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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

Allowance for Credit Losses In January 2004, AcSEC agreed to explore an SOP that would require only enhanced disclosures about the allowance for credit losses.

Costs and Activities Related to PP&E At its April 14, 2004 meeting, the FASB objected to issuance of the proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*. The Board removed the PP&E project from its agenda and no further Board discussion is planned. The Board indicated that the work performed by AcSEC would be retained for use in connection with any future convergence efforts with the IASB relating to property, plant, and equipment. Furthermore, some Board members suggested that the FASB staff should review the final draft of that SOP to identify any specific issues that may be appropriate to address through FASB Staff Positions.

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. At the January 14, 2004 FASB clearance meeting, the Board requested that for a number of reasons, AcSEC not include certain revenue recognition guidance in a final SOP. At the Board's request, the project task force worked with the FASB staff to identify those topics to be retained and addressed in the SOP. The task force redrafted the SOP excluding certain revenue recognition guidance and submitted it to 2002-2003 AcSEC for approval by negative clearance. That clearance was obtained in May 2004, and a clearance meeting will soon be scheduled with the FASB.

DAC on Internal Replacements At the February 11, 2004 FASB clearance meeting, the Board did not clear the SOP and requested that the project task force and AcSEC reconsider several tentative conclusions related to criteria for determining if an internal replacement is determined to involve contracts that are substantially changed, accounting for sales inducements offered in conjunction with an internal replacement that results in a replacement contract that is substantially unchanged from the replaced contract, and accounting for costs related to internal replacements. At its April 2004 meeting, AcSEC discussed several options for the direction of the project AcSEC unanimously voted to recommend that the task force pursue the option which includes the changes proposed by the FASB Board. AcSEC will review a revised SOP at its July 2004 meeting.

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. At its June 15, 2004 meeting, the FASB did not object to issuance of the SOP, subject to certain revisions. AcSEC will discuss certain proposed revisions at its July 2005 meeting. AcSEC expects to issue the SOP in the third quarter of 2004.

Accounting for Loans and Certain Debt Securities Acquired in a Transfer (formerly known as Accounting for Certain Purchased Loans and Debt Securities) On December 12, 2003, AcSEC issued SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*.

Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships On December 29, 2003, AcSEC issued SOP 03-4, *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 SOP provides guidance on the application of certain provisions of the AICPA Audit and Accounting Guide, *Audits of Investment Companies (*the Guide*)* and AICPA SOP 95-2 that are directed to the reporting by nonregistered investment partnerships of financial highlights and the schedule of investments. It amends certain provisions of the Guide and SOP 95-2 by adapting those provisions to nonregistered investment partnerships based on their differences in organizational and operational structures from registered investment partnerships.

Separate Account Financial Highlights On December 29, 2003, AcSEC issued SOP 03-5, Financial Highlights of Separate Accounts – An Amendment of the Audit and Accounting Guide *Audits of Investment Companies*. The SOP provides guidance on reporting financial highlights by separate accounts of insurance enterprises.

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.*

EFFECTIVE DATES

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.

SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*. The SOP is effective for loans acquired in fiscal years beginning after December 15, 2004. Early adoption is encouraged. For loans acquired in fiscal years beginning on or before December 15, 2004, and within the scope of Practice Bulletin 6, paragraphs 7 and 8 of SOP 03-3, as they apply to decreases in cash flows expected to be collected, should be applied prospectively for fiscal years beginning after December 15, 2004.

SOP 03-4, *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 SOP is effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application, except for the provisions to require certain nonregistered investment partnerships to compute and disclose internal rate of return from inception (IRR). The provisions to require certain nonregistered investment partnerships to compute and disclose IRR are effective for annual financial statements issued for fiscal years beginning after December 15, 2003, with early application encouraged.

SOP 03-5, Financial Highlights of Separate Accounts – An Amendment of the Audit and Accounting Guide *Audits of Investment Companies*. The SOP is effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application.

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AcSEC AGENDA PROJECTS

---------------2004---------------------

As of January 31, 2004

	1Q		2Q		3Q		4Q
Financing and Lending Activities							
Certain Entities that Lend or Finance — Guide					**F**		
Allowance for Credit Losses — SOP							
Investment Industry							
Scope Clarification, Investment Companies Guide — SOP					**F**		
Insurance Industry							
DAC on Internal Replacements — SOP							**F**
Real Estate Industry							
Real Estate Time-Sharing Transactions — 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 accounting for the allowance for loan losses at acquisition related to acquired loans that are not within the scope of the SOP. That is, the SOP will addresses accounting for the allowance for loan losses 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.

On December 12, 2003, AcSEC issued SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*. The SOP is effective loans acquired in fiscal years beginning after December 15, 2004. Early adoption is encouraged. For loans acquired in fiscal years beginning on or before December 15, 2004, and within the scope of Practice Bulletin 6, paragraphs 7 and 8 of SOP 03-3, as they apply to decreases in cash flows expected to be collected, should be applied prospectively for 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 third quarter of 2004.

Staff: Myrna Parker

Allowance For Credit Losses

Description and background. This project had been intended to provide additional guidance, within the framework of existing FASB literature, on periodic credit loss provisions and the related allowance for credit losses.

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. AcSEC discussed the comments received on the exposure draft at its December 2003 meeting. At that meeting, a majority of AcSEC members tentatively expressed support for proceeding with a project to provide guidance on the application of existing literature on accounting for credit losses or enhanced financial statement disclosures regarding the allowance for credit losses.

At its January 2004 meeting, the FASB observer reported that he discussed the project with six FASB members individually since the December 2003 meeting. Given the questions raised in the exposure draft about the FASB Statement No. 5 model in relation to credit losses, those Board members expressed significant concerns about the usefulness of AcSEC moving forward with the current project in the context of existing literature. There was support, however, for continued efforts to develop improved disclosures. In the light of that report and given the tentative views expressed at its December 2003 meeting, AcSEC agreed to move forward with a project to consider only disclosures about the allowance for credit losses.

The task force will consider what disclosures would be appropriate under the changed approach and whether there should be different disclosure requirements for different industries.

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. At its June 15, 2004 meeting, the FASB did not object to issuance of the SOP, subject to certain revisions. AcSEC will discuss certain proposed revisions at its July 2005 meeting. AcSEC expects to issue the SOP in the third quarter of 2004.

Staff: Joel Tanenbaum

DAC on Internal Replacements

Description and background. 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.

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.

- 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.

- 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

At the February 11, 2004 FASB clearance meeting, the Board did not clear the SOP and requested that the project task force and AcSEC reconsider the following conclusions:

- Criteria for determining substantial changes: The investment reward rights, if any, have not shifted between the insurance enterprise and the contract holder.
- Accounting for sales inducements: New sales inducements offered in conjunction with an internal replacement that results in a replacement contract that is substantially unchanged from the replaced contract should be accounted for as if the sales inducement was explicitly identified in the original contract at inception.
- Accounting for costs related to internal replacements: Acquisition costs incurred in connection with an internal replacement that results in a replacement contract that is substantially unchanged from the replaced contract should be accounted for consistent with acquisition costs incurred during the continuation of other existing contracts and should be evaluated for deferral in accordance with existing authoritative accounting literature.

At the April 2004 meeting, AcSEC discussed several options for the direction of the project. AcSEC unanimously voted to recommend that the task force pursue the option which includes the changes proposed by the FASB Board.

AcSEC will review a revised SOP at the July 2004 AcSEC meeting.

Staff: Kim Kushmerick Hekker

Non-Traditional Long-Duration Contracts

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

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. Four comment letters were received.

On December 29, 2003, AcSEC issued SOP 03-5, *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies.

This SOP requires, among other things, the following:

- *Disclosure of ranges.* Separate accounts with more than two levels of contract charges or net unit values per subaccount may elect to present the required financial highlights for contract expense levels that had units issued or outstanding during the reporting period (including the number of units, unit fair value, net assets, expense ratio, investment income ratio, and total return) for either:
    1. Each contract expense level that results in a distinct net unit value and for which units were issued or outstanding during each reporting period; or
    2. The range of the lowest and highest level of expense ratio and the related total returns, and unit fair values during each reporting period.

  The financial highlights table in the separate account's financial statements should state clearly that the expense ratio considers only the expenses borne directly by the separate account and excludes expense incurred indirectly by the underlying funds or charged through the redemption of units. The disclosure should include ranges of all fees that are charged by the separate account and whether those fees are assessed as direct reductions in unit values or through the redemption of units.

- *Expense ratio.* The expense ratio represents the annualized contract expenses of the separate account, consisting primarily of mortality and expense charges, for each period indicated. This ratio includes only those expenses that result in a direct reduction to unit values. Charges made directly to contract owner accounts through the redemption of units and expenses of the underlying fund are excluded. The financial highlights note should also provide disclosure of the ranges of all charges assessed to the separate account, including discussion of the manner in which the charges are assessed.

- *Total return ratio.* The total return ratio represents the total return for the periods indicated, including changes in the value of the underlying fund, which reflects the reduction of unit value for expenses assessed. This ratio does not include any expenses assessed through the redemption of units. The total return is calculated for each period indicated or from the effective (fund inception) date through the end of the reporting period.

- *Investment income ratio.* The investment income ratio represents the dividends, excluding distributions of capital gains, received by the subaccount from the underlying mutual fund, net of management fees assessed by the fund manager, divided by the average net assets. This ratio excludes those expenses, such as mortality and expense charges, that result in direct reductions to contract owner accounts either through reductions in the unit values or the redemption of units. The recognition of investment income by the subaccount is affected by the timing of the declaration of dividends by the underlying fund(s) in which the subaccount invests.

This SOP is effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis is permitted, but not required. The provisions of this SOP should be applied prospectively from the beginning of the year of adoption. However, if adopting this SOP results in presentation different from prior periods, companies should explain the effects of adoption on their financial highlights calculations.

Additionally, the SOP incorporates and elevates in authority certain 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. Twelve comment letters were received.

On December 29, 2003, AcSEC issued SOP 03-4, *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, *Financial Reporting by Nonpublic Investment Partnership.*

The SOP requires, among other things, the following:

- Nonregistered investment partnerships should disclose the range of expiration or maturity dates and fair values of derivative instruments in the condensed schedule of investments based on whether the fair value of a specific type of derivative and underlying (for example, equity index of a particular stock exchange, U.S. Treasury Bond, or natural gas) exceeds 5 percent of net assets, regardless of counterparty. For open futures contracts of a particular underlying, the disclosure should be based on appreciation (depreciation) rather than fair value and include the number of contracts outstanding.
- Funds-of-funds partnerships should provide certain qualitative disclosures (the investment objective and restrictions on redemption) in addition to the name of the investment for each investment in a nonregistered investment partnership for which the fair value exceeds 5 percent of net assets.
- Nonregistered investment partnerships should calculate average net assets (ANA) by using the fund's weighted ANA (as measured at each accounting period or periodic valuation) adjusting for capital contributions or withdrawals occurring between accounting periods.
- Nonregistered investment partnerships should calculate the denominator of their expense and net investment income ratios based on ANA.
- Nonregistered investment partnerships in which the majority of the expenses are based on committed capital should provide additional disclosures in the financial statements of the total committed capital of the partnership, the year of formation of the partnership, and the ratio of the total contributed capital to committed capital.
- Funds-of-funds and master-feeder funds should calculate net investment income and expense ratios based on the net investment income and expenses reported in the statement of operations.
- Nonregistered investment partnerships, other than those that meet certain criteria as indicated in the next bullet, should calculate and disclose as a financial highlight an annual total rate of return based on a geometric linking of performance for each discrete period within a year for which invested capital is constant.
- Nonregistered investment partnerships that meet the criteria by the terms of their offering document, as indicated in the next sentence, should calculate and disclose as a financial highlight an internal rate of return since inception for the current and prior accounting period. The partnership criteria are that the partnerships (1) have limited lives, (2) do not continuously raise capital and are not required to redeem their interests upon investor request, (3) have as a predominant operating strategy the return of the proceeds from disposition of investments to investors, (4) have limited opportunities, if any, for investors to withdraw prior to termination of partnership, and (5) do not routinely acquire (directly or indirectly) market-traded securities or derivatives as part of their investment strategy.

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

The SOP is effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application, except for the provisions to require certain nonregistered investment partnerships to compute and disclose internal rate of return from inception (IRR). The provisions to require certain nonregistered investment partnerships to compute and disclose IRR are effective for annual financial statements issued for fiscal years beginning after December 15, 2003, with early application encouraged.

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:

- How should cost of sales and inventory be recorded?
- 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. 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 in general be treated as inventory.

- *Use of relative sales value method* –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, including changes related to percentage of completion, will be accounted for on a cumulative catch-up (retrospective) basis.

- *Buyer's initial and continuing investments* – The buyer's initial and continuing investments, for purposes of determining buyer's commitment under the criteria for profit recognition under FASB Statement No. 66, *Accounting for Sales of Real Estate*, are to be reduced for sales incentives.

- *Estimated uncollectible sales* –Estimated uncollectible sales should be recorded as direct reductions of revenue rather than as bad debt expense.

- *Upgrades and reloads* – For purposes of applying the tests of initial and continuing investment for profit recognition under FASB Statement No. 66 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 in the tests of initial and continuing investment 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.

- *Transition* – 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 September 2003, AcSEC approved a final SOP. At the January 14, 2004 FASB clearance meeting, the Board requested that AcSEC not include certain revenue recognition guidance in a final SOP. In making that request the Board considered a number of factors, including (1) changes in revenue recognition practices that have occurred since AcSEC originally added the project to its agenda, (2) the Board's revenue recognition project and the potential for requiring preparers to change their revenue recognition practices twice in a short time frame, and (3) the "rules-based" nature of the revenue recognition requirements in the draft SOP. At the Board's request, the project task force worked with the FASB staff to identify those topics to be retained and addressed in the SOP. The task force redrafted the SOP excluding certain revenue recognition guidance and submitted it to 2002-2003 AcSEC for approval by negative clearance. That clearance was obtained in May 2004, and a clearance meeting will soon be scheduled with the FASB.

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 major maintenance costs.

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 included amendments to certain FASB pronouncements that would have been made in conjunction with issuance of the proposed SOP.

In September 2003, AcSEC approved a final SOP, pending AcSEC's positive clearance (subsequently obtained) of certain revisions and FASB clearance. At its April 14, 2004 meeting, the FASB objected to issuance of the SOP. The Board removed the PP&E project from its agenda and no further Board discussion is planned. The Board indicated that the work performed by AcSEC would be retained for use in connection with any future convergence efforts with the IASB relating to property, plant, and equipment. Furthermore, some Board members suggested that the FASB staff should review the final draft of that SOP to identify any specific issues that may be appropriate to address through FASB Staff Positions.

Staff: Marc Simon

OTHER AcSEC ACTIVITIES

At its October 2003 meeting, AcSEC approved comment letters on two exposure drafts:

- The FASB exposure draft *Employers' Disclosures about Pensions and Other Postretirement Benefits—An Amendment of FASB Statements No. 87, 88, and 106 and a Replacement of FASB Statement No. 132*
- The IASB exposure draft *ED 5 Insurance Contracts*

On December 15, 2003, AcSEC's Planning Subcommittee met with representatives of the Florida Institute of CPAs to discuss matters of mutual interest.

At its January 2004 meeting, AcSEC approved comment letters on four International Accounting Standards Board (IASB) exposure drafts:

- *Accounting Changes and Error Corrections—A Replacement of APB Opinion No. 20 and FASB Statement No. 3*
- *Exchanges of Productive Assets—An Amendment of APB Opinion No. 29*
- *Earnings per Share—An Amendment of FASB Statement No. 128*
- *Inventory Costs—An Amendment of ARB No. 43, Chapter 4*

Also at its January 2004 meeting, AcSEC held its annual liaison meeting with members of the AICPA Technical Issues Committee (TIC) to discuss matters of mutual interest.

At its April 2004 meeting, AcSEC discussed an outline of issues regarding its comment letter to FASB Exposure Draft, *Share-Based Payment an amendment of FASB Statements No. 123 and 95*. AcSEC agreed with FASB proposal that all share-based payment transactions should be recognized in financial statements at fair value. AcSEC agreed to issue a comment letter incorporating AcSEC's views subject to negative clearance.

NEW AND POTENTIAL FUTURE AcSEC PROJECTS

AcSEC will participate in updating the following AICPA Guides. The financial reporting issues to be addressed in those projects will be identified in Guide project prospectuses.

Airline Audit and Accounting Guide -

Description and Background. The AICPA Audit and Accounting Guide *Audits of Airlines* was originally issued in 1981. The Guide has not been revised or amended, other than for conforming changes, since its issuance. In 1981, the airline industry in the U.S. had recently been deregulated and the top 10 U.S. airlines carried substantially all domestic passengers. Since 1981, more than 100 airlines have filed for bankruptcy protection. And today low-cost and regional airlines, which were just in their infancy at the time the Guide was originally written, enjoy considerable market share. In addition, carriers have been affected by a number of recent unprecedented crippling events. Those events include, among other things, the terrorist attacks of September 11, 2001, and resulting closure of the entire U.S. airspace for several days thereafter. Key pieces of the strategy on which the major carriers based their businesses after airline deregulation have become risky and unworkable.

The industry events described above have resulted in substantial changes to the operations of airlines. Substantial industry changes have resulted in the emergence of many new accounting and auditing issues, as well as the need to revise the industry background section of the Guide. Many of the accounting issues have led to diversity in practice.

In 2002, a task force was appointed to begin work on a project to revise the Guide

Current developments and plans. At its January, April, and June 2004 meetings, AcSEC discussed a series of accounting issues raised by the Airlines Guide Task Force in order to provide the task force with guidance prior to the drafting of the Guide. Some of the tentative conclusions reached by AcSEC are:

- The Guide should refer to EITF Issue No. 91-9, *Revenue Recognition for Freight Services in Process*, for guidance on accounting for freight in transit at the end of a reporting period and should provide additional information on the application of the acceptable methods described in that Issue to the airline industry.
- The Guide should illustrate, using EITF Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent,* the analysis of whether a mainline carrier that purchases entire flights from a regional carrier under a capacity purchase agreement should (a) net the cost of capacity purchases from regional airlines against passenger revenue or (b) report the costs and revenue associated with capacity purchases on a gross basis. AcSEC observed that, based on the guidance in EITF Issue No. 99-19, the cost of capacity purchases generally should be reported as an operating expense. AcSEC acknowledged, however, that there may be cases in which such costs should be netted against passenger revenue.

AcSEC has not yet reached conclusions on the following issues:

- For amendable labor contracts, should a liability be recognized for a retroactive or lump-sum payment prior to contract ratification based on management's best estimate and prior experience, or should the liability be recognized for a retroactive or lump-sum payment at the time the new collective bargaining agreement is ratified and requires such payment?
- When should indefinite-lived status be reassessed for international route authorities?
- Should regional airlines that sell entire flights to major carriers under capacity purchase agreements present reimbursements for pass-through costs (costs over which the regional carrier typically has no control) as revenue on a gross basis, or should they net the reimbursements with the costs for which they are being reimbursed?
- Should amounts received by a regional airline under a capacity purchase agreement that are specifically attributable to maintenance be deferred and matched against the associated maintenance expense as it is incurred, or should such amounts be recognized as revenue immediately?
- Should the cost of returning leased aircraft to the contractually required maintenance condition prior to returning them be recognized:
  a. over the lease term, based on estimates that are adjusted periodically,
  b. over the period from the last overhaul to the lease termination date,
  c. following the airline's maintenance policy (i.e., charged to expense as incurred)?
  d. over the remaining lease period, beginning when the costs are determined to be probable and can be estimated?
- What are the acceptable methods of accounting for maintenance?
- What criteria should be used to determine whether payments related to a "power-by-the-hour" maintenance contract should be recognized as an expense based on the contract terms rather than when the maintenance event is performed?
- When should "breakage" (amounts of revenue that should be recognized on an estimated basis because certain ticket "lifts" are never processed and other valuation differences exist) be recognized as revenue?

Certain of these issues may be referred to the FASB, depending on factors such as the extent to which they may affect other industries.

Staff: Yelena Mishkevich and Fred Gill

Casino Audit and Accounting Guide:
Description and background. The AICPA Audit and Accounting Guide Audits of Casinos (the Guide) was originally issued in 1984. The Guide has not been revised or amended, other than for conforming changes, since its issuance. The casino industry and its financial reporting have changed since 1984. Casinos have experienced a shift in their primary revenue source from table games to slot machines; slot machine technology has evolved to where, for example, competing casinos participate together in progressive slots; and some regulator's positions and views about jackpot liabilities have changed. Also, the industry has grown and expanded to new jurisdictions. Some of these changes have resulted in accounting and auditing issues not contemplated in the existing Guide. Many of the accounting issues have lead to diversity in practice. Further, diversity in practice exists in applying certain accounting standards issued since 1984.

In the second quarter of 2003, AcSEC appointed a task force to begin work on a project to revise the AICPA Audit and Accounting Guide Audits of Casinos. The task force drafted a prospectus for the PSC's consideration and began deliberating certain issues.

Tentative conclusions. Some of the tentative conclusions reached by AcSEC in discussing the Guide are as follows:

- *Scope – Transactions and Entities Covered*: The Guide should address accounting issues of casinos, including issues arising from transactions that typically are unique to entities undertaking gambling activities. In addition, the scope of the Guide should be transaction based. Therefore, to the extent that entities other than those that traditionally may have been considered casinos undertake gambling and related activities that are the same as gambling and related activities undertaken by casinos, as well as other gambling and related activities, the activities of those other entities should be subject to the guidance in the Guide. To better describe the kinds of activities covered by the Guide, the Guide would likely be retitled Gaming and Related Activities or something similar.

  The FASB has on its agenda a project to address recognition of revenues and liabilities in financial statements. This Guide project is not intended to address issues that may overlap with issues addressed in the FASB's project.

- *Scope – Native American Entity Undertaking Gambling Activities:* The Guide should apply to entities owned by state and local governments that undertake gambling activities, such as Native American casinos. The Guide should include guidance for those entities electing post-1989 FASB pronouncements as well as those not electing post-1989 FASB pronouncements. The Guide should therefore have three tracks: (1) FASB entities that undertake gambling activities; (2) state and local governments electing post-1989 FASB pronouncements that undertake gambling activities; and (3) state and local governments not electing post-1989 FASB pronouncements that undertake gambling activities.

- *Impairment of Long-Lived Assets and Restructuring Charges*: The Guide should reiterate the requirements of category a GAAP, separately identifying those that are limited to FASB entities, GASB entities, and SEC registrants. Also, the Guide should include industry specific illustrations of typical impairment and restructuring transactions and activities and how they might be reported in applying those pronouncements to entities undertaking gambling activities, such as illustrations addressing asset groupings and triggering events. Those illustrations would be intended to provide guidance for specific fact patterns though not necessarily explicit requirements or prohibitions.

- *Jackpot Liability:* The Guide should provide that entities undertaking gambling activities should accrue jackpot liabilities only for amounts the entity is legally obligated to pay as of the reporting date. The Guide should discuss the various kinds of slot machines and other games that have jackpots; how those jackpots are determined; and transactions and events that create obligations to pay those jackpots. Some AcSEC members expressed concerns that this issue may overlap with the FASB's revenue recognition project.

- *Loan Guarantees*: For state and local governments electing post-1989 FASB pronouncements and undertaking gambling activities, FASB Interpretation (FIN) No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees Including Indirect Guarantees of Indebtedness of Others, provides guidance on accounting for guarantees and elaborates on the disclosures to be made by a guarantor about its obligations under certain guarantees that it has issued. The Guide should provide additional guidance, perhaps through illustrations, on the application of FIN No. 45 to entities undertaking gambling activities.

- *Incentive Programs:* Incentives to play should be bifurcated and characterized as either (a) marketing incentives to induce potential customers to enter into transactions or (b) loyalty programs for customers based on activities or transactions undertaken. The scope and provisions of any guidance in these areas should be coordinated with AcSEC's project to revise the AICPA Audit and Accounting Guide, Audits of Airlines.

  The Guide should include illustrations of typical incentive programs related to gambling activities and illustrate the application of EITF Issue No. 01-9, Accounting for Consideration Giving by a Vendor to a Customer (Including a Reseller of the Vendor's Products), if applicable, to those programs.

- *Participation Arrangements – Revenue vs. Expense (Display):* AcSEC asked the Task Force to consider whether participation arrangements may be leases in conformity with EITF Issue No. 01-8, Determining Whether an Arrangement Is a Lease. For participation arrangements that are leases, entities should follow lease accounting. For participation arrangements that are not leases, entities should consider the guidance in EITF Issue No. 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent. The Guide should include illustrations of typical participation arrangements and how they might be reported.

  Also, the Guide should note that activities of all parties undertaking participation arrangements would be subject to the provisions of the Guide to the extent that those activities are within the scope of the Guide. For example, a slot machine manufacturer and owner undertaking a participation arrangement with an entity undertaking gambling activities is effectively undertaking gambling activities itself and therefore would be subject to the provisions of the Guide pertaining to participation arrangements.

- *Classification of Complimentaries (Display):* Expenses for complimentaries should be reported at cost (no revenue should be reported as a result of providing complimentaries). In circumstances in which customers have the choice of receiving either complimentaries or free play, expenses should reported as the estimated cost of complimentaries to be provided (with free play presumed to have no cost). The expenses should be classified in the department in which they benefit, which typically is the casino department.

Current developments and plans. At its April 27, 2004 meeting, AcSEC discussed the project. AcSEC will continue its discussions at a future meeting.

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 as Compensation In October 2001, the Accounting Standards Team began 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 as compensation. In April 2004, the AICPA released a final Practice Aid, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*. To order a copy of the Practice Aid, call the AICPA Order Department at (888) 777-7077 or order online at:

https://www.cpa2biz.com/CS2000/Products/CPA2BIZ/Publications/Valuation+of+Privately-Held-Company+Equity+Securities+Issued+as+Compensation.htm

Representatives of the task force gave a presentation on the Practice Aid to the SEC staff on June 3, 2004.

Staff: Marc Simon

UPCOMING AcSEC MEETINGS

AcSEC meetings are open to the public.

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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