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American Institute of Certified Public Accountants. Accounting Standards Executive Committee

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AcSEC UPDATE

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

RECENT AcSEC ACTIVITIES

Accounting for Loans and Certain Debt Securities Acquired in a Transfer (formerly known as Accounting for Certain Purchased Loans and Debt Securities) FASB cleared the final SOP on October 10, 2003, subject to adding an additional disclosure for the carrying amount of nonaccrual loans within the scope of the SOP. AcSEC expects to issue the SOP in fourth quarter of 2003 with an effective date of loans acquired in fiscal years beginning after December 15, 2004.

Non-Traditional Long-Duration Insurance Contracts On July 7, 2003, AcSEC issued SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Non-Traditional Long-Duration Contracts and for Separate Accounts.* The SOP is effective for financial statements for fiscal years beginning after December 15, 2003, with earlier adoption encouraged. The SOP may not be applied retroactively to prior years' financial statements, and initial application should be as of the beginning of an entity's fiscal year.

Allowance for Credit Losses On June 19, 2003, AcSEC issued an exposure draft of a proposed SOP, *Allowance for Credit Losses*. The proposed SOP addresses the recognition and measurement by creditors of the allowance for credit losses related to all *loans*, as that term is defined in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, with certain exceptions, and would apply to all creditors other than state and local governmental entities and federal governmental entities. The comment letter deadline was September 19, 2003.

Separate Account Financial Highlights On July 15, 2003, AcSEC issued an exposure draft of a proposed SOP, Financial Highlights of Separate Accounts – An Amendment of the Audit and Accounting Guide *Audits of Investment Companies*. The exposure draft provides guidance on reporting financial highlights by separate accounts of insurance enterprises. The comment letter deadline was September 15, 2003.

Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships On July 15, 2003 AcSEC issued an exposure draft of a proposed SOP, *Reporting Financial Highlights and Schedule of Investment by Nonregistered Investment Partnerships* an amendment to the Audit and Accounting Guide, *Audits of Investment Companies, and SOP 95-2*. The comment letter deadline was September 15, 2003.

Clarification of the Scope of the Investment Companies Guide At its September 2003 meeting, AcSEC approved for final issuance the SOP, *Clarification of the Scope of the Audit and*

Accounting Guide Audits of Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, subject to AcSEC's negative clearance and FASB clearance. AcSEC expects to issue the SOP in the first quarter of 2004.

Costs and Activities Related to PP&E At its September 2003 meeting, AcSEC approved for final issuance the SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, subject to AcSEC's positive clearance and FASB clearance. AcSEC expects to issue the SOP in the first quarter of 2004.

Real Estate Time-Sharing At its September 2003 meeting, AcSEC approved for final issuance the SOP, *Accounting for Real Estate Time-Sharing Transactions,* subject to Chair's clearance of certain revisions and FASB clearance.

DAC on Internal Replacements At the September 2003 meeting, AcSEC approved for final issuance the SOP, *Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Specifically Described in FASB Statement No. 97*, subject to AcSEC's negative clearance, and FASB clearance. AcSEC expects to issue the SOP in the first quarter of 2004.

EFFECTIVE DATES

SOP 02-2, *Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator.* The provisions are effective for fiscal years beginning after June 15, 2003. The provisions of the SOP should be applied prospectively.

SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts.* The provisions are effective for financial statements for fiscal years beginning after December 15, 2003, with earlier adoption encouraged. The SOP may not be applied retroactively to prior years' financial statements, and initial application should be as of the beginning of an entity's fiscal year.

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Call 888-777-7077 (option #1), ask for operator NQ; **order via fax,** 800-362-5066; or **write** AICPA/cpa2biz Order Department, NQ, P.O. Box 2209, Jersey City, NJ 07303–2209. Exposure drafts should be obtained through the AICPA web site; see "AcSEC ON AICPA WEB SITE" later in this issue.

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AcSEC SHOWS APPRECIATION

Thanks to Outgoing AcSEC Members,
Welcome to New AcSEC Members

AcSEC and the Accounting Standards Team wish to thank the following outgoing members for their dedicated service to the Committee and the improvement of financial reporting:

Mark Sever – Ernst & Young, LLP
Larry Dodyk – PricewaterhouseCoopers, LLP
James Koepke – Doeren Mayhew
Fran McGettigan – General Electric Company
Rick Moseley- Altschuler, Melvoin & Glasser LLP
Tony Sondhi - A.C. Sondhi & Associates LLC
Mary Stone - University of Alabama

We welcome the following new AcSEC members as of October, 2003:

John Althoff - PricewaterhouseCoopers LLP
Rich Jones - Ernst & Young LLP
Carl Kampel - Ellin and Tucker
Peter Knutson - The Wharton School
Holly Nelson - Jetblue Airways Corp

AcSEC MEMBER ACTIVITIES

Speeches by AcSEC Members

Val Bitton - SEC Update, Real Estate Industry Current Accounting and Reporting Update, Deloitte & Touche, Chicago, IL, December 10, 2002

-AcSEC Update, Current Financial Reporting Issues Conference, Financial Executives International, New York, NY, November 4, 2002

-Coping with Sarbanes-Oxley Act and New Corporate Governance Requirements, Milwaukee Chapter of the American Society of Corporate Secretaries and Bowne, Milwaukee, WI, November 1, 2002

Andrew Mintzer – AcSEC Update, University of Southern California; Leventhal School of Accounting 22nd Annual SEC and Financial Reporting Institute Conference, Pasadena, CA, May 29, 2003

AcSEC Update and Current Developments, University of South Florida Accounting Circle Conference, Tampa, FL, May 22, 2003

AcSEC Update, Thirteenth Annual Conference on Financial Reporting, HAAS School of Business, University of California at Berkeley, San Francisco, CA, November 8, 2002

AcSEC AGENDA PROJECTS

------------2003--- -------------2004----------

As of September 30, 2003

	2Q		3Q		4Q		1Q		2Q
Financing and Lending Activities									
Loans and Certain Debt Securities — SOP					**F**				
Certain Entities that Lend or Finance — Guide					**F**				
Allowance for Credit Losses — SOP	**E**								**F**
Investment Industry									
Scope Clarification, Investment Companies Guide — SOP							**F**		
Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships - SOP			**E**		**F**				
Insurance Industry									
Non-Traditional Long-Duration Contracts — SOP			**F**						
DAC on Internal Replacements — SOP							**F**		
Separate Account Financial Highlights — SOP			**E**		**F**				
Real Estate Industry									
Real Estate Time-Sharing Transactions — SOP	**E**						**F**		
Other Projects									
Costs and Activities Related to PP&E — SOP							**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 Loans and Certain Debt Securities Acquired in a Transfer (formerly known as Accounting for Certain Purchased Loans and Debt Securities)

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.

Current developments and plans. Subsequent to an AcSEC initial conclusion, AcSEC and FASB agreed that FASB, in one of its current projects, should address the accounting for allowance carry overs related to acquired loans that are not within the scope of the SOP. That is, the SOP will address the allowance carry over issue only as it relates to acquired loans with evidence of deterioration of credit quality since origination.

FASB cleared the final SOP on October 10, 2003, subject to adding an additional disclosure for the carrying amount of nonaccrual loans within the scope of the SOP. AcSEC expects to issue the SOP in fourth quarter of 2003 with an effective date of loans acquired in fiscal years beginning after December 15, 2004.
Staff: Dan Noll

Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others – Proposed Audit and Accounting Guide

Description and background. SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, issued in December 2001, and this Guide (also referred to as the combined Guide) apply to certain 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 Guide will also apply to manufacturers, retailers, wholesalers, and other business enterprises that provide financing for products and services.

All entities (except insurance companies and 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 were subject to the provisions of the AICPA Audit and Accounting Guide *Audits of Finance Companies*.

SOP 01-6 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* (collectively, the Guides), portions of which have been superseded by the issuance of that SOP. The 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.

This project consists of two parts. First, SOP 01-6 reconciles the specialized accounting and financial reporting guidance established in the Guides. With limited exceptions, the SOP includes guidance for *all* entities engaged in lending and financing activities (including trade receivables). AcSEC believed that this guidance should stand alone in an SOP. If that guidance had been included only in the combined Guide, AcSEC was concerned that preparers and auditors would have focused on the organizational structure of an entity rather than the activities of the entity. In other words, auditors and preparers could have potentially overlooked guidance contained in an industry-specific Guide. In addition to being issued as a stand-alone SOP, the SOP will be included in the combined Guide.

Second, the chapters from the Guides have been combined and redrafted for consistency in a new combined Guide. The draft chapters for the Proposed Audit and Accounting Guide, *Certain Financial Institutions and Entities That Lend to or Finance the Activities of Others,* are available online at: http://www.aicpa.org/members/div/acctstd/edo/chapters.htm

Current developments and plans. The chapters for the combined Guide were posted to the AICPA web site for comment during the first quarter of 2001. AcSEC expects to issue the final combined Guide during the fourth quarter of 2003.

Staff: Myrna Parker

Allowance For Credit Losses

Description and background. This project will provide additional guidance, within the framework of existing FASB literature, on periodic credit loss provisions and the related allowance for credit losses. The guidance will apply to all creditors other than state and local governments and entities subject to pronouncements of the Federal Accounting Standards Advisory Board (FASAB).

Tentative conclusions. The proposed SOP addresses the recognition and measurement by creditors of the allowance for credit losses related to all *loans*, as that term is defined in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, with certain exceptions.

The proposed SOP provides that:
- The allowance for credit losses reported on a creditor's balance sheet should consist only of (1) a component for individual loan impairment recognized and measured pursuant to FASB Statement No. 114 and (2) one or more components of collective loan impairment recognized

pursuant to FASB Statement No. 5, *Accounting for Contingencies*, and measured in accordance with the guidance in the proposed SOP.

- If a creditor evaluates or grades an individual loan as part of a credit risk evaluation or grading process, that loan has been "identified for evaluation" within the meaning of paragraph 6 of FASB Statement No. 114.
- A creditor should group into pools, based on similar credit risk characteristics, loans other than those that were individually determined to be impaired. Those pools should be evaluated for collective loan impairment and include loans that were individually evaluated and determined to not be impaired and loans that were not individually evaluated. Loans that have been individually evaluated and have been determined to be impaired, regardless of whether an impairment allowance has been recorded, should not be included in those pools.
- Creditors should specifically consider relevant observable data in the recognition and measurement of components of collective loan impairment and each component of collective loan impairment should be supported with one or more sets of relevant observable data.
- The measurement of a component of collective loan impairment should be directionally consistent with changes in the related observable data from period to period, taking into account the interaction of components of collective loan impairment over time.
- Creditors should change the observable data considered only if changes in the environment indicate that other observable data have become more relevant or if new observable data that is more relevant becomes available.
- Components of the allowance for credit losses recognized pursuant to FASB Statement No. 5, that is, components of collective loan impairment, should be measured based on the present value of expected future cash flows. Each component of collective impairment should be estimated based on relevant observable data relating to existing conditions; creditors should not project changes in the observable data that may occur in the future. The estimate of loss in pools of loans should reflect losses that have already been incurred, even if not yet identifiable, and not losses that might be incurred over the remaining life of the loans, even if predictable based on historical experience.

The provisions of the proposed SOP would be effective for financial statements for fiscal years beginning after December 15, 2003, with earlier application permitted. The effect of initially applying the provisions of the proposed SOP would be reported as a change in accounting estimate. Previously issued financial statements should not be restated.

Current developments and plans. On June 19, 2003, AcSEC issued an exposure draft for public comment. Comments on the exposure draft were due by September 19, 2003.

Staff: Fred Gill

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. Also, this project will address whether investment company accounting should be retained by a parent company (of an investment company) in consolidation or by an investor (in an investment company) that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the entity. 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.

In December 2002, AcSEC issued an exposure draft of a proposed SOP, *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*. The comment letter deadline was March 31, 2003. At its June, July, and September 2003 meetings, AcSEC subsequently discussed the comment letters received on the exposure draft and proposed revisions to the SOP

Tentative conclusions. Some of the conclusions reached by AcSEC in discussion after the exposure draft are as follows:

- The SOP should include an overarching definition of an *investment company* (a separate legal entity), focusing on purpose (investing in multiple substantive investments for current income, capital appreciation, or both rather than for strategic operating purposes).

- The SOP should include factors to consider to help entities weigh all existing evidence in determining whether the entity meets the overarching definition of an *investment company*. Depending on the facts and circumstances, some factors may be more significant than others. (The factors are derived from the conditions in the ED.)

- Two categories of investment companies should exist: regulated investment companies (within the scope of the Guide) and all other investment companies (based on the overarching definition and evaluation of factors).

- The SOP should include illustrations demonstrating the application of the guidance in the SOP to various fact patterns.

- The SOP should not include separate guidance for direct interests in real estate. The SOP should include illustrations of behavior pertaining to investments of direct interests in real estate and application of the guidance in the SOP to those fact patterns. The aim of those illustrations should be to demonstrate that typical activities undertaken by investment companies pertaining to direct interests in real estate would not necessarily disqualify the entity from using investment company accounting. Those illustrations also should provide indications of the type of activities related to real estate operations that would be inconsistent with the activities of an investment company.

- The SOP should 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 September 2003 meeting, AcSEC approved for final issuance the SOP, *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, subject to AcSEC's negative clearance and FASB clearance. AcSEC expects to issue the SOP in the first quarter of 2004.

Staff: Joel Tanenbaum

Non-Traditional 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.

In July 2002, AcSEC issued an exposure draft of a proposed SOP *Accounting and Reporting by Insurance Enterprises for Certain Non-Traditional Long-Duration Contracts and for Separate Accounts*. Twenty comment letters were received.

Current developments and plans. On July 7, 2003 AcSEC issued SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts.* The SOP provides guidance on accounting and reporting by insurance enterprises for certain nontraditional long-duration contracts and for separate accounts, including:

- Separate account presentation
- Accounting for an insurance enterprise’s interest in a separate account
- Transfers to separate accounts
- Valuation of liabilities
- Accounting for contracts with death or other insurance benefit features
- Accounting for contracts that provide annuitization benefits
- Sales inducements to contract holders
- Disclosures

The SOP is effective for financial statements for fiscal years beginning after December 15, 2003, with earlier adoption encouraged. The SOP may not be applied retroactively to prior years' financial statements, and initial application should be as of the beginning of an entity's fiscal year.

Staff: Kim Kushmerick Hekker

DAC on Internal Replacements

Description and background. 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.

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 March 2003 AcSEC issued for comment an exposure draft SOP, *Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Specifically Described in FASB Statement No. 97.* Ten comment letters were received. Some of the proposed guidance discussed in the exposure draft is as follows:

- *Internal Replacements.* An internal replacement is defined as a modification in product benefits or features that occurs by amendment or rider to an existing contract or by the exchange of an existing contract for a new contract. In addition, the election of a feature within an existing contract may result in a modification that would require evaluation under the provisions of this SOP. The legal form of an internal replacement should not determine the accounting applicable to the transaction. The same accounting treatment should apply to a given modification however made, whether structured as an amendment or rider to an existing contract or as the issuance of a new contract in replacement of the original contract. Certain specified modifications of an existing contract are not considered internal replacements if they are both contemplated in the original contract and do not change the inherent nature of the original contract.

- *Determining "Not Substantially Different."* An internal replacement transaction results in a contract that is substantially different from the original contract unless the modification is specifically identified in paragraph 9 of this SOP or if all of the following conditions exist:
    a. The modification does not result in a change in the inherent nature of the contract.

b. An additional deposit, premium or charge relating to the original benefit, in excess of amounts contemplated in the original contract, is not required to effect the transaction.
c. There is no net decrease in the balance available to the contract holder, when applicable.
d. The modification does not result in a change to either the amortization method or revenue classification of the contract.
e. Additional benefits, whether elected as a result of provisions of the original contract or provisions added subsequently, do not become the primary benefits under the contract.

- *Accounting for Internal Replacements that are Substantially Different.* An internal replacement that is deemed to be substantially different from the original contract should be accounted for as an extinguishment of the initial contract and treated as a lapse or surrender. Unamortized deferred acquisition costs, deferred revenue liabilities, and deferred sales inducement assets from the original contract associated with an internal replacement transaction that is substantially different should not be deferred in connection with the replacement contract.

- *Accounting for Internal Replacements that are Not Substantially Different.* An internal replacement that is determined to be not substantially different from the original contract should be accounted for as a continuation of the original contract. Unamortized deferred acquisition costs, deferred revenue liabilities, and deferred sales inducement assets associated with the original contract should continue to be deferred in connection with the replacement contract. Other balances that are determined based on activity over the life of the contract, such as a minimum guaranteed death benefit (MGDB), which under the provisions of SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*, are determined based on estimated gross profits and benefit costs, should consider the entire life of the contract, including activity during the term of the original (replaced) contract.

- *Sales Inducements.* New sales inducements that otherwise meet the criteria in SOP 03-1, offered in conjunction with an internal replacement that is not substantially different from the original contract, should be accounted for as if they were explicitly identified in the original contract at inception.

- *Costs and Charges Related to Internal Replacements.* Acquisition costs incurred in connection with an internal replacement with contracts that are determined to be not substantially different, are considered to be costs associated with renewals. Acquisition costs related to and front-end fees incurred in connection with internal replacement activity should be evaluated for deferral in accordance with the provisions of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* as amended, and other existing accounting literature.

- *Recoverability.* Unamortized deferred acquisition costs and the present value of future profits continue to be subject to loss recognition testing in accordance with the provisions of FASB Statement No. 60.

- *Disclosures.* The notes to the financial statements should clearly describe the accounting policy applied to internal replacements.

Current developments and plans At its September 2003 meeting, AcSEC voted to approve a revised SOP, *Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Specifically Described in FASB Statement No. 97*, for issuance subject to AcSEC negative clearance, and FASB clearance. AcSEC expects to issue the SOP in the first quarter of 2004.

Some of the changes in guidance from the exposure draft are as follows:

- The insurance enterprise must first determine if the internal replacement is a contract exchange or other contract modification, and follow the applicable guidance in the SOP.

- If it is not reasonably practicable for an insurance enterprise to account for, in the manner described in paragraph 15 of this SOP, a contract exchange that has resulted in a replacement contract that is substantially unchanged from the replaced contract, the insurance enterprise should determine an appropriate balance of unamortized deferred acquisition costs related to the replaced contract to carry forward to the replacement contract and utilize estimated gross profits or margins only of the replacement contract to determine future amortization.

- A transaction where the only substantive modification to the replaced contract is the addition of a sales inducement should be accounted for under the sales inducement guidance in SOP 03-1, and not under the guidance of this SOP.

- The notes to the financial statements should describe the accounting policy applied to internal replacements, including whether or not the company has availed itself of the alternative application guidance outlined in paragraph 16 of this SOP and, if so, for which types of internal replacement transactions.

- The effective date has been changed to be effective for internal replacements occurring in fiscal years beginning after December 15, 2004, with earlier adoption encouraged

Staff: Kim Kushmerick Hekker

Separate Account Financial Highlights

Description and background AcSEC's Planning Subcommittee added to AcSEC's agenda a project to address the application of certain provisions of the AICPA Audit and Accounting Guide, *Audits of Investment Companies* (Guide), specifically reporting financial highlights by separate accounts. The Guide applies to all investment companies, and requires that separate accounts provide relevant financial highlights in their financial statements. Questions have arisen in the application of the Guide with respect to per share and per unit data, and in the computation of per share and per unit data when reporting financial highlights by separate accounts.

Current developments and plans On July 15, 2003, AcSEC issued an exposure draft SOP, Financial Highlights of Separate Accounts: An Amendment of the Audit and Accounting Guide

Audits of Investment Companies. The exposure draft provides guidance on reporting financial highlights by separate accounts of insurance enterprises. The exposure draft had a 60-day comment period that ended September 15, 2003.

A final SOP would be effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis is permitted, but not required. The provisions of the SOP would be applied prospectively from the beginning of the year of adoption.

AcSEC plans to issue a final SOP during the fourth quarter 2003.

Some of the proposed guidance discussed in the exposure draft is as follows:

- Expense Ratio Disclosure of Ranges – AcSEC agreed that an insurance enterprise is required to disclose financial highlights for its separate accounts, and may elect to present for separate accounts with more than two levels of contract charges or net unit values per subaccount, either:
    a. each contract expense level that results in a distinct net unit value and for which units were issued or outstanding during the reporting period, or
    b. the range of lowest and highest level of expense ratio and total return, and the related unit fair value during the reporting period

- Calculation of Expense Ratio – AcSEC agreed that the expense ratio should consist of annualized contract expenses of the separate account, consisting primarily of mortality and expense charges, for each period indicated. This ratio should include only those expenses that result in a direct reduction to unit values, with additional disclosure that provides the ranges of all charges to the separate account. Charges made directly to the contract owner accounts through the redemption of units and expenses of the underlying fund should be excluded.

- Calculation of Ranges – AcSEC agreed that the lowest to highest ranges for the amounts disclosed in the financial highlights should first be determined for the products having the lowest and highest expense ratio, and that the total return ratio and unit fair value should be presented for those corresponding products.

- Investment Income Ratio – AcSEC concluded that an investment income ratio should be included in the financial highlights and that the calculation should be based on the distribution received from the underlying fund.

- Effective Date & Transition – AcSEC agreed that the SOP would be effective for annual financial statements issued for fiscal years ending after December 15, 2003. It was also agreed that the SOP should be applied prospectively, with restatement allowed but not required.

Additionally, the proposed SOP incorporates and elevates in authority the guidance provided in previously issued Technical Practice Aids (TPAs) No. 6910. 11 – 6910.15. Staff: Kim Kushmerick Hekker

Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships

Description and background AcSEC's Planning Subcommittee added to AcSEC's agenda a project to address the application of certain provisions of AICPA Audit and Accounting Guide, *Audits of Investment Companies* (Guide) to non-registered investment partnerships. The Guide applies to both investment companies registered under the Investment Company Act of 1940 (and similar vehicles) and to non-registered investment partnerships. Because the Guide had principally been directed to registered investment companies, substantial changes were made to the 2001 Guide to clarify the differences in accounting and reporting between registered investment companies and non-registered investment companies. However, despite those changes, questions continue to arise in the application of Guide by non-registered investment partnerships. The differences arise because of the significant dissimilarity between the operating structures of non-registered investment partnerships and registered investment companies.

Current developments and plans On July 15, 2003, AcSEC issued an exposure draft SOP, *Reporting Financial Highlights and Schedule of Investment by Nonregistered Investment Partnerships* an amendment to the Audit and Accounting Guide, *Audits of Investment Companies, and SOP 95-2.* The exposure draft had a 60-day comment period that ended September 15, 2003.

AcSEC plans to issue a final SOP during the fourth quarter 2003.

Some of the proposed guidance discussed in the exposure draft is as follows:

- Nonregistered investment partnerships, other than those indicated in the next bullet, should calculate and disclose as a financial highlight an annual total rate of return based on a "geometric linking" of performance for each discrete period within a year for which invested capital is constant.

- Nonregistered investment partnerships that meet the criteria by terms of their offering document as indicated in the next sentence should calculate and disclose as a financial highlight an annualized inception-to-date internal rate of return for the current and prior accounting period. The criteria are: (a) have limited lives, (b) do not continuously raise capital, (c) predominant strategy is to return the proceeds from disposition of investments to investors and, (d) do not invest significantly in market-traded securities.

- Nonregistered investment partnerships should calculate expense and net investment income ratios based on average net assets (ANA).

- Nonregistered investment partnerships whose expenses are based on committed capital should provide additional disclosures of the total committed capital of the partnership, the year of formation of the partnership, the year the partnership made its first investment, and the ratio of the total contributed capital to total committed capital.

- Nonregistered investment partnerships should measure and disclose derivative instruments in the condensed schedule of investments based on aggregate fair value or unrealized appreciation (depreciation) by type of derivative (e.g., futures, swaps, options) and underlying (equity index of a particular stock exchange, U. S. Treasury Bond, natural gas), not individual instrument, regardless of counterparty, if fair value exceeds 5 percent of net assets.

- In addition to the name of the investment, "fund-of-funds" partnerships should provide additional qualitative disclosures for investments in nonregistered investment partnerships that exceed 5 percent of net assets.

- Nonregistered investment partnerships should calculate ANA by using the fund's weighted average net assets (as measured at each accounting period) and any other period in which capital is contributed or withdrawn.

- Fund-of-funds and master-feeder funds should calculate net investment income and expense ratios based on the net investment income and expenses reported in the statement of operations.

Additionally, the proposed SOP incorporates and elevates in authority the guidance provided in previously issued Technical Practice Aids (TPAs) No. 6910. 04 – 6910.10.

Staff: Fabiola Ferrer

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 addressed in this proposed SOP include:

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

Tentative conclusions. Tentative conclusions reached by AcSEC subsequent to the comment period include:

- *Selling and marketing costs* – Selling and marketing costs will be accounted for as proposed in the exposure draft. Direct and incremental costs of tour fulfillment, such as costs of airline tickets to bring customers to a tour location, are to be charged to expense at the time the tour takes place. Costs of tour generation, such as costs of call centers, are to be charged to expense as incurred. AcSEC affirmed its conclusion that selling and marketing costs should be excluded from the calculations of the percentage-of-completion method.

- *Operations during holding periods* – Rental activities during holding periods will be accounted for as incidental operations. The "holding period" begins at the time intervals are held for and are available for sale—for example, when units in domestic locations are legally registered for sale as time-shares. If rental activities occur other than during the holding period, the corresponding units will be depreciated and the activities accounted for as rental operations rather than as incidental operations. A seller is to evaluate each period whether units heretofore considered held for and available for sale should continue to be characterized as such.

- *Conduit entities* – The exposure draft discussed the situation whereby a time-share developer (1) creates a "conduit" entity lacking economic substance and established for the purpose of facilitating sales (for example, for purposes of being able to sell intervals to United States citizens in a country in which citizens of other countries are not allowed to own real estate), (2) transfers real estate to the entity and receives in exchange interests in the entity, and (3) sells interests in the entity to time-share purchasers. Because in substance those interests represent time-sharing intervals, they will be treated as inventory. The task force is in the process of communicating with the FASB staff regarding whether the conduit entity represents a variable interest entity subject to the requirements of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities—an Interpretation of ARB No. 51*, and, if so, how that would affect the guidance in the proposed SOP.

- *Use of relative sales value method* – AcSEC affirmed its conclusion that the relative sales value method is the appropriate approach for recording cost of sales and the related inventory.

- *Changes in estimate under relative sales value method* – Changes in estimate under the relative sales value method will be accounted for prospectively, except for changes relating to percentage of completion, which would be accounted for on a cumulative catch-up (retrospective) basis.

- *Buyer's cumulative payments* – The buyer's cumulative payments are to be reduced for sales incentives.

- *Sales incentives and buyer payments* – There will not be a "practicality cut" associated with the method in paragraph 107 of the exposure draft of allocating principal and interest payments, on a buyer's note, that a seller requires before delivering to the purchaser a promised incentive; general considerations of materiality will suffice. If the allocation of payments in the method resulted in a period of negative amortization of the portion of the note related to the time-share interval, the proposed SOP will not impose a limit on the period of negative amortization.

- *Seller services* – If a seller provides program services (such as an exchange, points, or affinity program, or a vacation club) without compensation or at compensation less than market rates, compensation is to be imputed when the sale is recognized and such compensation recognized in income when the seller perform the services. The guidance on valuing the imputed compensation for an internal exchange program will be clarified to state that the fees of independent time-sharing exchange companies are to be considered in determining prevailing market rates, but recognizing that the services of an independent exchange company may be more complex than the services of an internal exchange program. The intent of the guidance with respect to vacation clubs and affinity programs will be clarified as well.

- *Sale recognition* – AcSEC affirmed that the four criteria for recognizing a sale that were proposed in the exposure draft should be retained.

- *Revenue recognition* – AcSEC affirmed its conclusion that the retail land sales model of FASB Statement No. 66, *Accounting for Sales of Real Estate*, should be retained as the underlying model for time-sharing revenue recognition. The 10% test for buyer's commitment will be based on cumulative payments of principal, as proposed in the exposure draft. One test for collectibility will be based on seller collection of cumulative payments (excluding interest) of 20% of the time-share sales value, which is a modification from the 25% proposed in the exposure draft. The alternative test for collectibility will be based on seller collection of 85% of notes receivable balances for the project or the seller's prior similar projects, as proposed in the exposure draft. The criteria in the exposure draft for recognition of revenue on a time-share sale under the full accrual, percentage-of-completion, cash-received, and combined methods of accounting will, with the modification noted above for the cumulative payments test for collectibility, be retained.

- *Change in revenue recognition methods* – AcSEC affirmed its conclusions that (a) when the criteria for a "higher" revenue recognition method are met for a time-sharing transaction, the seller is required to change to the higher method for that transaction, (b) changes to a higher revenue recognition method should be recorded on an individual transaction basis (versus on a project or phase basis), and (c) a change to a higher revenue recognition method should be recorded as a change in accounting estimate.

- *Credit losses* – AcSEC affirmed its conclusion that credit losses should be recorded as direct reductions of revenue rather than as bad debt expense.

- *Upgrades and reloads* – For purposes of applying the cumulative payments tests for sale and revenue recognition to an upgrade transaction, any payments made on the original (ceded) interval should be counted as payments on the upgrade interval. For a reload transaction, the seller should not include payments on the original interval toward the buyer's cumulative payments for the second interval (or the first and second intervals combined). That is, the transactions for the original and second interval should, for accounting purposes, be treated as two separate transactions, irrespective of whether the two transactions are cross-collateralized or combined into a single note receivable.

- *Effective date and transition* - A final SOP would be effective for financial statements for fiscal years beginning after December 15, 2004. AcSEC affirmed its conclusion that the SOP should be applied retroactively via a cumulative effect of a change in accounting principle.

Current developments and plans. In February 2003, AcSEC issued an exposure draft of the proposed SOP, *Accounting for Real Estate Time-Sharing Transactions*. Concurrently, the FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting for Real Estate Time-Sharing Transactions—an amendment of FASB Statements No. 66, 67, and 135*. That proposed Statement includes amendments to certain FASB pronouncements that would be made in conjunction with issuance of the proposed SOP. In June 2003, AcSEC discussed the comment letters received on the proposed SOP and task force recommendations. In view of the FASB/IASB revenue recognition project, the Board discussed on June 18, 2003 whether a final SOP should include (as AcSEC recommended) or exclude revenue-recognition-related guidance. The Board decided that, in view of the current level of uncertainty associated with that project (timing of project, possible scope-out of real estate) that AcSEC is not precluded from proceeding with an SOP that includes revenue recognition guidance. The Board reserved the right, however, to reassess at any SOP clearance meeting the status of the revenue recognition project and possibly have AcSEC remove the revenue recognition guidance from the SOP at that time.

In September 2003, AcSEC approved a final SOP, pending Chair's clearance of certain revisions and FASB clearance.

Staff: Marc Simon

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

Description and background. 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. Tentative conclusions reached by AcSEC during discussions subsequent to the FASB's February 2003 decision that AcSEC should continue its deliberations toward issuing a final SOP (subject to FASB clearance) include:

- *Project stage framework* – The preacquisition and acquisition-or-construction stages will remain separate and distinct rather than be combined into a single stage. If it becomes no longer probable that specific PP&E will be acquired, the preacquisition stage costs previously capitalized related to the specific PP&E are to be reduced to the lower of cost or fair value less cost to sell.

- *Property taxes, insurance* – In the case of real estate, costs incurred from property taxes and insurance are to be capitalized, for the portion of the property under construction, during the time that activities necessary to get the asset ready for its intended use are in progress. A building or structure held for lease on which construction is substantially complete, except for the construction of leasehold improvements, is considered substantially complete and ready for its intended use.

- *G&A expenses* – General and administrative costs will be charged to expense as incurred. Whether or not classified as "general and administrative costs" by an entity, the following costs are to be charged to expense as incurred: occupancy costs; all costs (including payroll and payroll benefit-related costs) of executive management, corporate accounting, acquisitions, office management and administration, marketing, human resources, and similar functions. With respect to capitalization of payroll and payroll benefit-related costs of employees who devote time to a specific PP&E-related activity, the proposed SOP will neither (1) prescribe a project-time-related threshold (for example, 50% of an employee's time spent on a project) below which an employee's payroll and payroll benefit-related costs would be expensed, nor (2) state that an entity is not required to capitalize payroll and payroll benefit-related costs of an employee who spends a de minimus amount of time on a project.

- *Removal costs* - Removal costs not within the scope of FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, will be considered costs associated with the removed asset rather than any replacement asset. Such removal costs are to be expensed, and the proposed SOP will not provide further guidance related to salvage value or the period over which expense should be charged (for example, expensing all removal costs at time of removal versus expensing over the life of the asset through a reduction of the salvage value used in depreciation calculations).

- *Demolition costs* – The proposed SOP's guidance on demolition costs, which represents a limited exception to the guidance on removal costs, will be expanded to cover not only the situation of land and a building thereupon to be demolished but also equipment—for example, a situation in which an entity acquires a factory with equipment to be removed.

- *Disposals* – When an entity disposes of PP&E having a net book value to be removed from the entity's balance sheet upon disposal, the proposed SOP will not provide guidance as to where any income statement effect of the disposal should be recorded (for example, depreciation expense versus gain or loss on disposal).

- *Component accounting* – The proposed SOP will retain the concept of component accounting. The level or degree of componentization would be an accounting policy decision by management.

- *Disclosures* – An entity is to either present in the basic financial statements or disclose in the notes the gross carrying amounts of land and land improvements, buildings and building improvements, machinery and equipment, and construction in progress, as well as total accumulated depreciation for PP&E. Those four categories are to be further subcategorized if costs within a category are significant, either quantitatively or qualitatively, in relation to PP&E as a whole.

- *Replacement and removal* – A "replacement" consists of the removal of a component and the installation of a new component in its place. A replacement is to be interpreted more broadly than a component identical to the one removed—for example, a higher quality component that performs the same function as the component removed. Additionally, "removal" is to be interpreted to mean removal of a component from service and not necessarily an actual physical removal.

- *Liquidated damages* – A purchaser of PP&E is to account for liquidated damages as a reduction of the PP&E cost, with any damages in excess of the total PP&E cost recognized as income.

- *Change in principle* – If an entity, upon replacement of a part or portion of a component, elects to subsequently account for that part or portion as a separate component, this constitutes a change in the level of component accounting and will be accounted for as a change in accounting policy or principle and a cumulative effect adjustment recorded.

- *Mass-asset accounting* – Mass asset accounting (referred to by AcSEC in previous discussions as the group-life method of accounting) is considered an acceptable alternative to component accounting in certain limited circumstances and provided certain criteria are met. The proposed SOP will include those criteria.

- *Disclosures* – An entity should disclose its component accounting policy. In the prescribed disclosure of carrying amounts and ranges of expected useful lives by category of PP&E, if the range of expected useful lives within a category or subcategory is wide, there should be a further subcategorization such that the resulting ranges of expected useful lives are narrower and therefore more meaningful.

- *Effective date* – The effective date of the proposed SOP will be for fiscal years beginning after December 15, 2004.

- *Transition and component accounting* – At transition the component accounting guidance in the proposed SOP will be initially adopted as follows: (a) determine the level of component accounting for all existing PP&E assets; (b) allocate cost and accumulated depreciation to determine net book values of each component as discussed in paragraph 71a of the exposure draft; (c) depreciate the net book value of each component over the remaining expected useful life of that component. For each PP&E asset for which the level of component accounting is unchanged upon adoption from its pre-adoption level, that PP&E asset is considered a single component. Therefore, in future periods, when the entity incurs costs to replace a part or portion of that component, the costs of the replacement are to be charged to expense as incurred. It is acceptable for an entity, at date of adoption, to choose a different (that is, more or less) detailed level of component accounting for existing PP&E than the level that existed prior to adoption. Similarly, it is acceptable for an entity to have a different level of component accounting for PP&E assets acquired or constructed prior to adoption of than for identical PP&E assets acquired or constructed subsequent to adoption.

- *Transition and elective cumulative effect adjustment* – At transition, an entity may elect to record a cumulative effect adjustment to write off previously capitalized costs (other than deferred costs of planned major maintenance activities) that, under the proposed SOP, are required to be charged to expense as incurred. For example, an entity may have previously capitalized certain overhead costs, occupancy costs, or "preliminary stage" costs prior to adoption.

Current developments and plans. In July 2001, AcSEC issued an exposure draft of a proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*. Concurrently, the FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant, and Equipment, an amendment of APB Opinions No. 20 and 28 and FASB Statements No. 51 and 67 and a rescission of FASB Statement No. 73*. That proposed Statement includes amendments to certain FASB pronouncements that would have been made in conjunction with issuance of the proposed SOP. In October 2002, the FASB requested that AcSEC not issue a final SOP. At its January 2003 meeting, AcSEC discussed alternatives for the future of the project and decided to recommend to the FASB that AcSEC issue a "carve-out" SOP that would include one or more topics from the original exposure draft SOP. In February 2003, the FASB decided that AcSEC should continue its deliberations toward issuing a final SOP (subject to FASB clearance) and that the SOP would be limited to certain topics.

In September 2003, AcSEC approved a final SOP, pending AcSEC's positive clearance of certain revisions and FASB clearance.

The AICPA staff has discussed with the staff of the IASB with respect to the proposed SOP and the portion of the IASB's "Improvements Project" dealing with IAS 16, *Property, Plant and Equipment*, in order that AcSEC and the IASB can better monitor each other's projects and to promote opportunities for harmonization.

Staff: Marc Simon

OTHER AcSEC ACTIVITIES

On July 21, 2003, the Accounting Standards Planning Subcommittee met with representatives of the California Society of CPAs to discuss matters of mutual interest.

AcSEC staff met with the Governmental Accounting Standards Board to discuss matters of mutual interest.

NEW AND POTENTIAL FUTURE AcSEC PROJECTS

AcSEC will participate in the AICPA's overhaul of the following Guides. The financial reporting issues will be captured in Guide project prospectuses, subject to AcSEC Planning Subcommittee (PSC) and FASB approval

Airline Audit and Accounting Guide - Staff: Fred Gill

Casino Audit and Accounting Guide - Staff: Joel Tanenbaum

Employee Benefits Audit and Accounting Guide - Staff: Kim Kushmerick Hekker

HealthCare Audit and Accounting Guide - Staff: Marc Simon

Not-for-Profit Audit and Accounting Guide - Staff: Joel Tanenbaum

Oil and Gas Producing Activities Audit and Accounting Guide - Staff: Fabiola Ferrer

Property and Liability Insurance Companies Audit and Accounting Guide - Staff: Kim Kushmerick Hekker

NON-AcSEC PROJECTS OF THE AICPA ACCOUNTING STANDARDS TEAM

Valuing Privately-Held-Company Equity Securities Issued for Purposes of Compensation
Since October 2001, the Accounting Standards Team has been working with a task force made up of a cross section of experts from industry, public accounting firms, academia, the legal community, and valuation firms to identify best practices related to valuation of privately-held-company equity securities that are issued for purposes of compensation. The final product will be an AICPA Practice Aid addressing valuation and related accounting and disclosure issues. A final Practice Aid is expected to be issued during the fourth quarter of 2003.

Staff: Marc Simon

UPCOMING AcSEC MEETINGS

AcSEC meetings are open to the public.

October 28, 2003	New York, NY
December 16-17, 2003	South Beach, FL
January 27-28, 2004	New York, NY
March 16-17, 2004	New York, NY
April 27-28, 2004	New York, NY
June 8-9, 2004	New York, NY
July 20-21, 2004	Salt Lake City, UT
September 8-9, 2004	New York, NY
October 26-27, 2004	New York, NY
December 14-15, 2003	TBD

AcSEC ON AICPA WEB SITE

Visit the Accounting Standards webpage, located on the AICPA website, at http://www.aicpa.org/members/div/acctstd/index.htm, to view information about AcSEC activities, including AcSEC's meeting agenda and materials, highlights of recent AcSEC meetings, and to obtain a copy of an Exposure Draft.

COMMENTS OR SUGGESTIONS?

We welcome any comments or suggestions you may have concerning this publication. Please send to khekker@aicpa.org, fax to 212-596-6064, or write to Kim Kushmerick Hekker at AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775.

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