



Financial Reporting

February 1999

Year in Review

Significant 1998 Financial Reporting Developments

1998 was a very active year for accounting standard setters with the Financial Accounting Standards Board (FASB) issuing three statements, including one on accounting for derivatives and hedging activities which may prove difficult and costly to implement. The FASB also issued three exposure drafts of statements that, if adopted, would impact only companies in specific industry sectors. However, significant progress was made on four other agenda projects that have wide application and of which the eventual conclusions are likely to be controversial.

The American Institute of Certified Public Accountants (AICPA) Accounting Standards Executive Committee (AcSEC) issued three Statements of Position (SOPs). Two address software accounting issues, and the other addresses the recognition of costs associated with start-

up activities. As always, the FASB's Emerging Issues Task Force (EITF) addressed numerous limited-scope issues and reached consensus positions on a few issues of broader interest.

This letter summarizes the significant new and proposed rules considered by these bodies as well as some of their other projects in process.

New FASB Rules

Accounting for Derivatives and Hedging

After several years of deliberation, exploring possible alternatives and compromising on some of its original positions, the FASB issued SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*. The new rules provide standardized accounting and reporting for derivative instruments, including derivative instruments embedded in other contracts and for hedging activities. SFAS 133 requires all entities to recognize derivatives contracts as either assets or liabilities in the balance sheet and to measure them at *fair value*. Fair value measurements are based on the guidance contained in SFAS 107, *Disclosures about Fair Value of Financial Instruments*.

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SFAS 133 defines a derivative as a financial instrument or other contract with the following characteristics:

- Has one or more *underlyings* and one or more notional amounts or payment provisions, or both
- Requires no initial investment or an initial investment less than would be required for other types of contracts expected to have a similar response to changes in market factors
- Requires or permits net settlement, has a market mechanism that facilitates net settlement, or requires the delivery of an asset that is readily convertible to cash and places the recipient in a position not substantially different from a net settlement.

Some of the more common types of derivatives include options, futures, forwards and interest rate swaps.

Derivatives Designated as Hedging Transactions

A derivative may be specifically designated by a company as a hedge of the:

- Exposure to changes in the fair value of a recognized asset or liability, or an unrecognized firm commitment (“fair value hedges”)
- Exposure to variable cash flows of a forecasted transaction (“cash flow hedges”), or
- Foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security or a foreign-currency-denominated forecasted transaction (“foreign currency hedges”).

The objective of hedge accounting is to match the timing of gain or loss recognition on the hedging derivative with the recognition of: (1) the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk or (2) the earnings effect of the hedged forecasted transaction.

Fair Value Measurements

Gains and losses on derivative transactions result from changes in

their fair values. In general, the fair value of a derivative is determined as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Quoted market prices are the best evidence of the fair value of financial instruments; however, if these are not available, fair value may be based on the quoted market price of a derivative with similar characteristics or on valuation techniques (e.g., the present value of estimated future cash flows using a discount rate commensurate with the risks involved, option pricing models or matrix pricing models).

Reporting Derivative Gains and Losses

The financial reporting for derivative gains and losses depends on the company’s intended use of the instrument and its designation by management.

- *Fair value hedges:* For a derivative designated by the company as a hedge against exposure to changes in the fair value of an asset or liability that is reported in the balance sheet or an unrecognized firm commitment, the gain or loss is recognized in earnings in the period of change, together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. The effect of that accounting is to reflect in earnings the extent to which the hedge is *not* effective in achieving offsetting changes in fair value. In other words, an income statement gain or loss will be recognized whenever changes in the fair value of a designated hedging derivative do not have a 100 percent correlation to the changes in fair value of the asset, liability or firm commitment being hedged.
- *Cash flow hedges:* For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction, the *effective* portion of the derivative gain or loss is initially reported as a component of other com-

prehensive income (outside earnings) and subsequently reclassified into earnings in the period in which the forecasted transaction occurs and affects earnings. The *ineffective* portion of the gain or loss is reported in earnings immediately.

- *Foreign currency hedges:* For a derivative designated as hedging the foreign currency exposure of a company’s net investment in a foreign operation, the gain or loss is reported in other comprehensive income (outside earnings) as part of any cumulative foreign currency translation adjustment. The accounting for a fair value hedge described above applies to a derivative designated as a hedge of the foreign currency exposure of an unrecognized firm commitment or a security classified as available-for-sale. Similarly, the accounting for a cash flow hedge described above applies to a derivative designated as a hedge of the foreign currency exposure of a foreign-currency-denominated forecasted transaction.
- *Speculative derivative transactions:* All derivative transactions that are *not* designated as hedges are speculative in nature and, thus, the gain or loss from reporting them at fair values is recognized in income in the periods the changes occur.

Hedging Effectiveness

SFAS 133 requires companies that elect to apply hedge accounting to establish at the inception of the hedge the method they will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Hedging effectiveness is the extent to which changes in fair value or cash flows attributable to the risk being hedged are offset. Effectiveness should be assessed periodically - whenever financial statements or earnings are reported but at least every 3 months. Hedging assessment must specify

whether all of the gain or loss on a hedging derivative will be included. The methods used to assess effectiveness should be consistent with the risk management approach they follow.

Not-for-Profit Entities

These organizations should recognize the change in fair value of *all* derivatives as a change in net assets in the period of change. In a fair value hedge, the changes in the fair value of the hedged item attributable to the risk being hedged are also recognized. However, because of the format of their statement of financial performance, not-for-profit organizations are not permitted special hedge accounting for derivatives used to hedge forecasted transactions.

Non-Derivative Instruments

SFAS 133 precludes designating a nonderivative financial instrument as a hedge of an asset, liability, unrecognized firm commitment or forecasted transaction, except that a nonderivative instrument denominated in a foreign currency may be designated as a hedge of the foreign currency exposure of an unrecognized firm commitment denominated in a foreign currency or a net investment in a foreign operation.

Amended Guidance

SFAS 133 amends the guidance in SFAS 52, *Foreign Currency Translation*, to permit special accounting for a hedge of a foreign currency forecasted transaction with a derivative. It also supersedes SFAS 80, *Accounting for Futures Contracts*, SFAS 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and SFAS 119, *Disclosure about Derivative Financial Instruments*. In addition, it amends SFAS 107, *Disclosures about Fair Value of Financial Instruments*, to include in SFAS 107 the disclosure provisions about concentrations of credit risk from SFAS 105. Moreover, it nullifies or modifies many EITF issues.

Effective Date and Transition

The Statement is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. Initial application should be as of the beginning of a company's fiscal quarter. On that date, hedging relationships must be designated anew and documented. Earlier application of all of the provisions of SFAS 133 is encouraged, but it is permitted only as of the beginning of any fiscal quarter that begins after issuance (June 1998). Retroactive application to financial statements of prior periods is prohibited.

Disclosure - Effects of Adoption For SEC Registrants

SAB Topic 11M, *Disclosure of the Impact of Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period (SAB 74)*, concludes that the SEC staff believes registrants should discuss in the financial statements and MD&A the potential effects of adoption of accounting guidance which has been issued but has not yet been adopted unless the impact on its financial position and results of operations are not expected to be material. The SEC staff has said that they expect to see such disclosures related to SFAS 133 for all filings made after the date the Statement has been issued.

The FASB has formed a group to discuss implementation issues related to SFAS 133. The activities for the group can be located on the FASB Web site: www.fasb.org.

Defined Benefit and OPEB Disclosures

The FASB issued SFAS 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, which amends the disclosure requirements of the following FASB Statements: SFAS 87, *Employers' Accounting for Pensions*, SFAS 88, *Employers' Accounting of Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, and SFAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. Although SFAS 132 does

not affect the recognition and measurement requirements of those Statements, it does revise the disclosure requirements for SEC registrants and reduces disclosures for non-public companies.

The Statement became effective for fiscal years beginning after December 15, 1997. Restatement of disclosures for earlier periods provided for comparative purposes is required unless the information is not readily available, in which case the notes to the financial statements should include all available information and a description of the information not available.

Classification of Mortgage-Backed Securities Retained by Mortgage Bankers

SFAS 134, *Accounting for Mortgage-Backed Securities Retained After the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, amends SFAS 65, *Accounting for Certain Mortgage Banking Activities*. It requires that after the securitization of a mortgage loan held for sale, a company engaged in mortgage banking activities should classify the resulting mortgage-backed security or other retained interests based on its ability and intent to sell or hold those investments. Prior to this amendment, these companies were required to classify mortgage-backed securities as a trading security. The Statement is effective for the first fiscal quarter beginning after December 15, 1998. Early application is encouraged.

FASB Proposals

Motion Picture Film Producers and Distributors

The FASB has proposed to rescind SFAS 53, *Financial Reporting by Motion Picture Film Producers and Distributors*. The proposal would defer to a concurrent proposal from the AICPA to publish an SOP, *Accounting by Producers of Motion Picture Films*, which would provide updated guidance to the industry. (See Proposed Accounting by Producers and Distributors of Films on page 9.)

Real Estate Accounting

The FASB released a proposal that would amend SFAS 66, *Accounting for Sales of Real Estate*, to clarify that the scope of that Statement is consistent with the scope of SFAS 98, and rescind SFAS 75, *Deferral of the Effective Date of Certain Accounting Requirements for Pension Plans of State and Local Governmental Units*, which deferred indefinitely the effective date of the FASB Statement on pension plan accounting by state and local governments, and offer a number of other technical corrections of FASB standards. Under the proposal, SFAS 66 would be clarified to indicate that it applies to all real estate transactions, including real estate with property improvements or integral equipment such as manufacturing facilities, power plants and refineries. The FASB expects to issue a Statement in the first quarter of 1999.

Transfers of Assets Involving a Not-for-Profit Organization That Raises or Holds Contributions for Others

SFAS 116, *Accounting for Contributions Received and Contributions Made*, states that it does not apply to transfers of assets in which the reporting entity acts as an agent, trustee or intermediary, rather than as a donor or donee. This proposed Statement would clarify the use of the terms *agent*, *trustee*, and *intermediary* and establish standards for transfers to those organizations and other not-for-profit organizations that serve as recipient organizations. The Statement also would establish standards for the specified organizations that benefit from those transfers.

Other FASB Projects

Business Combinations

The FASB project on accounting for business combinations and goodwill will affect many companies and is highly controversial. The FASB is reconsidering APB 16, *Business Combinations*, and APB 17, *Intangible Assets*, focusing on the following issues:

- What constitutes a business combination
- Determination of when pooling of interests and purchase methods should be applied, including whether pooling of interests should be permitted at all
- Income statement recognition and timing of purchase accounting adjustments
- Accounting for goodwill and identifiable intangible assets

Tentative Conclusions

Board discussions to date on the project have focused primarily on accounting for goodwill, arising in conjunction with a purchase business combination (purchased goodwill). The Board has tentatively decided that:

- Purchased goodwill should be recognized as an asset and measured initially as the difference between the fair value of the purchase consideration and the fair value of the net assets acquired, which is consistent with the current requirements of APB 16.
- Prior to recording goodwill, every effort should be made to recognize all of the net assets acquired, including intangible assets, and measure them at their fair values, which also is consistent with the current requirements of APB 16.
- All purchased goodwill should be amortized on a straight-line basis over its useful life, limited to no more than 20 years. *(The Board agreed to consider, however, an approach where the useful life of goodwill would be presumed to be 10 years or less, absent evidence provided to support a longer life - i.e., up to 20 years).* A method other than straight-line may be used if it can be demonstrated to be more appropriate and the resulting amortization charge is no less than it would be under the straight-line method.
- The notes to the financial statements should include a description of how the useful life of goodwill was determined and a description of the elements of

goodwill used in determining that useful life (e.g., customer base, product loyalty).

- Goodwill amortization should be displayed as a separate line item within income from continuing operations.
- If certain indicators are present at the date of acquisition, goodwill should be reviewed for impairment 2 years after the acquisition date. A review of the remaining useful life of goodwill, however, would continue to be required under APB 17, *Intangible Assets*.
- Goodwill should be reviewed for impairment at the lowest level not requiring disaggregation; in many cases, that review will have to be performed on a company-wide basis. Impairment should be based on the procedures outlined in SFAS 121.

Other issues that the Board will be discussing in the next few months include guidance for testing goodwill for impairment, disclosure requirements, accounting for other purchased intangibles (including in-process research and development), and the definition of a business combination. A summary of the Board decisions to date on the business combinations project can be found on the FASB Web site: www.fasb.org. That summary is updated after each Board meeting.

Invitation to Comment – Recommendations of the G4+1 for Achieving Convergence

An Invitation to Comment, *Methods of Accounting for Business Combinations*, was issued in late 1998, by the FASB, to solicit comments on certain issues that the Board will address in its business combinations project. An invitation to comment identifies issues prior to the development of an exposure draft of an SFAS. This Invitation to Comment solicits views on the recommendations of a group of standard setters known as the G4+1 for achieving convergence on the methods used to account for business combinations. The G4+1 includes representatives from the

accounting standards boards of Australia, Canada, New Zealand, the United Kingdom, and the United States. The fundamental recommendation of the document is to prohibit pooling of interest accounting.

After reviewing comments on the document, the Board plans to deliberate the issues with a view toward issuing an exposure draft (ED) of a proposed standard in the second quarter of 1999. That ED will incorporate the Board's decisions about those matters as well as its decisions about accounting for goodwill and other purchased intangibles.

Stock Compensation—Interpretation of APB 25

As the Board was reconsidering the accounting for stock-based compensation (which eventually led to the issuance of SFAS 123, *Accounting for Stock-Based Compensation*), it decided not to address practice issues related to APB 25, *Accounting for Stock Issued to Employees*. SFAS 123 permits companies to continue applying APB 25 to transactions with employees. APB 25 permits compensation costs to be measured at the grant date based on intrinsic value (i.e., the excess of the market price of shares over the option's strike price). SFAS 123, on the other hand, requires compensation costs to be measured based on *fair values*, so options with an intrinsic value of zero often have considerable fair value. If APB 25 is applied by a company, the footnotes must include information about compensation costs as if these costs were measured based on a fair value concept.

In 1996, the Board added a project to its agenda to address significant outstanding practice issues related to the accounting for stock-based compensation under APB 25. The most significant proposed changes to date involve requiring SFAS 123 to be applied to non-management directors and requiring variable plan accounting (and possible additional compensation expense) when employee incentive stock options are repriced in response to a decline in the market value of the employer's stock.

Tentative Conclusions Scope: The scope of APB 25 should be limited to individuals who qualify as employees under "common law." Based on that definition, members of the board of directors would be excluded from the scope of APB 25, unless they qualify as employees under common law. Thus, compensation costs for options granted to directors would be measured based on their fair value.

Variable Plans: If the terms of an option (originally accounted for as a fixed plan) are modified during the option term by changing the exercise price, the modified option should be accounted for as a variable plan. Variable-plan accounting should be applied to the modified option from the date of the modification until the date of exercise.

Example

Assume at the end of 19X1, Company X grants to Employee Y, a 5-year incentive stock option with a strike price of \$15 when the stock price is also \$15. Assume the option allows Y to purchase 100 shares of X common stock, and the employee vesting period is 3 years from the date of grant. Since the intrinsic value of this fixed award is zero ($\$15 - \15), X would not recognize any compensation costs over the vesting period under APB 25. However, further assume that the price of X shares has declined to \$10 in 19X2, and X decreases the strike price on the option to \$10 in order to provide a renewed incentive under the award.

From the date the award is repriced, it is considered a variable plan, and compensation costs would be recognizable by X in the event that its share price increases above the new strike price of \$10. Thus, if it is assumed that shortly after repricing, the share price increases to \$12, compensation costs of \$200 [$(\$12 - \$10) \times 100$] would be recognized by X over the remaining vesting period (i.e., through 19X4). Additional compensation costs would also be recognized if the share price increases above \$12 at any time before the option is exercised (i.e., through 19X6).

New Measurement Date: Other than plan modifications requiring variable grant accounting, a new measurement date should be required if a plan modification results in more than a de minimis increase in the fair value of an option. However, if a new measurement date is required, any additional compensation expense still should be measured and recognized based on the excess of market price of the shares over the price an employee must pay to acquire those shares. In other words, the change in fair value should be used only to determine whether the effect of a plan modification is sufficient to require a new measurement date. The Board also decided that for purposes of evaluating the effect of a plan modification on the fair value of an option, the remaining contractual term should be used (rather than the remaining expected life).

A new measurement date is not required for accelerated vesting that occurs in accordance with the terms of the original option. However, accelerated vesting that is granted separately from the terms of the original option represents a plan modification. Consequently, a new measurement date is required if the acceleration of vesting results in more than a de minimis increase in the fair value of the option.

Noncompensatory Plans: The criteria in APB 25 for determining whether a plan is noncompensatory is to be used rather than the criteria under the Internal Revenue Code. A plan with a market price discount of up to 15 percent may qualify as a noncompensatory plan. A plan with a look-back option could meet the criteria for and qualify as a noncompensatory plan.

Business Combinations: No new measurement date should be required for an exchange of stock options in a business combination accounted for under the pooling-of-interests method, provided: (1) the aggregate intrinsic value of the options immediately after the change is not greater than the intrinsic value

immediately before the change and (2) the ratio of the exercise price per option to the market value per share is not reduced.

In a purchase business combination, options granted by the acquiring entity in exchange for outstanding vested options of the target company should be included as part of the consideration paid to acquire the target company.

Definition of Grant Date: Awards made under a plan that is subject to shareholder approval should not be deemed granted until that approval is obtained, unless the approval is essentially a formality (e.g., if management and the members of the board of directors control enough votes to approve the plan).

Other areas covered by the tentative conclusions, include accounting for: (1) the issuance of nonvested options in a purchase business combination, (2) cash bonus plans that are linked to stock-based award plans, (3) issuance of shares to employees of a subsidiary, and (4) deferred income taxes on compensation awards.

Effective Date: The proposed effective date would be the issuance date of the final Interpretation. If adopted, the Interpretation would be applied prospectively but would cover events that occur after December 15, 1998. There would be no effect on financial statements for the period prior to the effective date of the final Interpretation.

The FASB expects to issue an ED in the first quarter of 1999.

Consolidations—Policy and Procedures

An Exposure Draft, *Consolidated Financial Statements: Policy and Procedures*, was issued in 1995. The ED proposed that a controlling entity (parent) consolidate all entities that it controls (subsidiaries), unless control is temporary at the time that the entity becomes a subsidiary. The ED also proposed certain procedures for preparing consolidated financial statements.

Consolidation Policy – Tentative Conclusions

A parent should consolidate all entities that it controls (subsidiaries), unless control is temporary at the date it is acquired or otherwise obtained. Once a subsidiary is consolidated, it should continue to be included in the consolidated financial statements until the parent ceases control.

Control of an entity is defined as a non-shared, decision-making ability to direct the policies and management that guide the ongoing activities of another entity so as to increase the benefits and limit the losses from those activities.

The proposed Statement would be effective for financial statements of both interim and annual periods beginning after December 15, 1999 (calendar year 2000). The Statement would be applied retroactively by restatement of comparative financial statements for earlier periods. However, in the period the Statement is first applied, retroactive restatement would not be required for entities: (1) that were sold or (2) for which management has committed to a plan to sell or is obligated to do so, and that sale is likely to occur within 1 year.

The FASB plans to issue a revised ED on consolidation policy in the first quarter of 1999.

Impairment and Asset Disposal Issues

The Board issued SFAS 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, in 1995, effective for fiscal years beginning after December 15, 1995. After SFAS 121 was issued, questions were raised about its provisions for assets to be disposed of and the effect of those provisions on other accounting literature. To resolve those questions, the Board added a project related to SFAS 121 to its agenda.

Tentative Conclusions

Scope: The scope of SFAS 121 will be extended to apply its provisions for assets to be disposed of as goodwill associated with those assets.

Assets to Be Held and Used: An asset held and used is impaired when its carrying amount exceeds its fair value. However, impairment losses should continue to be recognized only when an asset's carrying amount exceeds the sum of its future cash flows (undiscounted).

If it becomes more likely than not that an asset held and used will be disposed of by sale or abandonment before more than half of its previously estimated remaining useful life would have expired, the asset should be reviewed for impairment.

Assets to Be Exchanged for a Similar Productive Asset or Distributed to Owners in a Spin-Off: An asset that will be exchanged for a similar productive asset or distributed to owners in a spin-off should be reported at the lower of its carrying amount or fair value (and an impairment loss recognized).

Assets to Be Disposed of by Sale: An asset that will be disposed of by sale should be reported at the lower of its carrying amount or fair value, less cost to sell. Depreciation should cease when management, having the authority to approve the action, has committed to a plan to sell the asset, meeting *all* of certain criteria:

- The asset is available for immediate sale
- An active program to find a buyer has been initiated
- An estimate of the probable timing of the sale has been made
- The sale is probable, and its transfer is expected to qualify for sale accounting under GAAP
- A reasonable estimate of the sale proceeds has been made
- Actions taken to complete the plan indicate that it is unlikely that significant changes will be made
- If the plan conditions are met subsequent to the balance sheet date, reclassifications to the held-for-sale category should not be made

Assets Held for Abandonment: An asset that will be abandoned should be reported at the lower of its carrying amount or fair value less costs to abandon (but not less than zero) when the asset is no longer being used or is being used at substantially less than full capacity.

Assets Held for Disposal by Sale or Abandonment: Future expenditures arising from a plan to sell or abandon an asset should be recognized as liabilities only when a company has a present obligation for those expenditures. Operating losses should be recognized in the period(s) in which they are incurred.

Goodwill: Goodwill identified with assets to be disposed of should be allocated to those assets ordinarily on a pro rata basis, using the relative fair values of the long-lived assets and identifiable intangibles acquired at the acquisition date.

The FASB expects to issue an ED in the third quarter of 1999.

AcSEC Activities

Software Revenue Recognition (SOP 97-2)

SOP 97-2 covers issues including when revenue should be recognized and in what amounts for licensing, selling leasing arrangements, or otherwise marketing computer software. The SOP supersedes SOP 91-1.

If an arrangement to deliver software or a software system does not require significant production, modification or customization of software, revenue should be recognized when all of the following conditions are met:

- Persuasive evidence of an arrangement exists
- Delivery has occurred
- Vendor fee is fixed or determinable
- Collectibility is probable

Software arrangements may consist of many elements, (e.g., additional software products, upgrades, enhancements, post-

contract customer support (PCS) or services, including elements deliverable only on a when-and-if available basis). If contract accounting does not apply, the vendor fee should be allocated to the various elements based on vendor-specific objective evidence of fair values. If sufficient vendor-specific evidence of fair value does not exist, all revenue from the arrangement should be deferred until such evidence exists or until all elements have been delivered. Exceptions to this rule are provided for PCS or services that do not involve significant customization, subscriptions, and arrangements in which the fee is based on the number of copies.

Vendor specific objective evidence of fair value is limited to: (1) the price charged when the element is sold separately or (2) if the element is not yet being sold separately, the price for each element established by management having the relevant authority. (See *Effective Date and Transition* for 1-year deferral of the effective date of this provision.)

Separate accounting for a service element of an arrangement is required if both of the following criteria are met: (1) the services are not essential to the functionality of any other element of the transaction, and (2) the services are described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services.

The portion of the fee allocated to an element should be recognized as revenue when all of the revenue recognition criteria have been met. In applying those criteria, the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of any delivered elements. Additionally, the collectibility of that portion of the fee is not considered probable if the amount of the fees allocable to delivered elements is subject to forfeiture, refund or other concession in the event the undelivered elements are not delivered.

If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification or customization of software, the entire arrangement should be accounted for in conformity with ARB 45, *Long-Term Construction-Type Contracts*, using the relevant guidance in SOP 81-1, *Accounting for the Performance of Construction-Type and Certain Production-Type Contracts* (unless criteria specified in SOP 97-2 for separate accounting for any service element are met).

Effective Date and Transition

The SOP became effective for transactions entered into in years beginning after December 15, 1997. Early application is encouraged as of the beginning of fiscal years or interim periods for which financial statements or information have not been issued. Retroactive application, however, is prohibited.

Amendment: SOP 98-4, *Deferral of the Effective Date of Certain Provisions of SOP 97-2, Software Revenue Recognition for Certain Transactions*. This delays for 1 year the effective date of the requirements of SOP 97-2 that limit vendor-specific objective evidence of fair value to the price charged, when an element is sold separately or the price established by management if the item is not yet sold separately. As amended, a company would allocate the revenue on a bundled software contract, using vendor-specific objective evidence of the fair value of each element; however, this evidence is not limited to the price of the element when it is sold separately.

Costs of Computer Software Developed or Obtained for Internal Use (SOP 98-1)

SOP 98-1 provides guidance on: (1) accounting by non-governmental entities, including not-for-profit organizations, for the costs of computer software developed or obtained for internal use and (2) determining whether computer software is for internal use. The

SOP does *not* change the conclusions reached in EITF Issue No. 96-14, *Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*, which requires that the external and internal costs associated with modifying internal-use software currently in use for the Year 2000 be charged to expenses as incurred.

Characteristics of Internal-Use Computer Software

Internal-use software has *both* of the following characteristics:

- Software is acquired, internally developed or modified solely to meet a company's internal needs
- During software development or modification, no substantive plan exists or is being developed to market the software externally

Research and Development Costs

The costs of internal-use software used in research and development generally should be expensed as incurred.

Capitalize or Expense

Determination of whether internal-use computer software costs should be capitalized or expensed is based on the following:

- Internal and external costs incurred during the preliminary project stage should be expensed as incurred.
- Application Development Stage: Internal and external costs incurred to develop internal-use software during the application development stage should be capitalized. Costs to develop or obtain software that allow for access or conversion of old data by new systems should also be capitalized. On the other hand, the process of data conversion from old to new systems should be expensed as incurred. In addition, any training costs incurred during the development stage should be expensed as incurred.
- Post Implementation/Operation Stage: Internal and external

training costs and maintenance costs should be expensed as incurred.

- Upgrades and Enhancements: If it is *probable* that internal or external costs associated with upgrades or enhancements will result in additional functionality, such costs should be capitalized, subject to the rules discussed above for the three stages of computer software development.

Capitalizable Costs

Costs of computer software developed or obtained for internal use that should be capitalized include *only*: (1) external direct costs of materials and services incurred in developing or obtaining internal-use computer software, (2) direct payroll and payroll-related costs for employees who work on the project, and (3) interest costs incurred while developing internal-use computer software. General and administrative costs, and overhead costs should not be capitalized.

Multiple-Element Software Arrangements

Included in the Purchase Price

Companies should allocate the cost among individual elements based on objective evidence about the fair value of the elements of the contract, not necessarily separate prices stated in the contract for each element.

Impairment

Impairment of internal-use software, being developed or currently in use, should be recognized and measured based on the guidance in SFAS 121.

Amortization

The costs of software developed or obtained for internal use should be amortized over the periods benefited on a straight-line basis, unless another systematic and rational basis is more representative of the software use.

Examples

The SOP contains examples illustrating when computer software is and is not for internal use.

Effective Date and Transition

The SOP is effective for financial statements for fiscal years beginning after December 15, 1998. The provisions of the SOP should be applied to internal-use software costs incurred in those fiscal years for all projects, including those projects in progress upon initial application of the SOP. Earlier application is encouraged in fiscal years for which annual financial statements have not been issued. Costs incurred prior to initial application of this SOP, whether capitalized or not, should *not* be adjusted to the amounts that would have been capitalized had this SOP been in effect when those costs were incurred.

Reporting on the Costs of Start-Up Activities (SOP 98-5)

This SOP, which affects many companies, requires that the costs of start-up activities, including organization costs, be expensed as incurred.

Start-up activities are defined broadly as those one-time activities related to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with a new class of customer (excluding ongoing customer acquisition costs, such as policy acquisition costs and loan origination costs) or beneficiary, initiating a new process in an existing facility or commencing some new operation. Start-up activities also include activities related to organizing a new entity and are commonly referred to as organization costs.

Activities related to routine, ongoing efforts to refine, enrich or otherwise improve upon the qualities of an existing product, service, process or facility are not start-up activities and are not within the scope of this SOP. In addition, activities related to a merger or acquisition, and ongoing customer acquisition are not start-up activities.

Examples

The SOP provides examples of activities that include start-up and organizational costs that are sub-

ject to this SOP and those that are outside its scope.

Effective Date and Transition

With certain limited exceptions, SOP 98-5 is effective for financial statements for fiscal years beginning after December 15, 1998. Earlier application is encouraged in fiscal years for which annual financial statements have not been issued. Restatement of previously issued financial statements is not permitted.

Initial application of the SOP generally should be reported as the cumulative effect of a change in accounting principle as described in APB 20, *Accounting Changes*.

Proposed Accounting by Producers and Distributors of Films

Under this proposed SOP, revenue should be recognized when all of the following conditions are met: (1) persuasive evidence of a sale or licensing arrangement with a customer exists, (2) the film is complete and, in accordance with the terms of the arrangement, either has been delivered or is available to be delivered, (3) the license period of the arrangement has begun, and the customer can begin its exploitation or exhibition, (4) the gross revenue is fixed or determinable and (5) collection is reasonably assured.

Licensing arrangements that meet all of the above conditions and transfer substantially all of the benefits and risks incident to ownership of the film on an exclusive basis for an individual market and territory should be accounted for as sales. In arrangements that do not meet the "substantially all" and exclusivity requirements, but meet all of the conditions above, revenue should be recognized, generally ratably, over the licensing period.

The costs of producing a film and bringing that film to market consist of production, exploitation and participation costs. The present value of participation costs should be accrued when their payment is probable, which is usually determined when the film has been

released. Production and capitalized participation costs should be amortized using the individual-film-forecast-computation method. This requires estimating remaining ultimate gross revenues. Pre-release and early release exploitation costs incurred on a territory-by-territory basis in the theatrical market should be capitalized and amortized over the expected period of exploitation of the film in that theatrical market and territory (not to exceed 3 months from release date).

The SOP would be effective for financial statements for fiscal years beginning after December 15, 1999, with earlier application encouraged. The cumulative effect of changes in accounting principle caused by adopting the provisions of the SOP would be included in net income in conformity with APB 20.

EITF Activities

During 1998, the EITF reached consensus positions on the following issues, many of which focus on narrow matters:

- *Balance Sheet Classification of Borrowings Outstanding Under Revolving Credit Agreements That Include Both a Subjective Acceleration Clause and a Lock-Box Arrangement (95-22)*
- *Debtor's Accounting for a Modification or Exchange of Debt Instruments (96-19)*
- *The Effect of Lessee Involvement in Asset Construction (97-10)*
- *Accounting for Internal Costs Relating to Real Estate Property (97-11)*
- *Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested (97-14)*
- *Accounting for Contingency Arrangements Based on Security Prices in a Purchase Business Combination (97-15)*
- *Valuation of Debt Assumed in a Purchase Business Combination (98-1)*
- *Accounting for Exchanges of Similar Equity Method Investments (98-7)*

- *Accounting for Transfers of Investments That Are in Substance Real Estate (98-8)*
- *Accounting for Contingent Rent (98-9)*
- *Accounting for Contracts Involved in Energy Trading and Risk Management Activities (98-10)*
- *The Application of EITF Issue No. 96-13, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," to Forward Equity Sales Transactions (98-12)*
- *Structured Notes Acquired for a Specified Investment Strategy (98-15)*

The SEC Observer made announcements about the following issues during 1998:

- *Gain Recognition on Transfers of Financial Assets under FASB Statement No. 125 (D-69)*
- *Reclassification and Subsequent Sales of Securities in Connection With the Adoption of FASB Statement No. 133 (D-73)*

The FASB staff made announcements about the following issues during 1998:

- *Accounting for Derivatives Used to Hedge Interest Rate Risk (D-64)*
- *Maintaining Collateral in Repurchase Agreements and Similar Transactions under FASB Statement No. 125 (D-65)*
- *Effect of a Special-Purpose Entity's Powers to Sell, Exchange, Repledge or Distribute Transferred Financial Assets under FASB Statement No. 125 (D-66)*
- *Isolation of Assets Transferred by Financial Institutions under FASB Statement No. 125 (D-67)*
- *Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of an Investee (D-68)*
- *Questions Related to the Implementation of FASB Statement No. 131 (D-70)*
- *Accounting Issues Relating to the Introduction of the European Economic and Monetary Union (EMU) (D-71)*
- *Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings Per Share (D-72)*

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- *Issues Concerning the Scope of the AICPA Guide on Investment Companies (D-74)*
 - *When to Recognize Gains and Losses on Assets Transferred to a Qualifying Special-Purpose Entity (D-75)*
 - *Accounting by Advisors for Offering Costs Paid on Behalf of Funds, When the Advisor Does Not Receive Both 12b-1 Fees and Contingent Deferred Sales Charges (D-76)*

Those interested in obtaining more information about issues discussed by the EITF can subscribe to the loose-leaf service or can purchase the soft-bound book; both

versions are titled "EITF Abstracts." These publications provide a summary of each EITF issue along with its resolution or other status. Those wishing to subscribe to the service or acquire the soft-bound book can call the FASB order department at (203) 847-0700, or visit their Web site at: www.fasb.org. SEC registrants may wish to monitor EITF deliberations even when no consensus is reached since SEC staff positions often are discussed at the meetings.

Effective Dates of Other Recently Issued Accounting Standards

The chart on the following page lists the effective dates of other recent accounting pronouncements. It includes certain pronouncements with an effective date for fiscal years beginning in 1997 because they could have an impact on 1998 financial statements. This information should be reviewed in conjunction with the effective date and transition information contained in the pronouncements.

Pronouncements

SFAS 128, *Earnings per Share*

SFAS 130, *Reporting Comprehensive Income*

SFAS 131, *Disclosures About Segments of an Enterprise and Related Information*

FASB Technical Bulletin 97-1, *Accounting Under Statement 123 for Certain Employee Stock Purchase Plans With a Look-Back Option*

SOP 97-1, *Accounting by Participating Mortgage Loan Borrowers*

SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*

SOP 98-2, *Accounting for the Costs of Activities of Not-for-Profit Organizations, and State and Local Governmental Entities That Include Fund-Raising*

SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts that Do Not Transfer Insurance Risk*

Effective Dates – Transition

Applies to financial statements for periods ending after December 15, 1997, including interim periods. All prior period EPS data presented should be restated.

Applies to years beginning after December 15, 1997. Reclassification of financial statements for earlier periods provided for comparative purposes is required.

Applies to years beginning after December 15, 1997. In the first year of application, comparative information for earlier years should be restated, unless it is impracticable to do so. The requirements need not be applied to interim financial statements in the initial year of application. However, the new disclosures should be reflected when the interim financials of the initial year of application are included as comparative statements in the second year of application.

Applies to stock-based awards granted, renewed or modified on or after January 1, 1998.

Applies to transactions entered into in years beginning after December 15, 1997. Retroactive application, however, is prohibited.

Applies to financial statements for years beginning after December 15, 1998.

Applies to years beginning on or after December 15, 1998.

Applies to financial statements for years beginning after June 15, 1999.

Material discussed is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual facts and circumstances.

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