SEC REGULATIONS COMMITTEE
Joint Meeting with SEC Staff
October 16, 1997
SEC Headquarters—Washington, D.C.

<u>HIGHLIGHTS</u>

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)

H. 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.

HI. 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 staffs 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:

1) How many tainted treasury shares were acquired from the family?

2) 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 staffs 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) that describes the staffs 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.

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ATTACHMENT A

Guarantee Financial Statements of Subsidiaries that Guarantee Securities Issued by Parent Company

Debt or preferred stock registered under the Securities Act may be guaranteed by one or more of the issuer's subsidiaries. Each guarantee (as well as the guaranteed security) must be covered by an effective registration statement. Rule 3-10(a) of Regulation S-X requires financial statements of guarantors of registered securities to be included in the registration statement. Moreover, the guarantor subsidiary, like its parent, is required to file periodic reports pursuant to Section 15(d) of the Exchange Act at least for the fiscal year during which the Securities Act registration statement became effective.

Although separate disclosure and reporting by a guarantor subsidiary generally is required, the staff will accept in some circumstances a registrant's proposal to include other disclosures in lieu of full separate audited financial statements of the guarantor subsidiary, and will take no-action with respect to a guarantor that does not file separate Exchange Act reports. Issuers seeking such relief ordinarily should address their requests to the Office of the Chief Counsel of the Division of Corporation Finance prior to filing a registration statement.

Topic 1.G, of the Staff Accounting Bulletins (SAD 53) provides relief from the general requirement of full separate disclosure and reporting by subsidiary-issuers where investors rely upon the parent's guarantee for the repayment of principal and interest on the subsidiary-issuer's guaranteed securities. On the other hand, Topic 1.H. states as a general rule that separate financial statements for a subsidiary-guarantor and a parent-issuer would be material to investors. However, in certain circumstances where subsidiary-guarantors are present, the staff has provided relief based upon the materiality to investors of the financial information about the guarantor. In any case, it is the issuer's responsibility to include full and complete disclosure of (1) the legal aspects of the guarantee arrangement that would be material for a investor to evaluate the sufficiency of the guarantee, **(2)** financial information in sufficient detail to allow investors to determine the nature of the assets held by, and the operations and cash flows of, each of the issuers, including the investors' priority position in the event of a default by the issuers, and **(3)** any significant restrictions on the parent's ability to obtain funds from its subsidiaries by dividend or loan.

Notwithstanding the general rule of Topic 1.H., the staff has stated, in Anheuser-Busch, that the three levels of disclosure set forth in Topic 1.G. will be applied to those situations in which the subsidiary is a guarantor of its parent's debt or preferred equity securities. If the registered security is guaranteed by all direct and indirect subsidiaries of the parent company and the parent has no operations or assets other than its investment in its subsidiaries, the staff generally would not require the registration statement to include any audited financial information of the guarantor subsidiaries provided that the registrant indicates the basis for their omission. If the registered security is guaranteed by all direct and indirect consolidated subsidiaries of the parent but the parent does have other assets or operations, the staff generally will accept, in lieu of separate financial statements of the guarantor subsidiaries, either summarized parent-only financial information or summarized combined financial information of the guarantor subsidiaries provided in an audited note to the parent's financial statements. The alternative disclosures described in this paragraph also have been accepted where the nonguarantor subsidiaries are inconsequential (i.e., when the assets and pre-tax income of and parent's net investment in the nonguarantor subsidiaries on an individual and combined basis is less than 3%).

The staff has addressed all other circumstances based upon the materiality of the information in the light of the particular terms and conditions of the guarantees. In circumstances in which the security is guaranteed on a full, unconditional, and joint and several basis by one or more of the issuer's wholly owned subsidiaries, the financial information required in the note to the parent's financial statements ordinarily should be consolidating condensed financial statements which depict, in separate columns, the parent company, the guarantor subsidiaries (on a combined basis), and the nonguarantor subsidiaries (on a combined basis), with an additional column reflecting eliminating adjustments. Additional columns may be necessary if the enforceability of the guarantees may be affected differently under the laws of the foreign or domestic jurisdictions in which they can be enforced.

In circumstances where condensed financial statements are accepted in lieu of full financial statements, registrants should follow the general guidance in Rule 10-01 of Regulation S-X concerning their form and content. However, the condensed consolidating financial information should be in sufficient detail to allow investors to determine the nature of the assets held by, and the operations and cash flows of, each of the consolidating groups and include a discussion of any significant restrictions on the parent's and the guarantors' ability to obtain funds from their subsidiaries by dividend or loan. Additional financial and narrative information about individual guarantors should be disclosed if the information would be material for an investor to evaluate the sufficiency of the guarantee.

If one or more of the guarantor subsidiaries is not wholly owned or if one or more of the guarantees is not full, unconditional, and joint and several, the staff will expect the issuer to furnish full audited financial statements of the guarantor subsidiaries pursuant to Rule 3-10.

Also, if historical operations of a guarantor subsidiary were not included in the audited consolidated financial statements of the issuer for at least one complete year because it was recently acquired or is a probable acquisition, the "substantial collateral" test defined in Rule 3-10 of Regulation S-X should be used to determine whether financial statements of the recently acquired guarantor subsidiary are required. If the book value, par value, or market value (purchase price), whichever is greater, of any recently acquired guarantor subsidiary equals 200 or more of the principal amount of the guaranteed debt securities, the financial statements required by Rule 3-01 and Rule 3-02 of Regulation S-X for the periods prior to their inclusion in the audited financial statements of the parent are required. These financial statements, when combined with the periods included in parent's audited consolidated financial statements should equal the periods required by Rules 3-01 and Rule 3-02 of Regulation S-X.

Registrants should note that the guidance in SAD 53 explain above for application to guarantor subsidiaries does not apply to affiliates whose securities collateralize another registered security, even if that affiliate is a wholly owned subsidiary of the issuer of the registered security. Rule 3-10 of Regulation S-X provides that financial statements of each affiliate whose securities constitutes a substantial portion of the collateral for any class of security must be furnished. The staff does not have a practice of providing relief with respect to the requirement of Rule 3-10 for financial statements of such affiliates.