

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

1. Respondent ArthroCare is a Delaware corporation headquartered in Austin, Texas. ArthroCare's stock is registered under Section 12(b) of the Exchange Act and is traded on NASDAQ. ArthroCare is a medical device company that develops, manufactures and markets surgical products, including products with the trade name SpineWands that were used by surgeons in the treatment of patients with spinal injuries.

2. DiscoCare, Inc. was a privately owned Delaware corporation incorporated in 2005. Based in Palm Beach, Florida, DiscoCare distributed ArthroCare products (especially SpineWands) until December 31, 2007, when it was acquired by ArthroCare. ArthroCare was DiscoCare's only supplier. At various times, DiscoCare was ArthroCare's largest distributor of SpineWands.

3. Between the fourth quarter of 2005 and the first quarter of 2008 (the "restatement period"), ArthroCare materially overstated and prematurely recognized revenue, primarily on sales of SpineWands to certain of ArthroCare's agents and distributors, including DiscoCare. Most of these transactions occurred at or near quarter-end and were intended to help the company reach aggressive internal revenue targets and satisfy analysts' revenue expectations. ArthroCare lacked an effective system of internal controls over sales, particularly with respect to its Spine Business Unit, where most of the improprieties occurred. This allowed ArthroCare sales personnel to withhold critical information on revenue recognition from the company's accounting staff.

4. During the restatement period, ArthroCare repeatedly turned to DiscoCare to help it overcome quarterly revenue shortfalls, by recording revenue from large orders shipped to DiscoCare at or near quarter-end. ArthroCare should not have recognized revenue from these shipments. The orders were initiated by ArthroCare employees for the purpose of filling shortfalls in meeting internal and external revenue targets. DiscoCare had no need for the excessive inventory and no reasonable likelihood of selling the products within a reasonable timeframe. Furthermore, ArthroCare accommodated DiscoCare by providing significantly extended payment terms, while also explicitly or impliedly agreeing that DiscoCare did not have to pay for the products until it had sufficient funds to do so.²

5. In addition, shortly after the close of the second quarter of 2006, ArthroCare employees arranged for DiscoCare to return products shipped just before quarter-end, while concealing from

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

² See Statement of Financial Accounting Standards No. 48, *Revenue Recognition When Right of Return Exists* ("FAS 48"), ¶ 6(b), which requires the buyer to have paid the seller, or the buyer to be obligated to pay the seller and the obligation not to be contingent on resale of the product, and ¶ 22, which clarifies ¶ 6(b) and provides "... if ... the buyer's obligation to pay is contractually or implicitly excused until the buyer resells the product, then the condition (for recording revenue in ¶6(b)) is not met."

ArthroCare's accounting staff the true reason for the product return. In fact, ArthroCare requested the product return only because the shipment had caused ArthroCare to exceed securities analysts' revenue targets, and the employees were concerned that this would cause analysts to set the next quarter's estimates too high. ArthroCare's recognition of revenue from sales to DiscoCare violated Generally Accepted Accounting Principles ("GAAP").³

6. ArthroCare also inflated revenue by mischaracterizing volume-based commission payments to distributors as fees for services. This enabled ArthroCare to record the gross amount of the sale as revenue and expense the commission, rather than recording the net revenue of the sale, as required by GAAP.⁴

7. Finally, on several occasions during the restatement period, ArthroCare recognized revenue from shipments of products to customers that did not conform to the customers' orders. ArthroCare also recognized revenue from products that it shipped after the products' expiration date had passed, which meant the products were not usable by an ultimate customer and therefore immediately returnable. ArthroCare's recognition of revenue from these sales violated GAAP.⁵

8. As a result of the conduct described above, ArthroCare violated Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13 and 12b-20 thereunder, which require every issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the Commission information, documents, and annual and quarterly reports as the Commission may require, and mandate that periodic reports contain such further material information as may be necessary to make the required statements not misleading.

9. As detailed above, ArthroCare's books, records, and accounts did not, in reasonable detail, properly reflect its sales and payments to distributors. As a result, ArthroCare violated Exchange Act Section 13(b)(2)(A).

10. In addition, ArthroCare failed to implement internal accounting controls relating to distributor sales to ensure these sales were accurately stated in accordance with generally accepted accounting principles and accurately reflected on its books and records. As a result, ArthroCare violated Exchange Act Section 13(b)(2)(B).

³ FAS 48, ¶ 6(b); *see also* Statement of Financial Accounting Concepts No. 5 ("CON 5"), ¶¶ 83-84, which states that revenues cannot be recognized until they are realized/realizable and earned. Revenues are realized when "products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash." Revenues are earned when "the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. An entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its on-going major or central operations"; *cf.* AICPA Statement of Position 97-2, *Software Revenue Recognition*, ("SOP 97-2"), ¶ 8.

⁴ *See* EITF 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*, ¶ 9.

⁵ *See* CON 5, ¶¶ 83-84; SOP 97-2, ¶ 8.

Cooperation and Remediation

In determining to accept the Offer, the Commission considered remedial acts undertaken by ArthroCare and the substantial cooperation provided by the company in connection with the Commission's investigation.

ArthroCare replaced its senior management team. In addition, ArthroCare (i) expanded its legal department and created a compliance department led by a newly hired Compliance Officer; (ii) hired a new Corporate Controller and International Controller, (iii) expanded its internal audit function; (iv) instituted enhanced preventative and detective controls relating to revenue recognition; (v) instituted quarterly ethics communications from senior management to employees; (vi) implemented a sub-certification process as part of its quarterly and annual financial reporting; (vii) adopted standard customer contracts and established rigorous approval requirements for modifying contracts; (viii) hired a contract administrator; and (ix) provided regular training on proper revenue recognition accounting and appropriate procedures for handling contracts.

During the investigation, ArthroCare (i) regularly updated the staff on its internal investigation; (ii) provided critical documents (organized by subject matter and witness) without waiting for staff requests or subpoenas; (iii) responded promptly and completely to the staff's requests for additional information; (iv) routinely granted the staff access to the company's consulting expert to discuss accounting and internal controls issues; (v) voluntarily produced for testimony witnesses who resided outside the United States and were beyond the staff's subpoena power; and (vi) provided the staff with a detailed analysis of its restatement, including a schedule of restatement categories and the impact on the company's historical financial statements.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in ArthroCare's Offer.

Accordingly, it is hereby ORDERED that:

Pursuant to Section 21C of the Exchange Act, ArthroCare cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder.

By the Commission.

Elizabeth M. Murphy
Secretary

Service List

Rule 141 of the Commission's Rules of Practice provides that the Secretary, or another duly authorized officer of the Commission, shall serve a copy of the Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order (“Order”) on the Respondent and its legal agent.

The attached Order has been sent to the following parties and other persons entitled to notice:

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