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SEC Year in Review

Significant 2000 Developments

Executive Summary

During 2000, the SEC continued its focus on building investor confidence and discouraging abusive "earnings management." Although the SEC did not issue a significant number of new rules, it issued a number of releases clarifying existing rules and/or facilitating their application.

The SEC's most notable accomplishment was the adoption of the controversial Regulation Fair Disclosure. With the ever-increasing number of individuals investing in the stock market, the SEC was concerned that those investors were not receiving information at the same time as analysts and institutional investors. The purpose of this new regulation is to eliminate selective disclosure of material nonpublic information.

Revenue continues to be the most often manipulated item in financial reporting frauds. In 1999, the SEC staff issued Staff Accounting Bulletin 101 (SAB 101), *Revenue Recognition in Financial Statements*, to summarize its views regarding the application of generally accepted accounting principles (GAAP) to revenue recognition. In 2000, the staff received numerous requests regarding the implementation of the guidance in this SAB. They twice deferred its effective date and late in the year issued further guidance in a question and answer format.

Another achievement was the modernization of the independence rules for auditors. The new rules, which were adopted after much controversy, focus primarily on three areas: (1) the scope of non-audit services provided by audit firms to their clients; (2) investments by auditors and their family members in audit clients; and (3) employment relationships between auditors and audit clients.

The year 2000 was a record year for foreign filers. Over 200 foreign initial public offerings became effective. During the year, the SEC staff provided interpretative guidance on the revised 20-F rules now in effect and continued their deliberations regarding the use of international accounting standards by foreign registrants. Another significant SEC initiative during the past year was the publication of *International Financial Reporting and Disclosure Issues in the Division of Corporation Finance*.

During 2000, Arthur Levitt announced his decision to step down as Chairman of the SEC. The last few years of his tenure were marked by a period of unprecedented growth in our economy, fueled in part by tremendous

growth in our capital markets. This growth was due in part to a significant increase in the number of individual investors, as well as outside investment into the U.S. markets. Chairman Levitt's initiatives have focused on protecting the individual investor and increasing transparency in financial reporting. His successor will undoubtedly have his/her own goals, which will shape the regulatory environment in the securities industry in the near future.

Regulation FD

In August 2000, the SEC adopted new Regulation Fair Disclosure (FD) due to the concern that issuers were disclosing important nonpublic information to securities analysts or selected institutional investors before making full disclosure of the same information to the general public. The new rules are applicable to all domestic registrants that have securities registered under Section 12 or that must file reports under Section 15(d) of the Exchange Act. Investment companies, other than closed-end investment companies, foreign governments, and foreign private issuers, are excluded from the rule.

The basic rule under Regulation FD states that when an issuer, or someone acting on its behalf, discloses material nonpublic information to certain persons, it must publicly disclose that information. "Certain persons" include security market professionals such as analysts, broker-dealers, investment advisers and institutional investment managers. Material nonpublic information, though not specifically defined in the regulation, would be information that a reasonable shareholder would consider important. This could include information such as earnings/losses; mergers; new products; events related to the company's securities; bankruptcy of the company; or a change in control, management or auditors. If the selective disclosure is intentional (i.e., the issuer knows that the information is both material and nonpublic), the issuer must simultaneously disclose the information to the public. However, if the disclosure is not intentional, the issuer has until the later of 24 hours or the start of the next day's trading to publicly disclose the information.

The SEC lists the following as means of acceptable public disclosure:

- Form 8-K;
- Press release through a widely disseminated news or wire service; or
- Making an announcement at a press conference or in a conference call if interested members of the public have been provided with adequate notice of the timing and location of the disclosure.

The new rule also amended Form 8-K. Under the amendment, an issuer may report a matter under new section "Item 9. Regulation FD Disclosure" or under amended section "Item 5. Other Events and Regulation FD Disclosure." A matter reported under Item 5 would automatically be incorporated into future filings, while a matter reported under Item 9 would not. The decision as to whether a matter should be disclosed under Item 5 or 9 is a legal issue.

The failure to comply with Regulation FD does not affect "current" or "timely" status for the purposes of using Forms S-2, S-3, S-8 and Rule 144. However, if an issuer fails to comply with Regulation FD, it would be subject to an SEC enforcement action for violating Section 13(a) or 15(d) of the Exchange Act and Regulation FD.

The SEC also has published a Q&A regarding Regulation FD that can be found on the SEC's Web site in the Division of Corporation Finance's *Manual of Publicly Available Telephone Interpretations*.

Frequently Asked Questions Regarding SAB 101

In December 1999, as part of the initiative to address "abusive" earnings management, the SEC staff issued SAB 101. According to the SEC staff, SAB 101 does not change GAAP. Rather, it summarizes, in one location, existing guidance and recaps the staff's views regarding the recognition, presentation and disclosure of revenue in financial statements. After its issuance, the staff received numerous requests for additional time to determine the effect, if any, SAB 101 would have on revenue recognition practices, as well as inquiries about how to apply the guidance to particular transactions. During 2000, the staff issued SABs 101A and 101B to delay twice the effective date of SAB 101. In late 2000, after working with representatives of major accounting firms, public registrants and a variety of industry groups, the SEC provided further guidance on revenue recognition in the form of a Commission Notice: *Staff Accounting Bulletin No. 101: Revenue Recognition in Financial Statements – Frequently Asked Questions and Answers*. A copy of the Q&A can be found on the SEC's Web site under "Current SEC Rulemaking."

SAB 101 provides guidance for improving financial reporting by stressing the basic criteria a registrant must meet before recording revenue. When implemented, it may significantly amend practice and have a pervasive impact on the timing of revenue recognition for many companies. Under the SAB, revenue should not be recognized unless:

- Persuasive evidence of an arrangement exists;
- Delivery has occurred or services have been rendered;
- Collectibility is reasonably assured; and
- Seller's price to the buyer is fixed or determinable.

SAB 101 also discusses the application of the guidance to specific examples, including bill-and-hold transactions, long-term service transactions, refundable membership fees, contingent rental income, and up-front fees when the seller has significant continuing involvement. In

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addition, SAB 101 addresses whether revenue should be presented at the gross transaction amount or on a net commission or fee basis when the seller is acting in a capacity similar to that of a sales agent. Finally, the SAB provides guidance on disclosure about revenue recognition policies that should be included in the financial statements, and the impact of events and trends on revenue that should be included in MD&A.

The FAQ provides answers to 31 questions on a variety of revenue recognition topics including:

- Significance of title transfer;
- Meaning of substantial performance, customer acceptance and unfulfilled obligations;
- Effect of undelivered elements on nonrefundable fees;
- Conditions for recognition of refundable service revenue;
- Accounting for certain costs of revenues, estimates and changes in estimates; and
- Whether fees are fixed or determinable.

SAB 101, as amended by SAB 101B, is effective no later than the fourth fiscal quarter of fiscal years beginning after December 15, 1999. As such, the provisions are effective for year 2000 for calendar-year companies. The SEC staff generally will not require retroactive restatement of prior period financial statements so long as the registrant's former policy was not an improper application of GAAP and the registrant reflects the adoption as a change in accounting principle in accordance with APB 20, *Accounting Changes*.

Observation:

The Emerging Issues Task Force is also addressing several issues related to revenue recognition, some of which build on the guidance in SAB 101. *The issues include gross versus net presentation, the accounting for and timing of sales incentives, and the accounting for point and loyalty agreements.*

Revision of the Commission's Auditor Independence Rules

In November 2000, the SEC issued amendments to modernize its rules for determining whether an auditor is independent and to expand proxy disclosure requirements for non-audit services. The new rules, which take a much more moderate approach than those originally proposed by the SEC, were adopted unanimously after extensive negotiations with the American Institute of CPAs and other representatives of the accounting profession. The new independence rules apply to all auditors (including non-U.S. auditors) that submit audit reports in SEC filings. The rules, first proposed in June, were adopted after considering approximately 3,000 comment letters and written and oral testimony from public hearings. The amendments generally take effect on February 5, 2001, although certain restrictions will become effective over an 18-month transition period. The rule changes are based on the assumption that investor confidence in auditor independence is dependent on whether the auditor is in fact independent and whether a reasonable investor would conclude, in light of all relevant facts and circumstances, that the auditor is capable of exercising objective and impartial judgment.

In summary, the rules:

- Significantly reduce the number of audit firm employees and their family members whose investments in, or employment with, audit clients impair an auditor's independence;
- Identify certain non-audit services that would impair an auditor's independence; and
- Require certain disclosures in annual proxy statements regarding non-audit services provided by the auditor during the last fiscal year.

Proxy disclosure of services

The SEC and others have expressed concern that the performance of non-audit services for audit clients might impair the fact or appearance of independence. Rather than prohibit auditors from providing any non-audit services to audit clients, the SEC adopted a two-pronged approach. First, the rules specify nine non-audit services that, if provided by auditors to an audit client, may be deemed inconsistent with an auditor's independence. Second, the new rules require the following disclosures in annual proxy statements filed after February 5, 2001:

- Fees billed or expected to be billed for the audit of the annual financial statements in Form 10-K or 10-KSB and the reviews of the financial statements included in Forms 10-Q or 10-QSB for that year;
- Fees for information technology services;
- Total fees for other services provided (e.g., tax services unrelated to the income tax accrual, work on registration statements, M&A work, or other consulting); and
- Whether the board of directors or the audit committee has considered whether the non-audit services are compatible with maintaining the auditor's independence.

The required disclosures need only be made in the proxy statement relating to an annual meeting of shareholders at which directors are to be elected. Companies reporting solely under Section 15(d) of the Exchange Act and foreign private issuers need not make the disclosures since they are not subject to the proxy rules.

A separate *Financial Reporting* letter devoted to the new independence rules will be issued shortly.

Responsibilities of Audit Committees

In 1999, the SEC adopted rules on "Audit Committee Disclosure." In addition to requiring the timely

review of interim financial information in Forms 10-Q and 10-QSB, the rules require proxy and information statements relating to shareholder votes occurring after December 15, 2000 to include the following:

- A report from the audit committee stating that the committee has: (a) reviewed and discussed the audited financial statements with management; (b) discussed with the auditors matters required to be discussed under SAS 61 and SAS 90; and (c) received disclosures from the auditors regarding the auditor's independence.
- A statement as to whether, based on the review and discussions noted above, the audit committee recommended to the Board of Directors that the audited financial statements be included in the company's Form 10-K or 10-KSB.
- Disclosure as to whether the audit committee has a written charter. If so, a copy must be filed at least once every three years.
- Information concerning the independence of the audit committee members.

The rules require that all companies (except small business issuers or foreign private issuers) provide in Form 10-K a note containing quarterly information and a reconciliation and description of any adjustments made to quarterly information previously reported in a Form 10-Q. This quarterly information is required in annual filings made after December 15, 2000.

International Disclosure Standards

In September 1999, the SEC adopted new rules to update and simplify its disclosure requirements for foreign private issuers. The changes became effective for registration statements filed on or after September 30, 2000 and for annual reports filed with fiscal years ending on or after September 30, 2000. The new rules conform to the international disclosure standards endorsed by the International Organization of Securities Commissions (IOSCO). They enable issuers to prepare one basic disclosure document that will be accepted in many jurisdictions and replace most of the non-financial statement disclosure requirements of Form 20-F, the basic disclosure document for foreign private issuers. The SEC also made changes to the registration statements used by foreign private issuers under the Securities Act of 1933 to incorporate the changes in Form 20-F, and revised the definition of "foreign private issuer" to clarify how foreign companies should determine whether their shareholders are U.S. residents. The amendments do not change the financial statement reconciliation requirements for foreign private issuers, nor do they eliminate the disclosure requirements for topics not covered by the international disclosure standards, such as market risk.

Changes in audit report

The new rules require that the audits of foreign private issuers be performed in accordance with U.S. generally accepted auditing standards (GAAS) and that the audit reports specifically make reference to U.S. GAAS. The past practice of stating that the audits were conducted in conformity with home-country GAAS which is "substantially similar" to U.S. GAAS is no longer acceptable. Except in two limited situations, the audit report on comparative prior financial statement periods should state that the audit was conducted in conformity with U.S. GAAS for all periods presented. The exceptions involve existing registrants that changed auditors in prior periods and Canadian registrants. In these two limited situations, former auditors may reissue their reports using "substantially similar" language, and Canadian registrants, although strongly encouraged by the SEC staff to cite U.S. GAAS, may continue to cite Canadian GAAS for comparative prior periods.

Age of financial statements

The SEC replaced Rule 3-19 which specifies the content, age and other requirements for financial statements of foreign private issuers with a new Item 8 of Form 20-F. The only substantive change relates to the age of financial statements. Item 8 requires that audited annual financial statements be no older than 15 months at the effective date of the registration statement, instead of the 18 months allowed under Rule 3-19. Basically, a foreign registrant is required to update a registration statement with audited annual financial statements three months after its fiscal year. Item 8 further requires interim financial statements if the registration statement is dated more than nine months after the last audited fiscal year, instead of the ten months allowed under Rule 3-19. Such interim financial statements may be unaudited but must cover at least six months of the issuer's fiscal year and, in accordance with U.S. GAAS, must be reviewed under the guidance of SAS 71, *Interim Financial Information*.

Definition of "foreign private issuer"

The definition of foreign private issuer (Rule 405 under the Securities Act and Rule 3b-4 under the Exchange Act) determines an issuer's eligibility to use certain SEC forms and to benefit from certain concessions under the SEC rules. There are two parts to the foreign private issuer definition. The first part deals with determining whether U.S. residents hold more than 50% of an issuer's outstanding voting securities. The second part is based on whether: (a) a majority of the issuer's executive officers or directors are U.S. citizens or residents; (b) over 50% of its assets are within the United States; or (c) its business is administered principally in the United States. If an issuer has majority U.S. ownership and meets any one of these three fac-

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tors, it does not satisfy the foreign private issuer definition. The new rule retained the two-part test but revised the first test from a record ownership test to one that more closely reflects the beneficial ownership of the issuer's securities.

Specific changes to registration and report forms

Form 20-F is used by foreign private issuers to register shares or as an annual report form under the Exchange Act. The amendments to Form 20-F replaced prior items 1 through 14 of Form 20-F with ten new items that follow the wording of the IOSCO disclosure standards. Previously required disclosures involving market risk, defaults under senior securities, and changes in securities were retained. Additionally, old Items 17 and 18 were also retained. These two items outline the financial statement requirements for registration statements and annual reports and the type of reconciliation to U.S. GAAP that must be provided by issuers preparing financial statements under home-country GAAP or international accounting standards.

Financial Requirements of Issuers and Guarantors of Registered Securities

In August 2000, the SEC adopted amendments to the rules governing the financial requirements of issuers and guarantors of registered securities. The revision was issued to clarify the guarantor financial statement requirements and to reflect the current staff interpretation of those requirements. The revisions supersede SAB 53, *Financial Statement Requirements Where Securities Are Guaranteed by Parent or Subsidiary*.

Over the years it has become more commonplace for a parent company to raise capital through (a) the offering of its own securities that are guaranteed by one or more of its subsidiaries, or (b) the offering of securities by a subsidiary that are guaranteed by the parent and sometimes one or more of the parent's other subsidiaries. Under the Securities Act of 1933, guarantees of securities are considered securities themselves. As a result, every guarantor of a registered security and every issuer of a registered security that is guaranteed must file the financial statements required for a registrant by Regulation S-X. This general rule in Rule 3-10(a) remains unchanged.

The revisions to the rule clarify when a registrant may provide modified financial information in lieu of separate guarantor or issuer financial statements. Summarized information for the issuer or the guarantor, previously allowed under SAB 53, is no longer an acceptable alternative. Specifically, modified information may be provided if the subsidiary issuer or subsidiary guarantor is 100% owned by its parent and the guarantee is full and unconditional. A subsidiary is 100% owned if all of its outstanding voting shares and any outstanding securities convertible into its voting shares (e.g., stock options and convertible debt) are owned directly or indirectly by its parent company. A guarantee is full and unconditional when the payment obligations of the issuer and guarantor are essentially identical and the guarantor's obligation is immediately triggered on the issuer's failure to pay. For example, the amounts and payment schedules must be the same and there can be no requirement to first exhaust remedies against the issuer.

A registrant meeting the above criteria should disclose condensed consolidating information in a note to the financial statements with separate columns for the parent, subsidiary issuer, guarantor subsidiaries on a combined basis, any other subsidiaries on a combined basis, consolidating adjustments and total consolidated amounts. Additionally, such information should include a consolidating balance sheet, statement of operations and statement of cash flows.

The revised rules also describe situations in which no condensed information would have to be disclosed as long as the facts are disclosed in a note to the financial statements. For example, financial information could be omitted if the parent has no independent assets or operations and any subsidiaries of the parent other than the issuer or guarantor are minor.

The revisions added Exchange Act Rule 12h-5, which provides an exemption from periodic reporting (i.e., Form 10-Ks and Form 10-Qs) for subsidiary issuers and subsidiary guarantors where parent company periodic reports include modified financial information.

The revised rules were effective September 25, 2000. Any registration statements that are filed on or after the effective date must comply with the amended rules. With regard to periodic reports, registrants must comply with the new rules in the annual reports for the first fiscal year ending after September 25, 2000 and in all quarterly filings for subsequent periods. Once effective, the financial statements must reflect the application of the amended rule for all periods presented.

Financial statement requirements for affiliates whose securities are pledged as collateral for a registered security, that were originally addressed in Rule 3-10, have not been changed. The requirement however is now addressed under Rule 3-16 and no relief from providing full financial statements is available.

Regulation M-A

The SEC adopted revisions to the rules and regulations applicable to takeover transactions (including tender offers and mergers and acquisitions). The rules were

intended to balance the treatment of cash and stock tender offers, simplify and centralize the disclosure requirements, and eliminate regulatory inconsistencies in mergers and tender offers.

In general terms, the more significant of the new rules:

- Loosen the existing restrictions on communications with security holders by allowing the release of more information on a timely basis;
- Balance the treatment of stock and tender offers by permitting both issuer and third-party stock tender offers to commence as early as the filing of a registration statement;
- Simplify and integrate the various disclosure requirements for tender offers and going-private transactions in a new series of rules within Regulation S-K;
- Combine the existing schedules for issuer and third-party tender offers into one schedule available for all tender offers; and
- Require a "plain English" summary term sheet in all tender offers, mergers and going-private transactions.

Most importantly, the new rules update and reduce the financial statement requirements in certain takeover transactions.

Cash merger and cash tender offers
Financial statements and other information about the acquiror in a cash merger is required only if the information is material to the shareholders' evaluation of the transaction. Such information generally would not be needed when the consideration is solely cash and the acquiror has demonstrated its financial ability to satisfy the offer terms (i.e., the offer is not subject to any financing condition). However, if considered material (e.g., the target shareholders are voting and financing is not assured), such information is only required for two years, rather than the three years previously required. Financial statements and other information about the target in a cash merger are required only if the acquiror's shareholders are voting on the transaction.

The rules do not change the requirement to provide financial statements and other information for the target in merger proxies that are going-private or roll-up transactions. The SEC believes that in these types of transactions the target shareholders need current financial statements of their company.

Stock mergers and stock tender offers
Financial statements for targets not subject to the SEC's reporting requirements (i.e., non-reporting company) are generally not required if the acquiror's shareholders are not voting on the transaction. In such situations, the target's shareholders would not expect to receive the same level of information required for a public reporting company and would most likely rely on the acquiror's financial statements for voting/investment decisions. However, if the target's significance to the acquiror as determined under Rules 3-05 and 1-02(w) of Regulation S-X is more than 20%, the following is required:

- GAAP financial statements for the latest fiscal year, and
- GAAP financial statements for the two fiscal years before the latest fiscal year, but only if such financial statements were previously provided to the target's shareholders.

For foreign targets, the financial statements may be prepared under a comprehensive basis of accounting other than U.S. GAAP (i.e., home-country GAAP or international accounting standards). In such cases, a reconciliation to U.S. GAAP is also required.

Additionally, to the extent financial statements for the non-reporting target are required, the requirements to have them "audited" remain unchanged. Specifically, for merger proxies and Form S-4 registration statements not being used for resale, financial statements for the latest fiscal year must be audited only to the extent practicable, and audited financial statements are not required for years before the most recent fiscal year if such statements had not previously been audited. This exception is not available for any other form.

Use of Electronic Media

The SEC first published its views on the use of electronic media to deliver information to investors in 1995. The 1995 release provided guidance on electronic delivery of prospectuses, annual reports and proxy solicitation materials. The SEC's 1996 electronic media release focused on electronic delivery of required information by broker-dealers, transfer agents and investment advisers. In April 2000, the SEC issued additional interpretive guidance on the use of electronic media that addressed the following areas: (1) use of electronic media to deliver documents under the federal securities laws; (2) issuer's liability for Web site content; and (3) basic legal principles that issuers should consider in conducting online offerings.

Use of electronic media to deliver documents under the federal securities laws
Evidence of delivery is one of the elements of satisfactory electronic delivery. The 1995 release provided that one method of satisfying the evidence-of-delivery requirement is to obtain an informed consent from an investor to receive information through a particular electronic medium. The 1996 release required that informed consent should be evidenced by written or electronic means. The new release clarifies, among other things, that:

- Investors may consent to electronic delivery telephonically;
- Issuers and intermediaries may deliver documents in portable document format (PDF), with appropriate measures to assure that investors can easily access the documents; and
- An embedded hyperlink within a prospectus or any other

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document required to be filed or delivered under federal securities laws causes the hyperlinked information to be part of that document.

Liability for Web site content

Issuers have raised a number of questions about their responsibility for the content of their Web sites, both when they are in registration and when they are not. The new release cautions issuers that the federal securities laws apply in the same manner to the content of their Web sites as to any other statements made by or attributable to them. Specifically, issuers are responsible for the accuracy of their statements that can reasonably be expected to reach investors or securities markets. Whether third-party information is attributable to an issuer depends on the issuer's involvement in the preparation of the information and its explicit or implicit endorsement/approval of the information. The new release does not provide a "bright line" mechanical test. Rather, it provides a framework of factors to consider in determining whether an issuer has adopted information from a third-party site to which the issuer is connected via a hyperlink including:

- Context of the hyperlink. For example, in the context of a document required to be filed or delivered under the federal securities laws, the issuer is always deemed to be adopting the information when that issuer embeds a hyperlink in the document;
- Presence or absence of precautions against confusion about the source of information. For example, there may be less confusion about whether an issuer has adopted hyperlinked information if the issuer provides an intermediate screen indicating that the visitor is leaving the issuer's Web site and the subsequently viewed information is not the issuer's; and
- Presentation and layout of the hyperlinked information. For example, any action to differentiate a particular hyperlink (by size, font or color) may suggest that the issuer favors the hyperlinked information over other information available through the Web site.

An issuer in registration must consider the application of the Securities Act to all of its communications, including information on its Web site as well as information on a third-party Web site to which the issuer has established a hyperlink. The SEC recommends that an issuer in registration should carefully review its Web site and any information on third-party Web sites to which it hyperlinks. The SEC will permit Web site communications so long as they are limited to ordinary-course of business and financial information (e.g., advertisements about the issuer's products and services, press announcements concerning business and financial developments, or answers to unsolicited telephone inquiries concerning business matters from securities analysts).

EDGAR Modernization

In April 2000, the SEC adopted rule changes in connection with the modernization of its Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system.

The most significant change eliminates the requirement to submit Financial Data Schedules for any filings due on or after January 1, 2001. Filings due before January 1, 2001, regardless of when they are submitted, are required to include the schedules.

Additionally, EDGAR now includes the following features:

- The ability to include graphic and image files in HTML documents;
- The ability to use hyperlinks in HTML documents, including links between documents within a submission and to previously filed documents on the EDGAR database at *www.sec.gov*; and
- The addition of the Internet as an available means of transmitting filings to the EDGAR system.

Proposed Rules on Supplementary Disclosure Information

The SEC staff is still considering a proposal, released last year, to expand disclosures regarding valuation and reserve accounts. The proposal would require registrants to (1) increase disclosures about changes in valuation and loss accrual accounts, along with the underlying assumptions, and (2) provide more information about long-lived assets and related accumulated depreciation, depletion and amortization. The SEC staff received many comment letters on the proposed rule. Many registrants are concerned that the disclosures about loss accruals could be harmful due to the sensitive nature of the information that would be divulged. The SEC staff is currently considering alternatives to address the concerns.

Those, as well as other, proposed rules, final rules and speeches made by SEC officials can be obtained from the SEC's Web site at *www.sec.gov*.

Material discussed in this *Financial Reporting* newsletter 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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