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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 At its September 20-21, 2005, meeting, AcSEC approved the issuance for public exposure of a draft Statement of Position, *Disclosures Concerning Credit Losses Related to Loans*, subject to a final review of a revised draft by AcSEC in November 2005 and FASB clearance.

DAC on Internal Replacements On September 19, 2005, AcSEC issued SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts*. The SOP is effective for internal replacements occurring in fiscal years beginning after December 15, 2006, with earlier adoption encouraged.

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. Subsequent to the June 15 clearance meeting, it came to the task force's attention that certain provisions of the draft SOP may create potential unintended consequences. The task force is considering proposing additional revisions to the SOP to address those potential unintended consequences. AcSEC expects to issue the SOP in the first quarter of 2006.

EFFECTIVE DATES

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. AcSEC is currently preparing a set of TPA Q&As that will address implementation issues related to SOP 03-3.

SOP 04-2, *Accounting for Real Estate Time-Sharing Transactions*. The SOP is effective for financial statements issued for fiscal years beginning after June 15, 2005, with earlier application encouraged. Initial application should be reported as a cumulative effect of a change in accounting principle.

SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts*. The SOP is effective for internal replacements occurring in fiscal years beginning after December 15, 2006, with earlier adoption encouraged.

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AcSEC SHOWS APPRECIATION

***Thanks to Outgoing AcSEC Members,
Welcome to New AcSEC Members***

We wish to thank the following outgoing members for their dedicated service to the Committee and the improvement of financial reporting:

Andy Mintzer, Sole practitioner, Santa Monica, CA
Coleman Ross
Brent Woodford, The Walt Disney Company, CA

We welcome the following new AcSEC members:

Jay Hanson, McGladrey & Pullen, LLP
David Morris, MORRIS Consulting
Roy Rendino

AcSEC SOP AGENDA PROJECTS

-----2005-----

As of October 1, 2005

	1 Q		2 Q		3 Q		4 Q
Insurance Industry							
DAC on Internal Replacements — SOP					F		

-----2006-----

As of October 1, 2005

	1 Q		2 Q		3 Q		4 Q
Financing and Lending Activities							
Allowance for Credit Losses — SOP	E						
Investment Industry							
Scope Clarification, Investment Companies Guide — SOP	F						

Codes:

E - Exposure Draft anticipated or actual issuance date

F - Final Pronouncement anticipated or actual issuance date

AcSEC's CURRENT SOP PROJECTS

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.

On June 19, 2003, AcSEC issued an exposure draft for public comment. 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.

Current developments and plans. At its September 20-21, 2005, meeting, AcSEC approved (11-0) the issuance for public exposure of a draft Statement of Position, *Disclosures Concerning Credit Losses Related to Loans*, subject to a final review of a revised draft by AcSEC in November 2005. AcSEC decided that the SOP should apply to all entities that hold loans as assets and not just to financial institutions. The proposed SOP would be effective for years ending after December 15, 2006, and comparative disclosures would be required in the year of transition. AcSEC asked the task force to add additional examples and made a number of suggestions for clarifying the SOP.

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. Subsequent to the June 15 clearance meeting, it came to the task force's intention that certain provisions of the draft SOP may create potential unintended consequences. The task force is considering proposing additional revisions to the SOP to address those potential unintended consequences. AcSEC expects to issue the SOP in the first quarter of 2006.

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.

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.

In November 2004, AcSEC issued for public comment a second exposure draft SOP, *Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements*, for a forty-day comment period. Ten comment letters were received.

Current developments and plans. On September 19, 2005 AcSEC issued SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts*.

This SOP provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in FASB No. 97:

- The SOP defines an internal replacement as a modification in product benefits, features, rights, or coverages that occurs by the exchange of a contract for a new contract, or by amendment, endorsement, or rider to a contract, or by the

election of a feature or coverage within a contract. Modifications that result from the election by the contract holder of a benefit, feature, right, or coverage that was within the original contract are not internal replacements subject to this guidance as long as all of the conditions listed in paragraph 9 of this SOP are met.

- The SOP introduces the terms integrated and nonintegrated contract features and specifies that nonintegrated features do not change the base contract and are to be accounted for in a manner similar to a separately issued contract. Integrated features are evaluated in conjunction with the base contract.
- Contract modifications meeting all of the conditions in paragraph 15 of this SOP result in a replacement contract that is substantially unchanged from the replaced contract and should be accounted for as a continuation of the replaced contract.
- An internal replacement that is determined to result in a replacement contract that is substantially changed from the replaced contract should be accounted for as an extinguishment of the replaced contract. Unamortized deferred acquisition costs, unearned revenue liabilities, and deferred sales inducement assets from the replaced contract in an internal replacement transaction that results in a substantially changed contract should not be deferred in connection with the replacement contract.
- Unamortized deferred acquisition costs and the present value of future profits¹ continue to be subject to premium deficiency testing in accordance with the provisions of FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, as amended.
- 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 paragraphs 18 and 19 of this SOP and, if so, for which kinds of internal replacement transactions.

This SOP is effective for internal replacements occurring in fiscal years beginning after December 15, 2006, with earlier adoption encouraged. Retrospective application of this SOP to previously issued financial statements is not permitted. Initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date, all prior interim periods of the year of adoption should be restated).

Disclosure of the effect of the change on retained earnings as of the date of adoption is required. If the financial statements of the year of adoption are

¹ The *present value of future profits* is as discussed in EITF Issue No. 92-9, *Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company*.

presented separately or included in comparative financial statements, the notes to the financial statements should disclose (a) the fact that this SOP has been adopted and the effective date of adoption, and (b) the nature of any differences in accounting principles or financial statement presentation applicable to the financial statements presented that resulted from adoption of this SOP.

Staff: Kim Kushmerick

OTHER AcSEC ACTIVITIES

At its July 19-20, 2005 meeting, AcSEC approved a draft comment letter on the FASB's April 28, 2005 exposure draft, ***The Hierarchy of Generally Accepted Accounting Principles***, subject to a number of revisions and Chair's clearance. The letter was issued on August 2, 2005.

AcSEC also approved a draft comment letter on the FASB's July 14, 2005 exposure draft, ***Accounting for Uncertain Tax Positions – an Interpretation of FASB Statement No. 109***, subject to AcSEC's negative clearance. The letter was issued on September 9, 2005.

At its September 2005 meeting, AcSEC discussed a draft comment letter on the FASB's June 30, 2005 exposure draft, ***Business Combinations: a replacement of FASB Statement No. 141 and Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries – a replacement of ARB No. 51***. AcSEC plans to finalize the letter in a conference call to be held in October 2005.

On September 19, 2005, AcSEC's Planning Subcommittee issued a comment letter on FASB Staff Position INV-a, ***Reporting of Fully Benefit-Responsive Investment Contract Held by Certain Investment Companies Subject to the AICPA Investment Companies Guide***.

CURRENT AcSEC PROJECTS

AcSEC participates in updating the following AICPA Guides. The financial reporting issues to be addressed in those projects are 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 began work on a project to revise the Guide.

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

- *Accounting for Freight in Transit.* 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.
- *Accounting for Maintenance.* A majority of AcSEC believes that maintenance should be charged to expense as it is incurred, and would not permit the built-in overhaul method, the deferral method, or the accrual method, which are currently permitted under the existing airlines Guide. This issue is expected to be addressed by the FASB.
- *Accounting by the Mainline Carrier for Capacity Purchase Agreements.* 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.

- *Accounting by Regional Airlines for Pass-through Costs Under Capacity Purchase Agreements.* The guidance on gross versus net presentation of regional airlines' pass-through costs should be based on EITF Issues No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent" and 01-14, "Income Statement Characterization of Reimbursements Received for "Out-of-Pocket" Expenses Incurred." Applying that guidance, the ability of a regional airline to use its discretion in choosing a supplier would support presenting reimbursements gross, rather than netting them with the costs to which they relate.

The goal of disclosure requirements should be to provide users with information about controllable costs and revenue attributable to those costs. AcSEC expressed concern over any requirement to disclose hypothetical amounts. AcSEC also agreed that:

- Disclosure should include the nature of the arrangement.
 - Disclosure of other information, for example, the extent of the arrangement without dollar amounts, may be appropriate.
 - The Guide should include examples of best disclosure practice, possibly including examples of MD&A disclosures.
 - The Guide should include a reference to FASB Statement No. 57, *Related Party Disclosures*, given that many pass-through arrangements involve related parties.
 - The Guide should include a reference to EITF Issue No. 99-19 with respect to disclosing transaction volume.
-
- *Amendable Labor Contracts.* A liability for a retroactive or lump-sum payment under an amendable labor contract should be recognized prior to contract ratification if, in accordance with FASB Statement No. 5, a retroactive or lump-sum payment is probable and the amount is reasonably estimable.
-
- *Accounting for Lease Return Costs.* Lease return costs should be accounted for over the remaining life of the lease in accordance with EITF Issue No. 98-9, *Accounting for Contingent Rent*, when the costs become probable. The manner of satisfying lease return conditions, for example, performing maintenance or making a payment to the lessor, should not affect whether a

lessee recognizes a liability for lease return costs. The measurement of the liability should be based on the lesser of (a) the payment required or (b) the cost to repair the aircraft or component. Any payment expected to be received from the lessor for returning an aircraft or component in a maintenance condition that is better than contractually required should affect only the measurement of liability.

If, however, an airline has the intent and ability to satisfy lease return conditions by swapping engines in a transaction that lacks commercial substance, it should not accrue a lease-return liability.

- *Revenue Breakage.* Historically, breakage included ticket sales that remained partially or wholly unused after either the scheduled departure date or ticket expiration date. In the revised Airline Guide breakage will be redefined to include only the tickets sales remaining unused with continuing validity (i.e. the ticket has value and the customer can exchange the ticket for future travel or obtain a refund.) Tickets for which an airline has no further obligation to the customer will no longer be part of breakage and no liability should continue to be recognized for such invalid tickets. Revenue from invalid tickets should be recognized when tickets become invalid, usually at departure date. Assuming that certain conditions are met, it is acceptable, based on SEC Staff Accounting Bulletin 104, *Revenue Recognition*, to recognize revenue related to valid unused tickets before ticket expiration. However, AcSEC agreed that it would be appropriate to express a preference for waiting until the ticket expiration date prior to recognizing revenue. AcSEC also agreed, however, that, if an airline recognizes revenue from breakage prior to the ticket expiration date, it should be recognized at the departure date rather than over the period from the departure date to the expiration date.

AcSEC also generally agreed that the Guide should include recommended disclosures about the company's accounting policy and method of recognizing breakage.

- *Maintenance Provided Under Power-by-the-Hour (PBTH) Contracts.* A transfer of risk is by itself a basis for changing the timing of expense recognition. AcSEC agreed that if the contract transfers risk, the airline should recognize maintenance expense under the PBTH contract as opposed to following the airline's maintenance policy. In this case, there should be a presumption that the expense should be recognized at a level rate during the minimum, non-cancelable term of the PBTH agreement. (However, changes in contractual rates that are tied to an index, such as the Consumer Price Index, would not need to be leveled.) That presumption could be overcome by empirical evidence that the level of service effort varies over time. If a

contract does not meet risk transfer criteria, a deposit or prepaid expense method should be used, with the expense recorded as incurred when the actual maintenance event takes place.

AcSEC generally agreed on the following risk transfer criteria:

- *True-ups* - If a contract provides for a true-up based on actual costs, there is no risk transfer, regardless of the size of the true-up or how well the true-up can be estimated. In addition, rate-reset provisions that call for prospective PBTH rate adjustments that effectively serve to recover or pay back based on historical contract performance would not achieve the risk transfer objective.
- *Contract adjustment provisions* - The contract may provide for adjustment payable by either party for out-of-scope work, including foreign-object damages and adjustments to the number of hours prior to the replacement of life limited parts, but may not simply include cost true-up provisions based on the service provider's cost experiences. Contracts may contain annual or periodic escalation provisions, either tied to specified inflationary or labor indexes or specifically agreed to by the parties, so long as they do not conflict with the other risk transfer criteria.
- *Termination provisions* - The contract may contain exit provisions for either party for cause or for other performance-related factors so long as they do not result in the recovery of amounts paid or in the incurrence of any additional liability by the airline on termination based on the relationship of contract payments to actual cost experience by the service provider ("cost true-up"). However, the contract may reasonably provide for the successful satisfaction of each party's obligations under the contract that had been incurred prior to the termination and penalty provisions, if appropriate.
- *Regional Airlines' Accounting for Maintenance Revenue Received under Fixed-Rate Contracts.* If a capacity purchase agreement does not contain a lease under EITF Issue No. 01-8, *Determining Whether an Arrangement Contains a Lease*, major maintenance should not be treated as an "executory cost" within the meaning of FASB Statement No. 13, *Accounting for Leases*, and revenue received in connection with major maintenance would not be separated from revenue received for transporting passengers. Services not encompassed in the transportation of passengers, however, may need to be separated under EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. If a capacity purchase agreement does contain a lease, major maintenance should be treated as an executory cost under FASB Statement No. 13 and revenue related to maintenance should be recognized in

accordance with FASB Technical Bulletin 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*.

Current developments and plans. At its September 20-21, 2005, meeting, AcSEC reviewed chapters 1, "The Airline Industry," and 5, "Employee Related Costs," of a proposed revised Guide. AcSEC also started discussing chapter 6, "Other Accounting Considerations," but ran out of time and will continue discussing it at its future meetings along with other revised chapters.

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 regulators' 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, a task force began work on a project to revise the Guide *Audits of Casinos*.

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 *Audits of Casinos and Other Gaming 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 primary example of amounts operators are obligated to pay is the incremental portion of progressive jackpots in circumstances in which the operator is prohibited from removing the machine from the floor without transferring the incremental progressive liability to other machines or games.
- *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. At its September 2005 meeting AcSEC agreed that the Casino Guides should:

- Describe current practice, including a (1) deferred revenue model and (2) model in which an entity reports the full amount of the original revenue transaction and accrues liabilities under loyalty or incentive programs for costs associated with rewarding the customers undertaking those original revenue transactions (referred to hereafter in this discussion as an *immediate revenue* model—with that term used as a placeholder), without expressing a preference for either model.
 - Describe the basis for each model and provide that in practice the deferred revenue model is acceptable in virtually all circumstances, while the immediate revenue model is acceptable only in certain circumstances. For example, an immediate revenue model is unacceptable (and a deferred revenue model therefore appropriate) in circumstances in which (a) a significant number of paying customers are being displaced by customers redeeming awards and (b) the value of an individual award is significant as compared with the purchase earning the award.
 - Provide detailed guidance applying appropriate EITF and other relevant literature, such as EITF Issue No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*, to those models, including guidance applicable to cash and free play awards. Consider what disclosures, if any, should be considered in connection with loyalty programs. The scope and provisions of any guidance in these areas should continue to be coordinated with AcSEC's project to revise the AICPA Audit and Accounting Guide, *Audits of Airlines*.
-
- *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 be 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.
- *Payments or commitments to make payments to not-for-profit organizations (or other entities) in connection with obtaining the right to manage properties for third parties*. Such payments or commitments are exchange transactions, rather than contributions. Payments made as part of efforts to acquire agreements should be expensed as incurred. Also, such payments made pursuant to an existing agreement should be capitalized and amortized over the life of the agreement, without anticipating potential renewals.
- *Gaming License and Market Entry Costs*. Gaming licenses typically, though not in all cases, have indefinite lives. Determining the life of a license may require judgment, including considering the nature of the renewal process and additional economic sacrifices, if any, required to renew the license. License and related market entry costs incurred in anticipation of obtaining a license should be expensed as incurred. License and related market entry costs incurred after it is probable that a license will be acquired should be capitalized. In circumstances in which licenses have indefinite lives, those capitalized costs should be assessed for net realizable value every year. In circumstances in which the licenses have finite lives, those capitalized costs should be amortized over the life of the license. Also, the revised Guide should include examples of factors that may affect the value of the license, such as if a jurisdiction issues a large number of licenses in subsequent years, therefore diluting the value of existing licenses.
- *Gaming Taxes*. Gaming taxes are not an income tax. Gaming taxes paid based on graduated rates should be reported in interim periods based on the

expected average rates. AcSEC also requested the Task Force to further consider the following issues to be discussed at a future AcSEC meeting:

-Consider whether international convergence issues exist.

-Consider further the effect of rate changes (other than changes based on graduated rates already in place). In particular, consider how and in what period to account for the change. AcSEC asked the Task Force to research analogous GAAP pertaining to this issue.

- *Customer Credit Policy.* For SEC registrants, the Guide should reiterate the SEC Management Discussion and Analysis requirements pertaining to changes in customer credit policy.
- *Free Cash Flows.* For SEC registrants, the Guide should reiterate that SEC Financial Reporting Release No. 65, *Conditions for Use of Non-GAAP Financial Measures*, provides, among other things, that public companies that disclose or release such non-GAAP financial measures include, in that disclosure or release, a presentation of the most directly comparable GAAP financial measure; a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure; and a statement explaining why the entity believes that non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations.
- *Segment Reporting.* AcSEC agreed to defer further discussion of this issue pending the outcome of a potential FASB FSP and EITF consensus on related issues. In the meantime, AcSEC agreed that the conforming change in the current Casino Guide should be more robust in tracking the guidance in FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*.
- *Illustrative Financial Statements.* The Guide should include illustrative financial statements for FASB casinos and for GASB casinos, including Native American casinos.

Current developments and plans. AcSEC will continue its discussions at a future meeting.

Staff: Joel Tanenbaum and Renee Rampulla

Health Care Audit and Accounting Guide

Description and Background. The AICPA Audit and Accounting Guide *Health Care Organizations* was originally issued in 1996. 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 2004, a task force began work on a project to revise the Guide.

Tentative conclusions. Some of the tentative conclusions reached by AcSEC are:

- ***Charity Care:***
 - Charity care does not include services provided in situations in which payments are accepted under contracts with third-party payors (such as Medicare or Medicaid) whereby such accepted payments are less than the “full” amounts billable under the provider’s rate schedule.
 - Typically the determination as to whether an individual meets the criteria for charity care should occur as soon as practicable, and before any substantial collection effort is initiated.
 - Disclosures on the level of charity care should include, at a minimum, a disclosure based on the health care organization’s costs of providing charity care. If other measures of the level of charity care are disclosed as well, such as the provider’s rates, additional details should be included as to the source of those measures and how they are determined.
 - It is recommended that a health care organization disclose information on its various categories (individually and in total) of the broader metric of uncompensated care other than bad debts.

- ***Medical malpractice.*** With respect to recognition and measurement of medical malpractice and other insurance-related liabilities, and related disclosures, the Guide will direct health care organizations to the relevant guidance in FASB Statement No. 5, *Accounting for Contingencies*, and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss: an interpretation of FASB Statement No. 5*. In determining “best estimates” of accrued liabilities under FASB Statement No. 5, health care organizations should take into consideration how claims develop over time—for example, the fact that some claims require a number of years before they are settled.

- ***Revenue recognition.*** Currently, notably in the case of self-pay patients, there is diversity in practice such that, following paragraph 5.03 of the Guide, some health care organizations may record revenue and an allowance (which may be relatively large) without necessarily determining first whether collectibility is reasonably assured. AcSEC plans to recommend to the FASB that the Guide be amended to state that a health care organization should recognize revenue, on a case by case (typically, patient by patient) basis, when the

organization has evidence that a “sale” has taken place, that is, when criteria along the lines of the following have been met:

- Persuasive evidence of an arrangement exists
 - Services have been rendered
 - The price is fixed or determinable, and
 - Collectibility is reasonable assured
-
- *Settlements.* It is recommended that health care organizations disclose summaries of period settlement activity for significant governmental and other third-party payor payables and receivables. In so doing, health care organizations should be mindful of the disclosure requirements of SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, related to changes in estimate for settlements.

 - *Loss contracts.* In determining whether a health care organization should recognize a loss when it is probable that expected health care and maintenance costs under a group of existing contracts will exceed anticipated future premiums and stop-loss insurance recoveries on those contracts, only incremental costs should be considered.

 - *Prepaid health care – classification of revenue.* Under typical prepaid health care services arrangements—for example, health maintenance organizations (HMOs)—revenue earned relates to both the assumption of medical risk and the providing of administrative services. Under such arrangements, administrative services are typically an integral part of providing or arranging medical care. That is, the HMO performs administrative services in support of its primary obligation to provide or arrange medical care (rather than for another party as is the case in administrative-services-only (ASO) arrangements). Revenue relating to such administrative services should not be bifurcated from premium revenue related to the assumption of medical risk but should rather be included in premium revenue.

 - *Prepaid health care – reporting of receivables and payables related to administrative-services-only (ASO) contracts.* Health care organizations should look to the terms of the contracts to determine the parties’ respective obligations and should apply FASB Interpretation No. 39 (FIN 39), *Offsetting of Amounts Related to Certain Contracts*. Under FIN 39, a right of setoff exists only if certain conditions are met, and typically those conditions are not met in situations involving more than two parties. Because a typical ASO arrangement involves three parties (the employer, the hospital or other provider of health care to employees, and the ASO organization), typically receivables and payables related to ASO contracts are reported gross.

- *Prepaid health care – capitation arrangements.* Capitation costs for a health care organization should not be reported analogous to reinsurance arrangements, that is, as premiums ceded that reduce premium revenue, but rather should be reported as an expense.
- *Gross versus net presentation of insurance claims and related insurance recoverables.* Currently, the Guide is scoped out of from the requirement under FIN 39 (as interpreted by EITF Issue No. 03-8, “Accounting for Claims-Made Insurance and Retroactive Insurance Contracts by the Insured Entity”) to, in general, not offset prepaid insurance and expected insurance recoverables against related insurance liabilities. The Guide currently permits offsetting, which is also current industry practice. AcSEC voted (14 to 0) to recommend to the FASB that the Guide be amended such that there would no longer be an exception to FIN 39 for health care organizations.
- *Income statement classification and disclosure of gains and losses from non-hedging derivatives.* AcSEC discussed “economic hedges,” that is, derivatives entered into by an entity to hedge a specific exposure but which do not receive special hedge accounting treatment under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. AcSEC agreed (14 to 0) that the Guide should recommend that a not-for-profit health care organization should disclose both the amounts of gains and losses relating to economic hedges and the specific line items (above the performance indicator) in which those gains and losses appear. AcSEC agreed (9 to 4) that the Guide should not provide guidance as to whether gains and losses should be bifurcated similar to under Statement 133 guidance for hedge accounting (e.g., a realized component included in the determination of “interest expense” that facilitates determining the effectiveness of the hedge, and an unrealized component included as a mark-to-market adjustment to nonoperating income [but above the performance indicator]).
- *Accounting for transfers between unrelated not-for-profit healthcare organizations.* AcSEC has agreed with the task force that equity transactions or transfers between unrelated not-for-profit healthcare organizations should be recorded as contributions at fair value with the transferor recognizing the contribution made as expense in the period made and as a decrease of assets or increase of liabilities, depending on the form of the benefits given, pursuant to paragraph 18 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*. The transferee would record the net assets at fair value at the transfer date. AcSEC has also discussed the financial statement presentation of the contributions made by the not-for-profit healthcare organizations. AcSEC concluded that contributions should be presented within the performance indicator in the financial statements of the

transferor. AcSEC concluded that Chapter 10 of the guide should also address the financial statement presentation of contributions received.

- *Accounting for intercompany receivables when collection is doubtful.* The Healthcare Guide Revision Task Force requested that AcSEC consider the issue of accounting for intercompany receivables when collection is doubtful, as currently there is diversity in practice in the accounting and reporting for such receivables. Currently, paragraph 11.26 of the AICPA Audit and Accounting Guide Health Care Organizations states, that “if the receivable is not to be repaid, or if the receiving entity is perceived as unable to repay, it [write-off of intercompany receivable] may be accounted for as an equity transfer with the transferor reducing net assets and the transferee increasing net assets at the date such determination is made”. AcSEC recommended clarifying the wording in paragraph 11.26 of the Guide to state that accounting for write-offs of intercompany receivables as equity transfers is not optional, and that it is intended to remind accountants to examine the facts and circumstances of each individual transaction. AcSEC further stated that the HC Guide should provide additional examples to assist practitioners.
- *Accounting for joint operating agreements.* The Healthcare Guide Revision Task Force requested that AcSEC consider the issue of accounting for joint operating agreements (JOAs). A JOA generally consists of two or more not-for-profit health care organizations (HCOs) entering into an agreement whereby both parties jointly operate and control certain of their hospitals or facilities while sharing the operating results and residual interest upon dissolution based upon an agreed-upon ratio or ratios. Currently there is diversity in practice in the accounting and reporting for joint operating agreements, as HCOs account for JOAs either by consolidating, under the equity method, at cost (e.g., risk sharing with a management agreement), or by using proportional consolidation. AcSEC agreed with the task force that Chapter 11 of the Healthcare Guide should incorporate guidance from the Technical Practice Aid 6400.33, *Accounting for a Joint Operating Agreement*, and include more explicit guidance to address the variance in practice that currently exists.
- *Accounting for transfers involving goodwill between for-profit healthcare organizations and not-for-profit healthcare organizations where one healthcare organization controls the other or they are under common control.* AcSEC requested that the task force expand the analysis to include other examples of transfers that may occur between for-profit healthcare organizations and not-for-profit healthcare organizations where one healthcare organization controls the other or they are under common control and relevant accounting literature that may provide guidance for other types of

such transfers. The task force agreed to broaden the issue and present it to AcSEC at a future meeting.

Current developments and plans. AcSEC will continue its discussions at a future meeting.

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FUTURE AcSEC PROJECTS

Employee Benefits Audit and Accounting Guide - Staff: Linda Delahanty and Kim Kushmerick

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

Oil and Gas Producing Activities Audit and Accounting Guide - Staff: Lori West

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

NON-AcSEC ACTIVITIES OF AICPA STAFF

The AICPA staff released a new Technical Practice Aid on accounting and disclosures for losses from natural disasters for nongovernmental entities. In August 2005, hurricane Katrina devastated several states along the Gulf Coast of the United States, took many lives, and caused considerable damage to entities. In its effort to provide financial reporting guidance on accounting and disclosures of losses from natural disasters, AICPA staff identified certain accounting issues and provided a road map reference to relevant accounting literature that will assist preparers and practitioners.

TPA 5400.05 — Accounting and Disclosures Guidance for Losses from Natural Disasters - Nongovernmental Entities

The AICPA staff also issued two technical practice aids on accounting and disclosures requirements for employee benefit plans:

TPA 6930.09 — Accounting and Disclosure Requirements for Single-Employer Employee Benefit Plans Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003

TPA 6930.10 — Accounting and Disclosure Requirements for Multiemployer Employee Benefit Plans Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003

These TPAs can be found on the AICPA's web site at www.aicpa.org/members/div/acctstd/general/recent_tpas.asp.

UPCOMING AcSEC MEETINGS

AcSEC meetings are open to the public.

2005

November 15-16, 2005 New York, NY

2006

January 10-11, 2006 Las Vegas, NV

March 21-22, 2006 New York, NY

May 9-10, 2006 New York, NY

June 20-21, 2006 TBD

September 12-13, 2006 New York, NY

November 28-29, 2006 New York, NY

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 recently issued AcSEC's documents, learn about the AICPA Industry Expert Panels, review recently issued accounting technical practice aids, and find web links to accounting standard setting bodies, regulators, and other AICPA technical teams.

COMMENTS OR SUGGESTIONS?

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

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

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