

## SEC Regulations Committee Highlights

Joint Meeting with SEC Staff - October 16, 1997

*Location:* SEC Headquarters – Washington, D.C.

**NOTICE:** The AICPA SEC Regulations Committee meets periodically with the staff of the SEC to discuss emerging technical accounting and reporting issues relating to SEC rules and regulations. The purpose of the following highlights is to summarize the issues discussed at the meetings. These highlights have not been considered and acted on by senior technical committees of the AICPA, or by the Financial Accounting Standards Board, and do not represent an official position of either organization.

In addition, these highlights are not authoritative positions or interpretations issued by the SEC or its staff. The highlights were not transcribed by the SEC and have not been considered or acted upon by the SEC or its staff. Accordingly, these highlights do not constitute an official statement of the views of the Commission or of the staff of the Commission.

### I. **ATTENDANCE**

#### A. **SEC Regulations Committee**

Robert H. Herz, Chairman  
Val Bitton  
Mark Bagaason  
Rusty Brinkman  
Jay Hartig  
Rodney Liddle  
Tom Milan  
Arthur Radin  
Keith Sandefur  
Stewart Sandman  
Bill Travis  
Bill Yeates

#### B. **Securities and Exchange Commission**

*Office of the Chief Accountant*

Jane Adams, Deputy Chief Accountant  
Robert Burns, Chief Counsel  
Scott Bayless, Assistant Chief Accountant  
Donna Coallier, Professional Accounting Fellow  
Jeffrey Jones, Professional Accounting Fellow  
Mike Kigin, Associate Chief Accountant  
Tim McKay, Assistant Chief Accountant  
Leslie Overton, Assistant Chief Accountant  
Armando Pimentel, Professional Accounting Fellow  
Cody Smith, Professional Accounting Fellow  
Walter Teets, Academic Accounting Fellow

Bob Uhl, Professional Accounting Fellow

*Division of Corporation Finance*

Robert Bayless, Chief Accountant

C. **AICPA**

Annette Schumacher Barr, Technical Manager

D. **Guests**

Robert Bartsch (BDO Seidman)

Ernie Baugh (Joseph Decosimo & Company)

Kenneth Chatelain (Coopers & Lybrand)

Brian Heckler (KPMG Peat Marwick)

Terri Iannaconi (KPMG Peat Marwick)

Amy Ripepi (Arthur Andersen)

II. **STAFF CHANGES**

*Division of Corporation Finance* - Robert Bayless noted that Ken Marceron and Joel Levine have been promoted to Associate Chief Accountants. They will join the Division of Corporation Finance's Chief Accountant's Office and assignments will be reallocated after their replacements as Assistant Chief Accountants are named.

*Chief Accountant's Office* - Walter Teets has joined the Commission as the new Academic Fellow. Cathy Cole has left the Commission.

III. **TRAINING MANUAL UPDATE**

Robert Bayless noted that the pending update to the Staff Training Manual has been delayed due to staff shortages in the Division of Corporation Finance's Chief Accountant's Office. It is not possible to predict when the updated manual will be completed. In the interim, any comments on the Manual should be provided to Melanie Dolan, who has assumed responsibility for the Manual since Kurt Hohl's departure.

IV. **COMPANY REGISTRATION/PLAIN ENGLISH UPDATE**

Robert Bayless stated the final rules on "Plain English" disclosures are expected to move ahead in the fourth quarter of 1997. Proposed rules reflecting the Commission's consideration of the Advisory Committee's Report on the Capital Formation and Regulatory Processes can be expected in the first part of next year.

V. **RULE 10A FILINGS**

Bob Burns stated that the staff has received only about 10 of these reports to date. There has been relatively little activity because the requirement does not yet apply to smaller companies and we are between peak audit seasons. The staff has seen

instances in which auditors did not understand the Rule 302 size tests and filed a report unnecessarily.

Mike Kigin added that all 10A reports should be sent directly to the Office of the Chief Accountant (this is a specific requirement in the Rule). He noted that some reports have been delayed because they were sent to the Consumer Affairs Office, the Division of Corporation Finance, or the Division of Enforcement.

#### **VI. DERIVATIVES DISCLOSURES**

Armando Pimentel reported that the staff has received fewer implementation questions since the staff's question-and-answer guidance was published this Summer. In a quick look at some of the disclosures in the June 30 Form 10-K's, the staff noticed that it was sometimes difficult to determine whether specific registrants were complying with all of the requirements of the rule. This, it seemed, was due to several reasons, including; lack of cross-referencing to locations where the information is located and inclusion of information in the footnotes where it was not clear whether the registrant was complying with some of the rule or whether they were providing information encouraged by FASB Statement No. 119, Disclosures about Derivative Financial Instruments and Fair Value of Financial Instruments. The release requires that the disclosures be outside of the financial statements and footnotes.

Robert Bayless indicated that the Division of Corporation Finance staff has identified a number of early adopters and will review their filings in search of implementation issues. Findings from the reviews and appropriate guidance will be communicated once the reviews are complete.

#### **VII. ANNUAL SEC CONFERENCE**

The Committee provided the staff with a list of recommended topics to be addressed by the SEC speakers at the AICPA Annual SEC Conference on December 9-10.

#### **VIII. SEGMENT REPORTING/FASB STATEMENT NO. 131**

Robert Bayless reported that the Division of Corporation Finance is working on changes to Regulation S-X and Regulation S-K to reflect the new segment reporting requirements in FASB Statement No. 131, Disclosures About Segments of an Enterprise and Related Information. He does not anticipate any new requirements that go beyond those in the Statement.

#### **IX. YEAR 2000 ISSUE**

Robert Bayless asked whether the Committee is still looking for additional reporting guidance related to the Year 2000 Issue after the release of Staff Legal Bulletin (SLB) No. 5. The Committee responded that it is in the process of considering SLB No. 5 to determine whether additional guidance is necessary.

#### **X. CHANGE IN AUDITOR NOTIFICATION**

Bob Herz provided Robert Bayless with a copy of the Committee's draft paper

regarding proposed changes in the SECPS Notification Letter process and asked for his input. Mr. Bayless indicated that he would review the paper and respond to the Committee.

**XI. MATERIALITY CONSIDERATIONS OF PROFORMA DISCLOSURES UNDER FASB STATEMENT NO. 123**

Robert Bayless provided clarification about his views regarding materiality considerations of proforma disclosures required under FASB Statement No. 123, Accounting for Stock-Based Compensation. He stated that although he does not believe that the disclosures are always material, the materiality decision needs to take into account the high level of investor interest in this information, particularly the assumptions used to calculate pro forma expense. Because many investors have indicated a desire for this information, the staff is reflecting that view of materiality in its comments to registrants that omit these disclosures. He also indicated that he could not understand a conclusion that the stock option activities table is material and should be included, while the pro forma expense and related disclosures are not material. He indicated a desire to work with the Committee to ensure that investors are given important information.

The Committee provided Mr. Bayless with a draft paper on the topic. Val Bitton indicated that he will revise the paper to explain why the activity table might be included and the pro forma expense and related disclosures excluded.

**XII. ACCOUNTING FOR A REIT'S ACQUISITION OF ITS ADVISOR OR MANAGEMENT ENTITY**

Donna Coallier discussed the staff's views regarding accounting for the acquisition by a REIT of a company acting as advisor or management company. The staff approaches the question by first establishing what the REIT has actually acquired. In some instances, the management contract includes a termination fee, and the acquisition price is close to the amount of the termination fee. In this case, the acquisition is, in substance, a contract termination and an expense should be charged. In other cases, such as when there is no contractual termination fee, the staff considers carefully what has been acquired. Unless the advisor or management company has significant contracts to provide services to third parties, the acquisition probably will not be viewed as a business combination. Depending on the nature of the acquired entity and the terms of the agreement, the transaction may include the acquisition of tangible and/or intangible assets and/or an imputed termination fee. Robert Bayless stated that any intangibles acquired in such a transaction (such as a work force) would be expected to have relatively short lives for amortization purposes. He added that similar transactions involving captive suppliers could arise in other industries.

**XIII. TAINTED TREASURY SHARES IN A LEVERAGED RECAP**

Jeff Jones discussed a transaction recently reviewed by the staff involving an enterprise owned by a family (57% by the parents and 43% by their adult children). In the transaction, the parents sold all of their interests in the companies and the children sold 95% of their interests although, as a result of leverage in the deal, the children owned 45% of the new company ("Newco"). This transaction was not a

"typical" leveraged recap that does not involve a newco; instead it was in the form of an EITF 88-16 transaction that did not meet the criteria for step up under EITF Issue No. 88-16 since a change in control, as discussed in the Issue, did not occur and was accounted for as a recapitalization. The form of the transaction was in three steps:

1. Unrelated new investors contributed cash and received common and preferred stock of Newco.
2. The children exchanged a portion of their shares for shares in Newco.
3. The proceeds from the new investors were used to purchase all of the parent's shares and the children's remaining share.

After the deal, the new investors had 55% of Newco common shares and the children had 45% of Newco. This transaction occurred about one year ago. Subsequently, Newco had an IPO and now was party to a business combination to be accounted for as a pooling.

The staff addressed the following two questions:

4. How many tainted treasury shares were acquired from the family?
5. Did issuance of shares to new investors cure any of that taint?

With respect to the first question regarding the number of tainted treasury shares acquired, the company made the following argument:

Since both parents and children participated in the deal, there was a substantive dividend payment to the extent there was pro rata cash distributed to the family. Therefore, only the payment to the parents in excess of the pro rata distribution should result in tainted shares. The 95% distribution should be evaluated as a distribution under paragraph 47(c) of APB 16, Business Combinations, and, being well over one year before the pooling transaction, would overcome the presumption that the distribution was in contemplation of the business combination.

The staff did not concur with the company's conclusion because the company did not declare a dividend; therefore a substantive dividend cannot be inferred to have occurred. As a result, all of the cash distributed to the family members should be viewed as reacquisitions of tainted treasury shares. Since Newco had recap accounting, the computation of the number of treasury shares had to be computed on a "Newco" share basis.

With respect to the second question regarding whether the issuance of shares cures the taint, the staff concluded that it did not. The staff stated that, in most cases in pooling accounting, a taint cannot be cured before it exists. The form of this transaction was that the new money was injected into the company for the sale of shares before the treasury shares were repurchased. In response to a question, Jeff Jones stated that if in a similar transaction the issuance of the new shares were to take place after the reacquisition of shares from existing shareholders, one should not necessarily conclude that the taint would be cured.

#### **XIV. JOINT VENTURES INVOLVING EXISTING OPERATING BUSINESSES**

Bob Herz described a transaction involving a "joint venture" between controlled

investments of two LBO funds. The venture was formed when one of the funds contributed a subsidiary of one of its portfolio companies and the other contributed an entire portfolio company. Because the latter was owned 53% by the fund with the remainder of the shares held by management and others, a newly-formed partnership was created to put together these interests and to then contribute the company to the venture. The venture agreement specified that each of the contributing parties would hold a 50% interest in the venture and provided for clear joint control. Although the companies believed this transaction was the formation of a joint venture (based on joint control), the staff argued that it was a business combination. Donna Coallier explained that, in the staff's opinion, some of the elements of a joint venture as defined in APB 18, The Equity Method of Accounting for Investments in Common Stock, were not present in this transaction. In particular, the staff noted that the contributing parties were not operating businesses, that one of the contributed entities was an entire operating business, and that a new holding partnership was formed to effect the transaction.

Bob Herz noted that the EITF will consider the issue of what distinguishes formation of a joint venture from a business combination

#### XV. **HYPERINFLATION IN BRAZIL**

Bob Uhl discussed the staff's views regarding the treatment of the Brazilian currency as highly inflationary under FASB Statement No. 52, Foreign Currency Translation, and the FASB staff announcement in EITF Topic D-55.

Recently, Brazil's three year cumulative inflation decreased significantly below 100%. Bob noted that EITF Topic D-55 specifies that if the three year cumulative inflation rate for a country exceeds 100%, the currency is considered highly inflationary. Subsequently, if the cumulative inflation rate declines below 100%, historical inflation trends and other pertinent factors should be considered to determine whether such information suggests classification of the economy as highly inflationary is still appropriate. While the staff understands that judgment is necessary in this determination, the staff believes that the longer the period and the greater the amount by which the three year cumulative rate of inflation is below 100% the more difficult it will be for other pertinent factors to outweigh the conclusion that an economy is no longer highly inflationary. Therefore, absent significant changes in the rate of inflation or other economic events, it will be difficult for entities to be able to justify treating Brazil as a highly inflationary economy for quarters beginning after December 31, 1997. In addition, Bob stated that FASB Statement No. 52 and EITF Topic D-55 do not provide a transition period once it has been determined that a currency is no longer considered highly inflationary (i.e., once it has been determined that hyperinflation no longer exists, use of a transition period before converting to the functional currency is inappropriate).

Bob also stated that for issuers whose financial statements are impacted by the Brazilian currency, MD&A should include discussions of matters such as the status of Brazil as either highly or non-highly inflationary, the date Brazil ceased being considered highly inflationary, the functional currency of Brazilian operations, and the effects of a change in functional currency.

XVI. **GUARANTOR FINANCIAL STATEMENTS**

Robert Bayless distributed a paper Attachment A [OMITTED FROM THIS VERSION] that describes the staff's views regarding the need to provide financial statements of a newly-acquired guarantor subsidiary. The staff is considering drafting rules to implement the views in that paper.