SEC Regulations Committee Highlights

Joint Meeting with SEC Staff - October 22, 1996

Location: SEC Headquarters – Washington, D.C.

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I. **ATTENDANCE**

A. **SEC Regulations Committee**

Robert H. Herz, Chairman
Mark Bagaason
Val Bitton
Rusty Brinkman
Michael D. Foley
Lee Graul
Jay P. Hartig
Eric Press
Art Radin
Lucien K. Sandefur
Stewart Sandman
Bill Travis
Bill Yeates

B. **Securities and Exchange Commission**

Office of the Chief Accountant

Steve Swad, Deputy Chief Accountant
Scott Bayless, Assistant Chief Accountant
Brian Heckler, Professional Accounting Fellow

Division of Enforcement

George Diacont, Chief Accountant

Division of Corporation Finance

Robert Bayless, Chief Accountant

Kurt Hohl, Associate Chief Accountant
Douglas Tanner, Associate Chief Accountant

C. **AICPA Staff**

Annette Schumacher Barr, Technical Manager

D. **Guests**

Kenny Chatelain, Coopers & Lybrand
Chris Holmes, Ernst & Young

II. ACCOUNTING AND AUDITING ENFORCEMENT MATTERS

George Diacont, Chief Accountant of the Division of Enforcement, briefed the Committee on recent enforcement cases. Areas of focus include:

- **"Bill and hold" transactions -** AAER 817 provides insight into the staff's views regarding "bill and hold" sales. AAER 108 describes the staff's longstanding policy on such transactions. In addition to the staff questioning the accounting for such transactions, they will take action for failure to describe their impact in MD&A (such as the reason for a sharp increase in current sales or a future decline in sales).
- **Exchange of assets for stock -** EITF 93-11 describes the appropriate accounting for barter transactions. The staff is investigating six public companies for overstating assets by accepting stock in exchange for obsolete inventory and similar overvalued assets. In many of these cases, the stock received was thinly traded or subject to price fluctuations or the issuer was in poor financial condition, calling into question the value of the stock when acquired.
- **Communication with the OCA and DCF staff -** Recently, an audit engagement partner made false representations to the staff when discussing a registrant reporting issue. The staff also has experienced instances of non-response to information requests and "clever" answers to staff questions. Practices like these cause the Office of Chief Accountant (OCA) and Division of Corporation Finance (DCF) staff to question the credibility of the information provided to the staff and to seek Division of Enforcement involvement. The Committee's "best practices" document, when issued, may help in this regard.
- **False confirmations -** The staff recently made a criminal referral of a friend of an officer of a public company. The friend gave the auditor a false confirmation of a $1.5 million debt to the company. In another case, a board member of a public company solicited a false confirmation from a customer. Auditors should be aware of the possibility of false confirmations and exercise appropriate skepticism based on the circumstances surrounding a confirmation (for example, in connection with the confirmation of unusual, last minute transactions), thus potentially requiring additional audit procedures.
- **CPA misconduct -** The staff recently sought indictment of a Big Six tax partner who issued false "agreed-upon procedures" letters for a client.
- **Independence -** Chairman Levitt continues to express interest in taking enforcement action for independence violations.
- **Overseas investigations -** The Division of Enforcement has had increased

cooperation with authorities in other countries. Recently, the German government used its subpoena power to aid the SEC in an investigation of the German subsidiary of a US company. A German-speaking SEC staff member questioned the German individuals. In addition, enforcement cases involving Mexican registrants have been dealt with by Spanish-speaking staff members.

- **Technology companies -** The enforcement staff continues to address revenue recognition problems in technology industries, including software and biotech. Abuses that lead to bad accounting include sales with right of return, side agreements, undisclosed requirements for additional performance, and sales financing by the seller. In some cases, the registrant's sales management may be entering into these agreements without knowledge of the accounting staff, making them difficult to detect. Auditors of such companies should be aware of the possibility of these matters and design audit procedures accordingly.

III. AUTONOMY AND SPIN-OFFS

Paragraph 46a of APB Opinion 16 states

Each of the combining companies is autonomous and has not been a subsidiary or division of another corporation within two years before the plan of combination is initiated.

There have been a limited number of exceptional cases where the staff has not objected to a registrant's conclusion that a subsidiary spun-off within two years prior to initiation could be the autonomous entity. In these exceptional cases, the subsidiary was clearly dominant compared to the combined entity prior to the spin-off based upon historical GAAP measures of assets, net assets, revenues, operating income, as well as fair value.

Some have concluded that if the spun-off entity is larger than the continuing smaller parent, the larger portion would be considered to be autonomous, notwithstanding the fact that it was formerly a subsidiary. This would imply that a simple majority based on some measure of size would determine autonomy.

The staff does not believe that, in the limited and exceptional cases where it has not objected to the conclusion that the "legal spinnee" was indeed the "accounting spinnor" for autonomy purposes, the decision regarding autonomy should be based on a simple majority size test. In addition, in those limited cases, the staff believed that to overcome the presumption that the legally spun-off entity lacked autonomy would require consistent, persuasive, and objective evidence that the "legal spinnee" was indeed the "accounting spinnor" due to its dominance taking into consideration the result of all size tests considering.

The staff has also considered the manner in which the spinoff was reported in accordance with APB Opinion No. 30, when applicable, as one, but not the only, form of evidence. The fact that the staff accepts the legal spinnor as the discontinued operation for financial reporting purposes does not necessarily lead to the conclusion that the legal spinnee would be deemed autonomous under the pooling rules. It is

doubtful that the staff would consider the legal spinnee to be autonomous unless it was treated as the continuing business for financial reporting purposes.

IV. DIRECTOR AND OFFICER INSURANCE RELATED TO AN IPO

The staff was asked to clarify whether the portion of Directors and Officers Insurance directly related to an IPO can be deducted from offering proceeds rather than presented as an expense. (Insurance providers are sometimes willing to separately bill for the premium directly related to the offering). The staff responded that such insurance is an expense. Robert Bayless added that there may be a reasonable basis for deducting the cost of an insurance policy that is solely indemnification relating to the specific offering if it is not tied with any other insurance product from the same agent or vendor. Registrants that believe they have purchased an insurance product that should be accounted for as a direct cost of the offering are requested to discuss the specific facts with the staff in advance of filing the registration statement.

V. APPLICATION OF MULTIPLE ACQUISITIONS UNDER RULE 3-14

Kurt Hohl described the requirements of Rule 3-14 of Regulation S-X with respect to individually insignificant real estate property acquisitions. Rule 3-14 requires financial statements of operating real estate properties acquired or to be acquired that are individually insignificant, if such acquisitions, in aggregate with other individually insignificant acquired or to be acquired properties, exceed 10% of the registrant's total assets. However, in certain instances the staff has granted relief under this requirement to permit omission of audited financial statements of an individually insignificant property that is significant below the 5% level if: (a) the property is acquired from an unrelated party, (b) descriptive and unaudited summarized financial information about the property is provided and (c) audited financial statements of the substantial majority of all individually insignificant properties acquired or to be acquired are provided.

The changes to Rule 3-05 of Regulation S-X do not change the requirements of Rule 3-14. The staff is considering the need to revise Rule 3-14 in conjunction with the disclosure simplification project.

Also, the staff made it clear that while Rule 3-05 permits the determination of significance to be made using pro forma financial information included in Form 8-K reporting a significant acquisition, this determination of significance is not applicable to Rule 3-14.

VI. RULE 3-05 CHANGES

Robert Bayless reported that on October 8, the Commission voted to amend Rule 3-05 of Regulation S-X and related rules governing financial statements of businesses acquired or to be acquired. The amendments take effect 30 days after publication in the Federal Register (which occurred on October 18, 1996). The new rules apply to any transactional filing made effective on or after November 18, 1996, and to Exchange Act filings timely filed on or after November 18. Until the new rules become effective, the Division's Office of the Chief Accountant will consider written requests by registrants for waiver of financial statements requirements under existing rules to the extent consistent with the requirements of the new rules. The

requested relief may be for any transactional filing made effective or mailed on or after October 18, 1996, or any Exchange Act filing timely filed on or after that date. Written request for waivers should be made prior to the date financial statements are required to be filed under the present rules. The staff will not consider any request to waive financial statements that were due prior to October 18. The change in the rules will not result in a registrant being deemed a timely filer if it failed to timely provide financial statements pursuant to the old rules and did not receive a waiver for their omission. Omission of financial statements pursuant to a granted waiver will not affect the registrant's status as timely filer. If a Form 8-K was filed timely to report an acquisition on or after September 19, that form's amendment filed on or after November 18 to furnish audited financial statements of the business need to comply only with the new rule. With respect to amendments to Form 8-K required to be filed between October 18 and November 18 following initial reports of acquisitions filed after August 20, the staff will consider registrants' timely requests for waiver of the requirements to the extent permitted under the new rules. A summary of the new rules is attached to these highlights.

VII. AUDITOR DETECTION AND REPORTING OF ILLEGAL ACTS

Scott Bayless reported that the Commission has proposed rules to implement the reporting requirements of Section 10A of the Exchange Act which was added by the Private Securities Litigation Reform Act of 1995. Section 10A codifies the auditor's responsibilities to include procedures designed, in accordance with generally accepted auditing standards, as may be modified or supplemented by the Commission, to identify illegal acts, identify related parties and evaluate an entity's ability to continue as a going concern. In addition, Section 10A expands the auditor's responsibility to report certain broadly defined "illegal acts." Illegal act are defined by Section 10A to mean "an act or omission that violates any law, or any rule that has the force of law." If an auditor becomes aware of information that an illegal may have occurred (regardless of its materiality) then the auditor must determine whether it is likely that an illegal act has occurred, consider the possible effect on the financial statements of the issuer (including fines, penalties, and damages), and, as soon as practicable, inform the appropriate level of management and assure that the audit committee or board of directors is adequately informed of the illegal act. Once the auditor has determined that the illegal act has a material effect on the financial statements of the issuer, that management has not taken appropriate corrective action, and that the illegal act is reasonably expected to warrant departure from the auditor's standard audit report or the auditor's resignation, then the auditor must report such failure to take corrective action to the audit committee or board of directors. Within one business day receiving such a report, the board is required to report to the Commission that it has received the report and furnish the auditor with a copy of the notice to the Commission. If the auditor does not receive notice of the report within the required one business day, then the auditor is required to notify the Commission within the following business day. Section 10A, through other provisions of the Exchange Act, provides for penalties of up to $500,000 for an auditor's failure to notify the Commission. Mr. Bayless pointed out that the proposed rule would exempt an auditor's Section 10A report to the Commission from Freedom of Information Act requests to the same extent as Commission investigative records which are exempt as long as the Division of Enforcement has an open case with respect to the matter. The proposed release would also conform the definition of "audit" in Regulation S-X with Section 10A by noting that audits of financial statements of Commission registrants should be performed in accordance with

generally accepted auditing standards as may be modified or supplemented by the Commission. Neither Section 10A nor the proposed release alter existing public reporting requirements such as the Form 8-K change of auditors report.

VIII. PROPOSED RULES ON DERIVATIVES DISCLOSURES

The staff has received over 100 comment letter on the proposed rules, and is considering how to proceed in light of the comments. They expect the Commission to issue final rules by year end. A number of commentors suggested flexibility in choosing the method of reporting so that trading and non-trading activities could be reported using different methods. Many commentors asked for more time to implement the final rules, since disclosures under the proposed rules would be required for calendar year 1996 financial statements.

IX. SAB 96 IMPLEMENTATION ISSUES -- HIGHLIGHTS OF JULY 31 MEETING

Steve Swad reported that the staff is close to approving the highlights of the Committee and staff's July 31 joint discussion of SAB 96 implementation issues.

X. ACCOUNTING CHANGES BY A SPINNEE IN A SPINOFF

Bob Herz reported that the Committee discussed the issue of accounting changes by a spinnee in a spinoff and concluded that the spinnee in a spinoff transaction may make a retroactive change in accounting principle in accordance with paragraph 29 of APB 20, as well as other subsequent changes in accounting principles under APB 20, provided the spinnee is no longer consolidated in the spinnor's financial statements and provided that any such changes meet the Commission's preferability requirements. Robert Bayless stated that the staff will consider the Committee's position in their review of the issue.

XI. LTO ACCOUNTING AND 16b-3 REPORTING

The SEC recently adopted amendments that eliminate the prohibition against transfer of derivative securities as a condition of exemption from the short-swing profit recovery provisions of Section 167 of Exchange Act. Some registrants are considering whether to elect to modify terms of their existing plans and outstanding options to remove transferability restrictions. The registrants and their auditors should be aware that changes in the terms of outstanding options may trigger a new measurement date under APB Opinion No. 25 and EITF No. 87-6, and may, in some circumstances, disqualify a business combination from being accounted for as a pooling of interests pursuant to paragraph 47 (c) of APB Opinion No. 16.

XII. PHYSICIAN PRACTICE MANAGEMENT (PPM) ARRANGEMENTS

After the meeting, Robert Bayless furnished the following summary of significant issues and current staff views pertaining to the accounting and reporting by physician practice management companies (PPMs).

Significant accounting and disclosure issues are presented by the changing structure of the health services sector and the diversity in arrangements between physicians and providers of management and administrative services. Many PPMs are

developing new forms of relationships with groups of medical practitioners that participate in a health care delivery system devised by the management company.

The PPM may assist in the formation of medical practitioner groups with which it contracts to be the exclusive provider of facilities, equipment and non-medical services and exclusive agent to obtain managed care contracts. Typically, members of the groups must agree to convey substantially all of their existing medical facilities and equipment to the PPM, and must enter into various employment, noncompete and operating agreements with each other that govern the affairs of the group and its relationship with the PPM. The PPM does not have voting control over the medical practitioner entities in the form of an equity interest. However, the PPM may participate through a services agreement in the net profits of the medial practice entities, and have substantial authority as the exclusive manager, contracting agent and holder of title to the tangible assets used in the medical practices. In some circumstances, the PPM may guarantee a return to the medical practitioner or be obligated to fund certain losses or liabilities incurred by the medical practitioner entities.

Many PPMs currently present the revenues and expenses of the medical practices entities as their own revenues and expenses, treating the medical practice's gross revenues net of amounts earned by the PPM under the services agreement as compensation expense or capital distribution to the employee-owners of the medical practice entities. Some companies believe that presentation is required because of the existence of a parent-subsidiary relationship between the PPM and the medical practice entities.

The staff understands that agreements between PPMs and medical practice entities vary in their design and often are individually negotiated. Under those contracts, the PPM incurs varying degrees of risks inherent in a medical practice and varying degrees of risk inherent in providing prepaid medical care, as well as risks typical to other providers of administrative and management services. The staff has increasingly become concerned that the currently prevalent analysis overlooks unique aspects and varying risk profiles of the individual arrangements.

In recent months, the staff has challenged representations in the financial statements that the PPM - medical practice relationship is equivalent to a parent-subsidiary relationship. That representation appears inappropriate where underlying contracts and disclosures outside the financial statements identify substantive rights of the medical practitioners over the medical practice entities. Also, the characterization of the establishment of relationships with the medical practices as "practice acquisitions" may fail to accurately reflect the substance of the arrangements. It is unclear whether presentation of the medical practice entity as a consolidated subsidiary is the most fair and accurate depiction of the PPM's incurred and contingent liabilities, the nature of amounts accruing to physicians, or the actual business and operational risks of the PPM. Since some stock valuation models currently focus on the PPM's reported revenues, inclusion of the client practice's revenues in the absence of a material net profits interest in that client may lead to significant abuses.

Some PPMs have developed mechanisms under which they may cause ownership of the medical practice to transfer to the PPM or to persons selected by the PPM. If exercise of those mechanisms would be substantive, legally binding, and within the

discretion of the PPM at nominal cost and without adverse consequence, consolidation of the medical practice may be required. However, the staff can be expected to inquire as to the substance and effectiveness of those mechanisms in the medical practice environment.

The Emerging Issues Task Force has agreed to address accounting and reporting issues surrounding the business structures adopted by many PPMs. Those issues include: (a) Under what circumstances is the establishment of a management or agency relationship with an operating business the acquisition of that business? (b) Under what circumstances does the establishment of such a relationship constitute a "pooling of interests?" (c) Under what circumstances would such a relationship result in a parent-subsidiary relationship? (d) How should amounts retained by or distributed to owners of the client be presented in the financial statements of the manager/agent? (e) If consolidation is not appropriate, under what circumstances may part or all of the client's revenues, expenses, assets and liabilities be included in the financial statements of the manager/agent? Other issues, including the mechanisms providing for transfer of practice ownership, will be discussed by the EITF.

The staff has determined that it will not object at the present time to display of the revenues and expenses of the medical practices in the statement of operations of a PPM if the terms of the servicing agreement provide the PPM with a net profits or equivalent interest in the preponderance of the medical services furnished by the individual medical practice. However, the staff believes that disclosures furnished in the financial statements should be no less complete than if the display of revenues and expenses were limited to those of the PPM itself. That is, revenues and expenses of the PPM should be disclosed separately on the face or in a note to the financial statements with meaningful explanation. Lease income from the medical practices and associated disclosures required by SFAS 13 should be furnished. The PPM's actual aggregate services fee income and material contract terms bearing on the calculation of that amount should be disclosed. SG&A of the PPM should be determinable. All material commitments and guarantees of the PPM to the medical practices, and material amounts paid under those arrangements, should be disclosed.

If a PPM obtains a net profits or equivalent interest in the client medical practice, the staff believes that the audited historical financial statements of the medical practice are likely to be material to investors. The staff has looked to the significance tests of Rule 3-05 of Regulation S-X as general guidance concerning the need for audited financial statements if establishment of such a relationship has occurred or is probable. However, if the terms of the arrangement are such that the PPM does not obtain a net profits interest in the historical medical practice, but will obtain such an interest only in new business generated by original efforts of the PPM, complete audited financial statements of the medical practice may not be warranted. If the management fee is calculated as a percentage of the medical practice's gross or adjusted revenues, then less comprehensive, unaudited financial information about the client medical practice may be warranted.

Acquisition Financial Statements

On October 8, 1996, the Commission adopted amendments to Rule 3-05 of Regulation S-X to streamline the requirements for financial statements of significant businesses acquired or to be acquired (Release No. 33-7355). Conforming changes were also made to Item 310 of Regulation S-B and the requirements of Form 8-K. The amendments will permit issuers, other than "blank check" issuers, to proceed with a registered offering without the financial statements of a business acquired or likely to be acquired until 75 days after the acquisition is consummated, except that financial statements of a recent or probable acquisition will continue to be required in registration statements if the acquiree exceeds the 50% level of significance compared to the issuer.

The amendments also revise the thresholds for determining the financial statements of acquired businesses that must be provided under both the Exchange Act and Securities Act. The amendments eliminate the requirement to provide financial statements for businesses falling below the 20% significance level, and require one, two or three years of audited financial statements for acquisitions at the 20%, 40% and 50% significance levels, respectively. The thresholds were formerly 10%, 20% and 40%.

Under the amendments, financial statements of individually insignificant businesses must be furnished in registration statements only if, in the aggregate, they exceed the 50% significance level. In that case, financial statements of the substantial majority of the businesses would be required. The rule previously required financial statements if the businesses aggregated to a significance exceeding 20%.

For purposes of evaluating the significance of an acquired business and the years for which financial statements are required, the amendments stipulate that acquisitions of "related businesses" must be treated as a single business acquisition. Businesses are deemed to be related under the rule if they are under common control or management, or their acquisitions are dependent on each other or a single common event or condition.

The new rules provide that no pro forma information relating to a business acquisition is required under Article 11 of Regulation S-X unless the audited financial statements are furnished. Companies will continue to provide required disclosures relating to business acquisitions pursuant to Item 303 of Regulation S-K (Management's Discussion and Analysis) and generally accepted accounting principles.

The amendments do not change Rule 3-14 (Acquisitions of Real Estate Properties) or the requirements of Form S-4 and the proxy rules regarding financial statements of the business acquisition that is the subject of those filings. Also, the amendments do not change the percentages or methods of evaluating significance for purposes of Staff Accounting Bulletin 80 (Topic I:J), although the staff is considering whether revisions to that guidance should be developed.

The amendments also are applicable to foreign private issuers and to acquired foreign businesses. However, the amendments do not change the requirements for reconciliation of financial statements of acquired foreign businesses, nor do they

impose any new interim reporting requirement for foreign issuers. Under the amendments, a foreign issuer need not furnish financial statements of a probable acquisition or an acquisition consummated within 74 days prior to effectiveness unless it exceeds the 50% significance level. In that case, audited financial statements of the foreign business must be furnished for three years, but need be reconciled only for the most recent two years and any required interim period. If financial statements of an acquiree are omitted from a registration statement because it falls below the 50% threshold, a foreign private issuer is not required to furnish those financial statements in any later Exchange Act filing unless they are required by the issuer's home country rules or are otherwise furnished in the issuer's domestic market.