies*. Although the scope of that Guide explicitly excluded insurance companies, this SOP is intended to include the financing activities of insurance companies.

This SOP also reconciles 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 all entities that lend to or finance the activities of others. 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. AcSEC has reached the following conclusions:

- Financing activities will continue to be included in the scope of the SOP. This includes manufacturers, retailers, wholesalers, and other business enterprises that provide financing

for products and services. Additionally, corporate credit unions and mortgage companies are explicitly included in the scope of the SOP.

- The Guide for finance companies does not explicitly address the recording of regular-way transactions. In keeping with the objective of this project to reconcile the accounting practices among similar financial institutions, AcSEC concluded that accounting for regular-way securities transactions at trade date should be required for finance companies.

- FASB Statements No. 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, that guidance for finance companies will be eliminated.

- FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, as amended by FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, required disclosure of the extent, nature, terms, and credit risk of financial instruments with off-balance-sheet credit risk. FASB Statements No. 105 and 119 were superseded by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Certain financial instruments with off-balance-sheet credit risk are not derivative instruments as defined in FASB Statement No. 133, and thus are not subject to its disclosure requirements. Examples of those instruments, commonly used by lending institutions, include off-balance-sheet loan commitments, financial guarantees, and letters of credit. AcSEC concluded that the disclosure requirements for off-balance-sheet financial instruments, previously addressed in FASB Statement No. 105, should still be applied to entities within the scope of this SOP.

Current developments and plans. In May 2000, AcSEC issued an exposure draft of the proposed SOP. AcSEC discussed the comment letters received on the proposed SOP at its December 2000 meeting. The discussion will continue at the February 2001 meeting with the intention of approving the document. AcSEC expects to issue a final SOP in the second quarter of 2001.

Staff: Sydney Garmong

Allowance For Loan Losses

Description and background. AcSEC 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. The task force is reviewing existing GAAP and identifying aspects that may need clarification. The task force is expected to develop an SOP that will provide additional guidance on periodic loan loss provisions and the related allowance for loan losses. The project may result in amendment of certain AICPA Audit and Accounting Guides, such as *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 if 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.

Current developments and plans. In July 2000, AcSEC discussed a draft SOP that reflected a task force proposal to base recognition of credit losses on all loans other than smaller-balance loans that are evaluated collectively for impairment on a change in the loans' credit risk grades. Under that proposal, recognition of losses on smaller balance, homogeneous loans would be based on past-due status. In December 2000, AcSEC discussed a task force proposal to dismiss the loss recognition "triggers" discussed at the July 2000 meeting and to instead require that loss recognition for pools of loans be based on loss attributes that reflect the conditions in paragraph 8 of FASB Statement No. 5, *Accounting for Contingencies*, and that are supported by observable data that are relevant to and directly representative of the specific loss attributes.

AcSEC instructed the task force to develop a draft SOP, following the approach discussed in December 2000, for discussion at the March 2001 AcSEC meeting. AcSEC plans to issue an exposure draft (subject to FASB clearance) in the third quarter of 2001.

Staff: Fred Gill

Accounting and Reporting For Certain Health and Welfare Benefit Plan Transactions

Description and background. The 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*. The project was undertaken because, since SOP 92-6 was issued in August 1992, there has been diversity in practice in implementing a number of its requirements, including the measurement date for benefit obligations and the disclosure of certain investment information. In addition, preparers and others have questioned the restrictive nature of some of the presentation requirements of SOP 92-6 and the adequacy of certain disclosure requirements. For example, many employers have amended their plans to add or increase participant contributions, creating the need for more relevant information about how a plan's costs are shared.

Also, in November 1992, FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*, was issued, establishing standards of financial accounting and reporting by employers for certain postemployment benefits provided to former or inactive employees after employment but before retirement. Benefits provided may include salary continuation, supplemental unemployment benefits, severance, disability-related job training and counseling, and continuation of health-care and life insurance. SOP 92-6 contains only limited accounting and reporting guidance related to postemployment benefits provided by health and welfare benefit plans (principally only accumulated eligibility credits). Therefore, this SOP adopts certain measurement concepts of FASB Statement No. 112, which applies to employer accounting. Terminology used in discussing postemployment benefits in this SOP is intended to follow that in FASB Statement No. 112.

Tentative conclusions. The SOP—

1. Specifies the presentation requirements for benefit obligation information.
2. Revises the standards for disclosing information about participant contributions toward the estimated cost of postretirement benefits.
3. Clarifies the measurement date for benefit obligations.
4. Establishes standards of financial accounting and reporting for certain postemployment benefits provided by health and welfare benefit plans.
5. Requires the identification of investments that are 5 percent of the net assets available for benefits.

Current developments and plans. AcSEC approved the final SOP for issuance at its September 12, 2000 meeting. Subject to the AcSEC Chair's clearance and FASB clearance, AcSEC expects to issue the final SOP in the first quarter of 2001.

Staff: Wendy Frederick

Clarification of the Scope of the Investment Companies Guide

Description and background. In February 1999, the FASB cleared a prospectus for a project to develop an SOP to address the scope of the AICPA Audit and Accounting Guide *Audits of Investment Companies*. At that meeting, the FASB expressed concern that the scope of the then

proposed Guide may be unclear. (The scope provisions of the Guide, which was issued in November 2000, are unchanged from the previous 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. Some of the tentative conclusions reached by AcSEC are as follows:

- 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 for current income, capital appreciation, or both. The SOP would include conditions that should be evaluated to determine whether the entity's primary business activity is investment activity, including 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 would also 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 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. At its October 2000 meeting, AcSEC approved a proposed SOP for exposure, subject to AcSEC's positive clearance and FASB clearance. AcSEC expects to release the exposure draft in the first quarter of 2001.

Staff: Joel Tanenbaum

SOP 95-2 Amendment

Description and background. 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. The exposure draft was issued on August 15, 2000 with comments due by November 15.

Current developments and plans. On December 11, 2000, AcSEC approved a final SOP subject to AcSEC's negative clearance of certain revisions and FASB clearance. AcSEC expects to issue the SOP during the first quarter of 2001.

Staff: Dan Noll

Nontraditional Long-Duration Contracts

Description and background. This project will address the classification and valuation of liabilities as well as disclosures for nontraditional annuity and life insurance contracts issued by insurance enterprises.

Tentative conclusions. Some of the 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. Sales 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 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.

Multiple benefit features – 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 an 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 17(b) regarding unearned revenue to the MGDB element of the contract). Paragraph 17(d) 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, an 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 for a direct writer.

Current developments and plans. At its December 2000 meeting, AcSEC continued its discussion of potential liability valuation models. The task force reported that liability models previously discussed by AcSEC could not be supported by current accounting literature and discussed a new liability model that is based on accreting to the account balance that would be available in cash or cash equivalents at the earlier of the reset date or contractual maturity.

AcSEC also discussed other liability valuation models proposed by AcSEC members, but a majority of AcSEC was in favor of the task force continuing to pursue the new “accretion model.” After the task force presented various product examples under that model, AcSEC requested that the task force revisit sales inducements and consider the possibility of using an effective yield model.

AcSEC will continue its discussion at its March 2001 meeting and plans to issue an exposure draft in the third quarter of 2001.

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

- With certain exceptions, an investor holding an equity investment in an investee would follow the equity method of accounting for that investee when the investor has the ability to exercise significant influence over the investee. For investees such as general partnerships, limited partnerships, limited liability companies (LLCs), and limited liability partnerships (LLPs) that are organized in a "specific ownership account"-like structure and over which the investor does not have the ability to exercise significant influence, the investor's accounting depends on whether its ownership interest meets the definition in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, of an equity security having a readily determinable fair value. If the ownership interest meets that definition, the investor would apply FASB Statement No. 115; if it does not, the investor would apply the equity method.

- The hypothetical liquidation at book value method (HLBV) would be followed in applying the equity method. HLBV is a balance sheet-oriented approach to equity method accounting. Under HLBV, an investor determines its share of the earnings or losses of an investee by determining the difference between its "claim on the investee's book value" at the end and beginning of the period. That claim is calculated as the amount that the investor would receive (or be obligated to pay) if the investee were to liquidate all of its assets at recorded amounts determined in accordance with GAAP and distribute the resulting cash to creditors and investors in accordance with their respective priorities.

- HLBV takes into account all forms of financial interest that an investor has with respect to an investee, including common stock, preferred stock, general or limited partnership interests, debt securities, loans, advances, notes receivable, and other obligations.

- In applying HLBV, an investor would report a negative investment only to the extent it has guaranteed obligations of the investee, is otherwise committed to provide further financial support for the investee, or if the imminent return to profitable operations by the investee appears to be assured. If the amount an investor would receive or pay upon the hypothetical liquidation of an investee at book value depends on the ability of another investor to fund its negative investment, the investor's claim on the book value of the investee would include only those amounts that it is probable the other investor would fund.

- An investor has a "basis difference" if there is a difference between the amount of its investment in an investee and its claim on the book value of the investee. Generally, a basis difference would be attributed to assets or liabilities of the investee and accounted for as if the investee were a consolidated subsidiary.

Current development and plans. The exposure draft was issued on November 21, 2000 with comments due by April 15, 2001. A copy of the exposure draft can be obtained at www.aicpa.org/members/div/acctstd/edo/index.htm.

Staff: Marc Simon

Real Estate Time-Sharing Transactions

Description and background. AcSEC added this project to its agenda because of diversity in practice caused by a lack of guidance specific to real estate time-sharing transactions.

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

Basic accounting model – The underlying structural basis for the time-sharing accounting model is the retail land sales model (RLS) of FASB Statement No. 66, *Accounting for Sale of Real Estate*, with inclusion of certain of the fundamental principles of the other-than-retail-land-sales model (OTRLS) of that Statement.

Basic accounting model - Buyer's commitment test – The accounting model's test for buyer's commitment is a 10%-of-principal test, similar to that of RLS, which could be passed by receipt by the seller of cumulative down payments of at least 10% of the sales price.

Basic accounting model - Collectibility-of-receivables test – Collectibility is demonstrated by either passing a test similar to the RLS model's "90% test" or by the seller's collection of cumulative principal payments of at least 25% of the sales price.

Basic accounting model - Estimability-of-defaults test – The estimability-of-defaults test is a non-bright-line test, subject to certain criteria, whereby a time-sharing entity would have to have sufficient collection experience to demonstrate that it can reliably estimate defaults (analogous to the ability to estimate future returns discussed in FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*).

Defaults versus "sales reversals" – For purposes of estimating default percentages in the collectibility-of-receivables and estimability-of-defaults tests, sales cancelled subsequent to being recorded as sales should be considered as defaults rather than as "sales reversals."

Passage-of-title requirement – Passage of non-reversionary title is a criterion for treating a time-sharing transaction as a sale rather than a lease.

Rentals of unsold interests – Rentals are considered to be holding-period activities and accounted for as incidental operations under FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*. Time-sharing interests should be accounted for as inventory rather than fixed assets, and should therefore not be depreciated during times of rental.

Expensing versus deferral of costs – Costs should be handled using the "directly associated" approach of paragraph 18 of FASB Statement No. 67, modified to include some restrictions similar to those in FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

Multiple-element arrangements – A sale of a deeded floating week, floating unit with exchange privileges would be considered as a multiple element arrangement with the elements including the time-sharing interval, the exchange privilege, and anything else passed from seller to buyer such as health club memberships and amusement park tickets. Sales in this structure would be accounted for similar to sales under the basic model, but with the sales price reduced by the fair value of elements other than the interval itself. The other elements would be recorded as deferred revenue and amortized over their lives.

Special purpose entities (SPEs) – The issue involves SPE structures in which a seller transfers deeded title to a trust or third party (the SPE) in exchange for stock or other interests in the SPE, which the seller then sells to the time-share buyers. Sales should be recorded only upon the sale of the stock or interests to the time-share buyer, not upon transfer of title to the SPE. Generally, an SPE should be viewed as a non-substantive entity established to facilitate sales, and the seller should show in its balance sheet the interests in the SPE as "timeshare inventory" rather than apply consolidation or some other accounting method to the seller's interests in the SPE as the seller's ownership percentage in the SPE decreases during the sell-out of a project.

Current developments and plans. AcSEC will discuss a draft SOP at its February 2001 meeting and plans to issue an exposure draft (subject to FASB clearance) in the second quarter of 2001.

Staff: Marc Simon

Certain Costs and Activities Related to Property, Plant, and Equipment

Background and description. Diversity in practice concerning the recording of costs for improvements, replacements, betterments, additions (and terms synonymous with those such as redevelopments, refurbishments, renovations, and rehabilitations), and repairs and maintenance is currently one of the most prevalent problems in the real estate industry. In March 2000, AcSEC expanded the scope of the project beyond real estate to address the accounting for property, plant, and equipment (PP&E) and the accounting for overhaul costs. The FASB approved a revised prospectus for the project. The project addresses accounting and disclosure issues related to determining which costs related to PP&E assets should be capitalized as improvements and which

should be charged to expense as repairs and maintenance. The SOP will also address capitalization of indirect and overhead costs and component accounting for PP&E assets.

Tentative conclusions. Some of the significant conclusions reached by AcSEC are as follows:

- The SOP would use a "project stage" framework whereby 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 *in-service* (beginning at the time acquisition or construction of PP&E is substantially complete and the PP&E is ready for its intended use).

- Except for the costs of options, preliminary stage costs would be charged to expense as incurred.

- Costs related to PP&E incurred during the acquisition-or-construction stage would be capitalized if the costs are directly identifiable with the specific PP&E. Directly identifiable costs include only:
    - Incremental direct costs of acquiring, constructing, or installing the PP&E incurred in transactions with independent third parties for the specific PP&E.
    - Certain costs directly related to specified preacquisition activities performed by the entity for the acquisition, construction, or installation of the specific PP&E.

  General and administrative costs and overhead costs would be charged to expense as incurred. Similar conclusions would apply to preacquisition stage costs.

- Costs related to PP&E that are incurred during the in-service stage, including costs of normal, recurring, or periodic repairs and maintenance activities, would be charged to expense as incurred unless the costs are incurred for (1) the acquisition of additional PP&E or components of PP&E or (2) the replacement of existing PP&E or components of PP&E. Removal costs would be charged to expense as incurred.

- The costs of planned major maintenance activities are not a separate PP&E asset or component. Those costs would be capitalized to the extent they are capitalizable under the in-service stage guidance of the SOP and represent additions or replacements, and would otherwise be charged to expense as incurred.

- A component is a tangible part or portion of PP&E that (1) can be separately identified as an asset and depreciated over its own expected useful life and (2) is expected to provide economic benefit for more than one year. If a component has an expected useful life that differs from the expected useful life of the PP&E asset to which it relates, the cost would be accounted for separately and depreciated or amortized over its expected useful life.

- If an entity replaces a part or portion of a PP&E asset that has not been previously accounted for as a separate component, and the replacement meets the definition of a component, the entity would capitalize the replacement, account for it as a separate component going

forward, estimate the net book value of the replaced item, and charge the net book value of the replaced item to expense in the period of replacement.

- The SOP would be effective for financial statements for fiscal years beginning after December 15, 2001, with earlier application encouraged. For PP&E owned or leased by an entity prior to the adoption date, the component accounting guidance in the SOP would be applied using one of the following two alternatives: (a) apply component accounting for all PP&E assets retroactively, to the extent practicable, on the adoption date, and for those assets for which component accounting is not used retroactively, alternative (b) would be applied, or (b) do not apply component accounting retroactively, and in future periods when an entity incurs capitalizable costs for PP&E that replace PP&E for which component accounting has not been used, the entity would estimate the remaining net book value of the asset replaced and charge that amount to expense. Entities that previously accounted for planned major maintenance activities under methods other than the one prescribed in the SOP would record a cumulative effect adjustment as of the date of adoption. All other costs that were charged to expense prior to adoption that would be capitalized after adoption, or vice versa, would not be accordingly reclassified.

Current developments and plans. At its September 2000 meeting, AcSEC approved for exposure, subject to AcSEC's positive clearance of certain revisions and FASB clearance, the draft SOP *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*. AcSEC's positive clearance has been obtained and a clearance meeting with the FASB is being scheduled. AcSEC plans to issue an exposure draft in the first quarter of 2001.

Staff: Marc Simon

OTHER AcSEC ACTIVITIES

At its October 2000 meeting, AcSEC approved comment letters on:

- The FASB's June 30, 2000 exposure draft, *Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities*.
- The Federal Financial Institutions Examination Council's proposed *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions*.

NEW AND POTENTIAL FUTURE AcSEC PROJECTS

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, if any, an entity should defer and amortize 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 Statements No. 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 has been formed to draft a prospectus seeking FASB clearance to undertake the project.

Staff: Joel Tanenbaum

Blockage Factor AcSEC's Planning Subcommittee added to AcSEC's agenda a project to address whether an entity within the scope of the AICPA Audit and Accounting Guide *Audit of Investment Companies* should use a blockage factor to estimate the fair value of an unrestricted investment that has a quoted marked price in an active market. Currently some entities use a blockage factor to determine fair value. The Guide provides that if an entity's accounting policy, in investment company financial statements issued for fiscal years ending on or before May 31, 2000, was to apply a blockage factor in estimating the fair value of certain unrestricted investments that have a quoted market price in an active market, that entity may continue to apply that policy, with disclosure, to those and similar investments. Otherwise, an entity may not elect to adopt such a policy pending completion of the AcSEC project on this matter or the FASB's project on measuring financial instruments at fair value. A task force has been formed to draft a prospectus seeking FASB clearance to undertake the project.

Staff: Fabiola Ferrer

DAC on Internal Replacements In July 2000, AcSEC's Planning Subcommittee approved a prospectus for an SOP project to provide authoritative guidance 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.* The FASB cleared the prospectus in November 2000.

In June 1999, a Staff Discussion Paper was issued on the topic. The intent of the 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 saying that guidance is needed. The task force will review the comment letters and draft materials for a future AcSEC meeting.

Staff: Kim Hekker

UPCOMING AcSEC MEETINGS

AcSEC meetings are open to the public.

February 1-2, 2001	New York, NY
March 6-7, 2001	New York, NY
April 24-25, 2001	New York, NY

June 19-20, 2001	New York, NY
July 26-27, 2001	Stanford University (CA)
September 11-12, 2001	New York, NY
October 23-24, 2001	New York, NY

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)

AICPA Expert Panels

Three of the AICPA's Expert Panels—Financial Services, Government/Not-for-Profit Organizations, and Employee Benefit Plans—have been established and have held their initial meetings. Expert Panels dealing with issues in High Technology, Biotechnology/Pharmaceuticals, Computer Auditing/Electronic Delivery, and Health Care are in the process of being established.

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*. The standard significantly 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-size 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 Statement No. 34, the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* 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 the 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 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 exposure. Instead, 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 the 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

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 in-process research and development (IPR&D).

Technical Practice Aids

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

The staff also released Q&As on financial accounting and reporting issues related to SOP 00-2, *Accounting by Producers or Distributors of Films*.

The Q&As may be viewed on the AICPA web site at http://www.aicpa.org/members/div/acctstd/general/othitem.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.

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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The views expressed herein are those of the authors and do not necessarily reflect the views of the American Institute of Certified Public Accountants. Official positions of the AICPA are determined through specific committee procedures, due process, and deliberations.

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