



Codification Issues
Board Meeting Handout
July 18, 2007

PURPOSE OF THE MEETING

The purpose of this meeting is to (1) discuss the escalation issues identified by the staff during the mapping of the U.S. GAAP literature for the Codification project and (2) solicit the Board's feedback on those items to determine a course of action.

ISSUES

Outdated Guidance

1. Appropriation of Retained Earnings for General Purpose Contingencies

APB Opinion No. 9, *Reporting the Results of Operations*, paragraph 28 (b), refers to "general purpose contingency reserves" as an example of what a "properly designated" appropriation for retained earnings would be. Additionally, FASB Statement No. 5, *Accounting for Contingencies*, paragraph 15, allows a portion of retained earnings be appropriated within the equity section for loss contingencies and only requires that the appropriation be clearly identified. Although an appropriation of retained earnings is a simple reclassification of the equity accounts and has no impact on the determination of net income, the staff believes that appropriating retained earnings for contingencies may be misleading to shareholders since that capital may be available to pay dividends.

The staff recommends that:

- Consideration be given as to whether the FASB and the IASB need to include the presentation of appropriation of retained earnings as an item for international convergence for the Financial Statement Presentation project.

- The parenthetical text in paragraph 28 (b) of Opinion 9 be removed because it is outdated and provides misleading and potentially conflicting guidance related to the purpose of an appropriation.
- More explicit guidance be provided as to what it means to be “properly designated” as appropriated retained earnings, as stated in paragraph 28 (b) of Opinion 9.
- The reference to appropriation of retained earnings in Statement 5 be removed, or if retained, more transparent disclosure requirements be provided explaining the reason for the appropriation and any changes from year to year, as dividends are paid out of retained earnings.

Does the Board agree with the staff's recommendations?

2. Original Revenue Recognition Guidance from 1934

ARB 43, Chapter 1A, “Rules Adopted by Membership,” paragraph 1, was one of the first of six rules adopted by the membership of the Institute in 1934. This paragraph provides general guidance for recognizing revenue. However, the manner in which it is written is unclear, outdated, and some of the guidance is better stated in other standards.

The staff recommends that:

- This guidance be removed from the authoritative literature, or
- If retained, the wording used in Chapter 1A, paragraph 1 of ARB 43 be revised and the terminology updated to eliminate any confusion in applying this guidance.

Does the Board agree with the first alternative, the second alternative or neither?

Potential Conflict in the Literature

3. Claims of Subcontractors for Terminated Government Contracts

ARB 43, Chapter 11C, “Terminated War and Defense Contracts,” paragraphs 24–30, present alternative views regarding the accounting and disclosure requirements of contingent liabilities of a government contractor who has outstanding claims from subcontractors that are deemed to be fully recoverable from the government in the event a contract is terminated. This section does not reflect the requirements in Statement 5 for recording and disclosing contingent liabilities. ARB 43, Chapter 11C, also does not provide the reasoning behind why subcontractors should be treated differently from other commercial relationships. This leads to inconsistency and noncomparable information.

The staff recommends that:

- The guidance in paragraphs 24–30 of ARB 43, Chapter 11C, be removed because the FASB has since issued guidance to address these issues, or
- If retained, this section of ARB 43 should be reconsidered by the Board to update the terminology used and to conclude on one method of accounting for subcontractor claims which enables consistent application. If a true exception is warranted due to the industry, then it should be stated along with the reasons why.

Does the Board agree with the first alternative, the second alternative or neither?

4. Accounting for Losses and Combining Contracts Related to Long-Term Construction-Type Contracts

ARB No. 45, *Long-Term Construction-Type Contracts*, paragraphs 6 and 11, provide less restrictive guidance as to when contracts can be combined for revenue recognition purposes and for the accounting for losses on contracts than does the guidance in paragraphs 34–37 and paragraph 85 of AICPA Statement of Position 81-1, *Accounting*

for Performance of Construction-Type and Certain Production-Type Contracts, issued in July 1981. Although the combining of contracts under both ARB 45 and SOP 81-1 is elective, SOP 81-1 permits combining contracts only if certain criteria are met. ARB 45 does not provide explicit criteria regarding when it is acceptable to combine contracts. This could potentially lead to different interpretations regarding when it is acceptable to combine contracts, given the fact that ARB 45 is in level A GAAP and SOP 81-1 is in level B GAAP of the existing GAAP hierarchy.

The staff recommends that paragraphs 6 and 11 of ARB 45 be removed from the authoritative literature, despite the fact that ARB 45 is in level A of the existing GAAP hierarchy and SOP 81-1 is in level B, to eliminate the inconsistencies in accounting for losses and combining of contracts.

Does the Board agree with the staff's recommendation?

5. Definitions of Proven and Probable Reserves for Extractive Industries

FASB Statement No. 89, *Financial Reporting and Changing Prices*, includes a less specific definition of proved and probable mineral reserves than EITF Issue No. 04-03, "Mining Assets: Impairment and Business Combinations." The definitions used in the EITF issue are sourced to the Securities Act Industry Guide 7, which is required to be followed by all issuers engaged in mining operations.

The staff recommends that the definitions in Statement 89 be revised to be consistent with the definitions in the Securities Act Industry Guide 7 included in EITF Issue 04-03 because mining entities are required to follow the guidance therein.

Does the Board agree with the staff's recommendation?

6. **Transfers of Real Estate in Exchange for Nonmonetary Assets Other than Real Estate**

The scope exception included in paragraph 3(c) of EITF Issue No. 01-2, “Interpretations of APB Opinion No. 29,” which excludes from the scope of Issues 1-6, “transfers of real estate in exchange for nonmonetary assets **other than real estate** (the recognition of profit from the exchange is addressed in FASB Statement No. 66)...” (emphasis added) raises a concern regarding the applicability of FASB Statement No. 66, *Accounting for Sales of Real Estate*, and APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, for these types of transactions in general, since both Opinion 29 and Statement 66 are silent on the issue. Therefore, the timing of when the gain is recognized may be different depending on which standard is followed.

The staff recommends that the Board clarify which guidance to follow when accounting for transfers of real estate in exchange for nonmonetary assets **other than real estate**, since the timing of when the gain is recognized is affected.

Does the Board have a preference regarding which guidance to follow?

The staff’s preference is to account for such transactions in accordance with the guidance in Opinion 29; that is fair value, because the party holding the exchanged asset is likely receiving an economic benefit from such asset, rather than Statement 66, which requires the exchanged asset to be converted to cash prior to recognizing a gain.

7. **Use of the term Retrospective for Changes in Estimates in Real Estate Time Sharing Transactions**

There is a conflict in the use of the term “retrospective” between AICPA Statement of Position 04-2, *Accounting for Real Estate Time-Sharing Transactions*, and FASB Statement No. 154, *Accounting Changes and Error Corrections*.

SOP 04-02 uses retrospective in the context of a change in estimate, whereas Statement 154 uses the term retrospective when there is a change in accounting principle. This

difference in use of the same term could potentially cause confusion in accounting for changes in estimates.

The staff recommends that the use of the term “retrospective” in SOP 04-2 be deleted to eliminate any confusion in accounting and reporting for a change in estimate.

Does the Board agree with the staff’s recommendation?

8. Temporary Control Exception to Consolidation for Not-for-Profit Organizations

The consolidation guidance in ARB No. 51, *Consolidated Financial Statements*, applies to not-for-profit organizations, other than health care providers, through AICPA Statement of Position 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, and to not-for-profit health care providers through guidance in Chapter 11 of the AICPA Audit and Accounting Guide, *Health Care Organizations* (the Health Care Guide). When ARB 51 was amended in 2001 by FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, to remove the temporary control exception to consolidation, conforming changes were made only to the guidance in SOP 94-3 and the Health Care Guide that was explicitly based on the “controlling financial interest” concept of ARB 51—primarily investments in for-profit entities. The temporary control exception was retained for most situations involving financially interrelated not-for-profit organizations.

The staff believes that elimination of the temporary control exception in those situations would result in simpler GAAP and, on balance, better financial reporting. In addition, the staff recommends to make two related changes suggested by AcSEC in their comment letter on the FASB’s October 9, 2006 Exposure Draft, *Not-for-Profit Organizations: Mergers & Acquisitions*, modifying the guidance in both SOP 94-3 and the Health Care Guide concerning when control via majority voting interest in another board exists, and conforming the guidance in SOP 94-3 concerning sole corporate membership to that in the Health Care Guide.

The following tables illustrate the effect of the proposed guidance:

SOP 94-3

Relationship Type	Par	Current Guidance	Proposed Guidance
Controlling financial interest (through ownership of majority voting interest or through other means)	10	Consolidation required (no temporary control exception)	No change, except sole corporate membership interests now included here
Control through majority voting interest in board of another entity (by means other than ownership) coupled with an economic interest	11	Consolidation prohibited (currently incl. sole corporate membership interests, which HCG deems a controlling financial interest akin to a majority voting interest)	Consolidation required (but would tighten guidance about definition of majority voting interest to avoid nuisance consolidations)
Control through other means coupled with economic interest	12	Consolidation prohibited	Consolidation permitted; if they don't consolidate, disclosures required

AICPA Audit and Accounting Guide: Health Care Organizations

Relationship Type	Par	Current Guidance	Proposed Guidance
Controlling financial interest (through ownership of majority voting interest or through other means)	11.10	Consolidation required (incl. sole corporate membership interests; no temporary control exception)	No change
Control through majority voting interest in board of another entity (by means other than ownership) coupled with an economic interest	11.11	Consolidation prohibited	Consolidation required (but would tighten guidance about definition of majority voting interest to avoid nuisance consolidations)

Control through other means coupled with economic interest	11.12	Consolidation prohibited	Consolidation permitted; disclosure required if not consolidated
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The staff recommends that the guidance:

- Be included in a proposed Omnibus Not-for-Profit FSP
- Have an effective date for fiscal years beginning after June 15, 2008
- Be applied prospectively with respect to temporary control and retrospectively otherwise.

Does the Board agree with the staff's recommendations?

9. Leasing Transactions by Not-for-Profit Organizations Involving Special Purpose Entity (SPEs) Lessors

FASB Interpretations No. 46 and 46 (revised December 2003), *Consolidation of Variable Interest Entities*, nullified EITF Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions," and related guidance in EITF Issues No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities," and 97-1, "Implementation Issues in Accounting for Lease Transactions, including Those involving Special-Purpose Entities." Except in rare instances, not-for-profit organizations are excluded from the scope of Interpretation 46(R). Thus, insofar as the otherwise nullified EITF guidance is relevant for not-for-profit organizations it is still applicable to them. Not-for-profit organizations, especially hospitals and universities, sometimes use leasing SPEs, including SPEs that would be deemed nonsubstantive in nature and require consolidation under the EITF guidance. However, there appears to be diversity in practice, in part because of lack of awareness of the applicability of those EITF Issues, especially by organizations with auditors outside of the Big Four. In addition, one could interpret the EITF guidance as being in conflict with the consolidation criteria contained in SOP 94-3 and the Health

Care Guide, especially in instances in which the leasing SPE itself is a not-for-profit organization.

To promote consistent, non-misleading financial reporting, the staff recommends that the Board reaffirm the continued applicability of these EITF Issues to not-for-profit organizations and amend SOP 94-3 and the Health Care Guide to remove any real or perceived conflict in this area. (An alternative approach would be to scope not-for-profit organizations into Interpretation 46(R) for these transactions. The staff, however, is concerned that doing so could have unintended consequences.)

The staff recommends that the guidance:

- Be included in a proposed Omnibus Not-for-Profit FSP
- Have an effective date for fiscal years beginning after June 15, 2008
- Be applied retrospectively.

Does the Board agree with the staff's recommendations?

10. Other Investments Held by Not-for-Profit Organizations

The equity method guidance in APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, applies to not-for-profit organizations, other than health care providers, through SOP 94-3, and to not-for-profit health care providers through guidance in Chapter 11 of the Health Care Guide. SOP 94-3 and the Health Care Guide focus on investments in common stock and in-substance common stock (EITF Issue 02-14, “Whether an Investor Should apply the Equity Method of Accounting to Investments Other Than Common Stock”), and contain only oblique references to investments in partnerships, limited liability companies (LLCs), and similar entities (AICPA SOP 78-9, *Accounting for Investments in Real Estate Ventures*, EITF Issue No. 03-16, “Accounting for Investments in Limited Liability Companies,” and FASB Staff Position SOP 78-9-1, “Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5”)—with the SOP 94-3 reference in a preface rather than the SOP itself.

Because of the way in which “other investments” are defined in the AICPA Audit Guide and Accounting Guide, *Not-for-Profit Organizations*—those outside of the scope of SOP 94-3, and FASB Statements No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, and 133, *Accounting for Derivative Instruments and Hedging Activities*—most not-for-profit organizations that choose to carry those investments at cost, rather than at fair value, do not use the equity method for investments in for-profit partnerships, LLCs, or similar entities in which they have a significant but noncontrolling financial interest. This contrasts with how for-profit entities and not-for-profit health care providers account for similar investments.

To promote consistent, non-misleading financial reporting, the staff recommends that SOP 94-3 be amended to indicate that not-for-profit organizations should consider the guidance on use of the equity method in SOP 78-9, EITF Issue 03-16, and FSP SOP 78-9-1, in instances in which the not-for-profit organization would otherwise choose to carry an “other investment” in a for-profit entity at cost rather than at fair value. For the sake of clarity, the staff recommends that a similar amendment be made to the equity method guidance in the Health Care Guide.

The staff recommends that the guidance:

- Be included in a proposed Omnibus Not-for-Profit FSP
- Have an effective date for fiscal years beginning after June 15, 2008
- Be applied retrospectively.

Does the Board agree with the staff’s recommendations?