

SOME COMMON DEFICIENCIES IN FIRST FILINGS

and

PREPARATION FOR CONFERENCES WITH SEC STAFF

**Prepared by Sydney C. Orbach for a Course on
Filings with the SEC
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Presented by

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at New York, June 24, 1963**

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at San Francisco, July 8, 1963
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and

**Andrew Barr, Chief Accountant
of the Commission,
at Chicago, July 18, 1963**

The topics assigned to me this evening are "Some Common Deficiencies in First Filings" and "Preparation for Conferences with the SEC Staff."

Any discussion of commonly cited deficiencies on the financial statements in registration statements filed with the Securities and Exchange Commission can best be understood if related to the three principal areas of review--(1) summary of earnings, (2) detailed financial statements (including comments covering the narrative portion of the prospectus relating to the financial statements) and (3) Part II of the registration statement. The following comments are limited to filings on Form S-1 (the basic form) since any attempt to cover deficiencies cited on all the various forms in use under the Securities Act of 1933 would be impracticable. All deficiencies cited are usually considered in the light of materiality as related to the particular financial statements. As will be noted in the following discussion, the majority of our comments relate to the summary of earnings.^{*/}

Summary of Earnings

The following comments relate to the introductory paragraph which normally precedes the summary of earnings and is used for the purpose of "expertizing" the summary and also referring to the detailed financial statements and related footnotes included elsewhere in the prospectus:

1. When the complete statement of income is used in lieu of the condensed summary contemplated by Item 6 of Form S-1 (which presentation

^{*/} The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

is provided for by Item 21(b) of this form), it would appear to be appropriate to characterize the statement as a statement of income in this paragraph, in the accountants' certificate and wherever used in the registration statement.

2. When the results for the period covered show losses rather than income, which is quite common, for example, in the first years of a life insurance company, it is normally requested that this paragraph refer to a summary of operations or a statement of operations as appropriate with similar designation in the accountants' certificate.

3. When a consolidated summary for the five-year period is based upon an accounting presentation other than conventional historical results, such as a post balance sheet pooling of interests, requiring the recasting of subsidiaries to a common fiscal closing, or combining of subsidiaries with different fiscal closings to common twelve-month periods, it is normally expected that reference to the discussion in a note to the detailed financial statements of such presentation be made in the introductory paragraph. Material acquisitions by purchase during the period covered by the summary which result in a substantial increase in sales from one period to another should be the subject of brief comment with the date or dates of acquisition indicated.

4. When the principal accountant of the registrant relies upon the certification of other accountants in his report, the use of his name in the paragraph without reference to the other accountants is inappropriate. In such cases the language should read "This statement has

been examined by 'Jones, Smith & Co.' to the extent indicated in their report" or "which is based in part upon the reports of other accountants," etc. In addition, when the accountants' opinion is qualified, the introductory paragraph should so state, indicating the nature of the qualification.

With respect to the financial statements included in the summary, the following may be deemed to be a representative list of comments that have been cited for correction:

1. Rule 5-03(c) of Regulation S-X provides that if income is derived from both gross sales and operating revenues the two classes may be combined in one amount if the lesser amount is not more than 10 per cent of the sum of the two items. If these items are combined, cost of goods and operating expenses may be combined in one amount. Inquiry as to the related percentages involved has revealed violation of this rule and correction has been requested resulting in the separate statements of sales and related cost of sales and of operating revenues and related operating expenses.

2. The combining in one amount of cost of goods sold and selling, general and administrative expenses is contrary to the instructions in Rule 5-03 of Regulation S-X. In cases of companies whose sales are made to the United States Government under contracts which provide that such latter expenses are included in reimbursable costs the combining of the amounts is appropriate.

3. The provision for income taxes is required to be segregated between (1) Federal, (2) other (which normally consists of provision for foreign income taxes), and (3) provision for deferred income taxes. The requirement for the last item is discussed in Accounting Series Release No. 85 issued by the Commission. When the amounts of deferred taxes are not deemed material in relation to the overall provisions for income taxes, compliance with the required disclosure may be met by furnishing the annual amounts in a note to the financial statements generally keyed to the item of deferred taxes in the balance sheet.

4. The practice of certain companies of showing the amount of depreciation as a separate item in the statement of income is permitted provided the caption "cost of goods sold" is accompanied by the phrase "(exclusive of depreciation shown below)" and Schedule XVI is properly presented to show the allocation of depreciation as between cost of goods sold and other expenses.

5. The use of the caption "Special Charges or Credits" to designate items in the statement of income prior to the determination of net income is confusing in view of the language of "Special Items" used to denote those items listed under Item 17 of Rule 5-03 of Regulation S-X which are reflected in the statement after determination of net income. In such cases, a caption such as "Extraordinary Charges or Credits" is preferred. When such items are shown in the statement of income, preferable presentation would list such items (net of related income tax charges or benefits which should be separately stated) as the final items prior to the item of net income.

6. When common stock is being registered, Item 6 of Form S-1 requires that the earnings per share be given for all periods covered in the summary. Many comments have been directed to this particular item. For instance:

When a company has preferred stock outstanding, the aggregate amount of earnings applicable to common stock is required to be given in addition to the amount of net income. The presentation which is readily understandable would be to show as a deduction the annual provisions for preferred stock dividends following the items of net income in order to arrive at the required amounts. In some cases where cumulative preferred dividends have not been declared, corrections have been requested to show an accrual for such dividends in order to arrive at a proper amount of net income applicable to common stock.

The basis of determining the amounts of earnings per share, i.e., shares outstanding at respective year ends, average of shares outstanding in each period, or some other method appropriate under the particular circumstances, is requested to be furnished if not given in the original filing. In some of the smaller companies there seems to be a tendency to present per share data carried to three and four decimal places. No useful purpose would appear to be served by this practice. In most cases per share data rounded to the nearest cent should suffice.

The presentation of earnings per share has been the subject of numerous deficiencies when a registrant has had a stock split or a stock dividend has been declared after the balance sheet date which will be effected prior to the sale of the stock to the public; retroactive effect of such split or dividend is required for all periods covered.

Where there have been poolings of interest during the five-year period, the computation of earnings per share and presentation of dividends per share are reviewed on an individual basis to determine whether the computations appear proper under the circumstances of the particular case. Deficiencies have been cited when the earnings per share data as presented appears to be inconsistent with the general principles discussed above. With respect to per share dividends declared or paid, generally they are related to the registrant's historical record clearly identified and adjusted where appropriate.

In many cases the treatment of earnings per share data with respect to "special items" has required correction. Item 6 requires that "special items" (Item 17 of Rule 5-03 of Regulation S-X) be shown after the determination of net income. In certain instances a per share figure has been included for the combined amount of net income and special items. Our opinion is that this amount should be deleted. Such presentation is consistent with Item 2(c) of Accounting Research Bulletin No. 49 issued by the American Institute of Certified Public Accountants which reads, "Where material extraordinary charges or credits have been excluded from

the determination of net income, the per share amount of such charges and credits should be reported separately and simultaneously." When there are two or more special items in one period, the per share amount should be based upon the aggregate or net amounts of the special items.

The effect of carry-forward benefits upon the net income reported is ordinarily required to be highlighted by furnishing in a note the benefits, per share and in the aggregate, and further indicating the unused amount of carry-forward benefits and the year of expiration. When the alternate presentation discussed in Item 17(b) of Chapter 10, Taxes, Section B, of Accounting Research Bulletin No. 43 is used, the aggregate benefit need not be repeated in the note.

Footnote disclosure would also be required as to net income and per share amounts relating to operations of significant Puerto Rican subsidiaries under the ten-year tax exempt certificates granted by Puerto Rico. This disclosure is particularly important since the prospectus ordinarily discloses that no provision for U. S. income taxes on such undistributed earnings (which provision would be based upon a 52% rate) is reflected in the consolidated statements because of representations made that there is no intention of transferring such earnings to the parent company in a taxable distribution. This results in "freezing" the earnings for the ten-year periods.

Where a sale of common stock is made for the purpose of redeeming bank loans or other debt, it normally results in a dilutive effect on per share earnings. In these cases request is made for a supplementary

pro forma calculation of per share earnings for the last year or latest year and interim period, as appropriate, based upon shares outstanding plus such number of the shares to be sold, the net proceeds of which are required to retire the debt and adjusting net income for the interest, net of related tax effect, being eliminated. The basis for this comment is discussed in paragraph 11(b) of Accounting Research Bulletin No. 49.

A number of companies filing for the first time have had recapitalizations in which the stock sold to the public will have prior dividend preferences whereas the stock retained by management will either have nominal subordinate dividend rights or no dividend rights, in both cases with conversion rights over a period of years generally based upon fixed percentages. In such cases earnings per share are required to be computed upon the total number of shares of both classes of stock outstanding.

Accounting Series Release No. 96 issued by the Commission on January 10, 1963, discussed the proper method of reflecting the investment credit in filings with the Commission. Since the publication of that release, many deficiencies have been cited requesting compliance with the principles discussed therein. The 48-52% allocation method creates no problem since the method normally results in a 100% reduction in the current provision for income taxes and a 52% provision for deferred income taxes. The 100% flow-through is accepted only in the case of regulated industries when authorized or required by regulatory authorities.

With respect to the 100% deferral of the benefits resulting from the investment credit, the following examples indicate a representative list of methods deemed acceptable under Release 96:

(1) A charge to income equivalent to the tax benefit resulting from the investment credit with contra credit to "deferred credits" in the balance sheet.

(2) A charge for depreciation equal to the tax benefit resulting from the investment credit with contra credit to the reserve for depreciation.

(3) A charge of 48% of the investment credit benefits to depreciation and a charge for 52% to deferred taxes with credits to the related depreciation and tax reserves.

(4) A charge to income equivalent to 48% of the investment credit benefits and a charge of 52% to deferred taxes with credits to "deferred credits" and "deferred tax reserve."

In all of these methods the current provision for taxes is reduced by the full investment credit and the full cost of the property is reported.

The last sentence of Item 6 of Form S-1 reads "In connection with such summary, whenever necessary, reflect information or explanation of material significance to investors in appraising the results shown, or refer to such information or explanation set forth elsewhere in the prospectus."

The above requirement is the basis for many comments to registrants requesting information in a footnote discussing abnormal relationships in gross profits from year to year and factors contributing to erratic or abnormal changes in sales or net income from year to year.

In addition, where the percentage of income taxes to net income before income taxes is materially affected as a result of filing of individual tax returns of the parent and subsidiaries with multiple sur-tax benefits, disclosure of this factor is requested.

Finally, particular attention is directed to Release No. 4475 of the Securities Act of 1933 which was issued as a guide for determining the need for "up dating" financial statements and related data. Unless the registration statement represents a routine repeat filing which normally can be cleared in a relatively short period of time, it can reasonably be expected that a comment requesting "updating" will be included in the letter of comments. The extent of the disclosure required with respect to such "updating" is fully covered in paragraphs II A 1(a)-(b) and (c) of that release. Time can be saved by registrants in having the filing made effective when procedures are instituted to have such later information available prior to receipt of the letter of comments.

Financial Statements

With respect to the detailed financial statements included in the prospectus and certain information in the narrative section of the prospectus dealing with financial statements, the following deficiencies are frequently cited:

1. Although not covered by any specific requirement, it is customary to include in prospectuses a discussion under the caption "Experts" as to the fact that the financial statements have been included in the prospectus in reliance upon the reports of the certifying accountants and their authority as experts in auditing and accounting. Numerous requests for revision of this paragraph to limit the "expertization" to the certified financial data when the prospectus includes unaudited data have been necessary.

2. Rule 3-20(d) of Regulation S-X requires certain detailed information as to stock options. Revision is requested when the complete information is not furnished (which usually results from incorporation to the text for details which are incomplete) or when the information is presented in narrative form rather than tabular form, making it difficult to comprehend. In some cases we have asked for simplification of data by requesting information on an annual and interim period basis and allowing a low and high range of option and market prices per share rather than listing individual options for the required three-year and any interim period.

3. Interest rates and maturities of long term debt for the five years following the balance sheet date have required comment. Where there are different classes of long term debt with various maturities, the aggregate maturities of all long term debt is requested. In other words, let the registrant do the adding rather than the reader.

4. Rule 3-20(a) of Regulation S-X covering instalment or deferred sales requires disclosure particularly with respect to "percentage of completion" method of reporting income, and accrual accounting for book purposes and "cash - collection" for tax purposes.

5. The method and amortization rate of intangibles acquired and starting-up costs capitalized should be included. Where there is a material amount of "Excess cost of subsidiaries over tangible assets at date of acquisition" it is desirable to explain the justification for non-amortization of such amount. Our Accounting Series Release No. 50 expresses a preference for timely charges to income.

6. Where the balance sheet reflects a material amount of "Research and Development Expense," we have requested an analysis of this account in the notes to the balance sheet showing the following:

- (a) Additions and amortization for a minimum of three years,
- (b) Policy of amortization followed by the registrant,
- (c) A representation that such amounts relate to items being commercially produced or are deemed to be commercially feasible, and
- (d) Upon determination that any amounts capitalized cannot be recovered by future sales a representation as to immediate write-off to income.

7. The use of the term "stock-dividend" is deemed objectionable when the amounts relate to 20% or more and have been reflected in the accounts at par. Language such as "Stock split, effected in the form of a stock distribution" is the usual substituted phrase.

8. When long-term receivables are included in current assets in accordance with trade practices, Rule 3-13 of Regulation S-X requires the showing of the estimated amount, if practicable, not due within one year.

9. Fixed assets acquired from predecessors or promoters in tax free exchanges are required to be shown at cost to the transferors and any "write-ups" are eliminated.

10. The caption required on the balance sheet reading "Contingent Liabilities and Commitments" with a direct reference to the related footnote disclosure is frequently omitted and correction requested.

11. When disclosure in the text under remuneration of officers clearly discloses deferred compensation arrangements upon retirement, provision for such accrued liability to retirement date is required rather than the cash pay-out method prescribed by tax regulations.

12. Notes stating restrictions which limit the availability of surplus for dividend purposes have required revision when there are a number of restrictions in the debt indenture or other loan agreement and the amount of retained earnings restricted under the most restrictive covenant is not disclosed.

Rule 4-04(a) of Regulation S-X requires a statement as to the principle adopted in determining the inclusion and exclusion of subsidiaries in the consolidated balance sheet. Generally speaking, the burden of proof is on the registrant to justify the exclusion of majority-owned subsidiaries. We have accepted the practice that finance companies may be excluded from consolidation and that world-wide

consolidation with foreign subsidiaries has not been uniformly followed by domestic registrants. On the other hand, we have taken the position that real estate subsidiaries whose property is leased to the parent company and/or its subsidiaries should be included in consolidation since the primary purpose of not consolidating these subsidiaries seems to be to avoid showing mortgage indebtedness in the consolidated balance sheet.

Where justification exists for exclusion of certain subsidiaries from consolidation, problems arise as to the basis of carrying such investments in the consolidated balance sheet. Accounting Research Bulletin No. 51 issued by the American Institute of Certified Public Accountants indicated a preference for reflecting the equity in undistributed earnings or losses of such subsidiaries in the consolidated statement of income with contra adjustments of the investment in such subsidiaries in the consolidated balance sheet. If these subsidiaries are profitable, we have ordinarily not objected to carrying such investments at cost and reflecting dividends as income. However, registrants owning unconsolidated subsidiaries carried at cost with continuing losses would normally be requested to provide for such losses in the consolidated income statement to avoid misleading statements.

When the consolidated financial statements include foreign subsidiaries deemed to be significant in size as compared to the domestic companies included in consolidation, footnote disclosure is requested to show in suitable form a summary of current assets, other assets, and liabilities as of the balance sheet date and equity in earnings or losses

of such subsidiaries for at least the required three-year period. Some registrants have furnished additional information such as intercompany dividends and accumulated foreign retained earnings.

Accountants' Reports

Deficiencies have been cited on accountants' reports covering the following points:

1. When the financial statements include both the parent company and consolidated financial statements, the examination and opinion paragraphs should cover both sets of statements. This rule applies even though in some cases parent company statements are included in somewhat condensed form as an additional note to the consolidated statements.
2. When the summary is presented on a certified basis for a full five-year period, the accountants' report must cover the first two years in the summary as well as the three years in the financial statements.
3. When the principal accountant relies in part upon the examinations of other accountants, corrections have been requested in the wording of the reports of other accountants included in the prospectus in those cases where such wording is considered inappropriate. In most cases these comments are related to the opinion paragraph which normally should be limited to the operating statements and analysis of retained earnings and should include the phrase "not separately included herein."
4. Rule 2-02 (c)(ii) of Regulation S-X requires that the opinion paragraph include a statement as to any material changes in accounting

principles or practices or method of applying the accounting principles or practices, or adjustments of the accounts, required to be set forth by Rule 3-07 of Regulation S-X together with the accountants' opinion thereon. In order to comply with this rule, the phrase discussing the change should include words such as "which we approve" or "with which we concur."

5. The type of report acceptable to the Commission in those cases where the first examination covers the required three-year period is discussed fully in Accounting Series Release No. 90 issued by this Commission. The requirements of that release are strictly observed and variations of accountants' language which appear to avoid or limit the accountants' responsibility as to the fairness of the inventory valuations used in the determination of net income for the three-year period are unacceptable.

Part II - Registration Statement

Part II of the registration statement is covered by the group accountant in his review of the filing. The following accounting comments are limited to Items 24, 31(a), and the accountants' consent.

Item 24 deals with the relationship of experts named in the registration statement with the registrant. Since the item is worded in terms of a "substantial interest" as to all experts, a positive statement repeating this language when referring to the certifying accountant is inadequate as the "Instruction" to this item defines a "substantial interest" in the case of an accountant as "any direct financial interest or any material indirect financial interest." An unambiguous answer must be given as to the accountants' status.

Item 31(a) requires a list of all financial statements filed. As provided by Rule 3-03(c) of Regulation S-X, financial statements and schedules omitted from the registration statement and the reasons for their omission are required to be stated as part of the answer to this item. Particular care should be given to the basis of omission of the parent company statements, since those cases where the parent company is primarily a holding company or the subsidiaries are wholly-owned (but not totally held--as defined in Regulation S-X) and are significant does not provide the basis for omission of parent company financial statements and schedules.

Item 14 of the "Instructions As To Financial Statements" of Form S-1 requires answers to certain items listed under the caption "Historical Financial Information." Such information is required from registrants who have had no previous filings under the Securities Act of 1933 or Securities Exchange Act of 1934. When no answer is furnished in Part II and the exemption referred to above is not applicable, the basis for omission of an answer to this item is requested as part of Item 31(a) under the above referred to Rule 3-03(c).

Finally, the accountants' consents are reviewed to make sure that one copy is manually signed, they are dated as of or later than the date of the accountants' report, cover the naming of the accountants in the summary of earnings, the paragraph under "Experts," the accountants' report in the prospectus and the accountants' report in Part II covering supporting schedules.

PREPARATION FOR CONFERENCES

In the last few years monthly statistics of first-time registrants show that these have numbered from less than one-third to over two-thirds of the total registrations. Many, but not necessarily all, of the problems which have been discussed and other difficulties of the first-time registrant may be avoided to a large extent by a pre-filing conference with the accounting staff of the Commission. The inexperienced practitioner should not hesitate to suggest this to his client. This is standard practice of the most experienced accountants, lawyers and underwriters when their preliminary work for a new registrant discloses novel problems involving accounting principles, difficult problems of presentation of the financial statements, marginal questions in the application of the Commission's rules of independence of accountants and, in the case of large foreign registrants, all of these and the further complication of accommodating foreign accounting, auditing, financial and legal practices to the requirements of the Securities Acts.

Preliminary inquiries may be made by letter or telephone. After today's sessions it should not be necessary to suggest that one step in your operations should be to acquire and study the applicable laws, regulations and forms and then, if the need arises, make an appointment for a conference. If the problem is one of the form on which to file and the manner of presentation of the financial statements and the application of generally accepted accounting principles therein, the appointment should be made with the Chief Accountant of the Division of

Corporation Finance. If there is a question of independence to be resolved, or a unique problem of accounting principle, the conference should be arranged with the Office of the Chief Accountant of the Commission.

Who should attend? The financial statements are those of the registrant. The independent accountant expresses his opinion on them. When the statements and accounting principles to be applied are the cause of the meeting, both parties should be represented by persons who can speak with authority--usually a partner of the accounting firm and a senior financial officer of the registrant. In the case of small companies it is not unusual for the president to attend.

New registrants have problems other than accounting which counsel for them or their underwriters may be exploring with other members of the staff while the accounting questions are discussed with the accounting staff. Representatives of the underwriters are usually interested in the financial statements--particularly the summary of earnings. When common problems are the subject of discussion, arrangements can be made for appropriate staff members to be present. In all cases appointments should be made in advance to avoid conflicts and to make sure the persons you want to see will be available.

A premature conference is usually a waste of time and unnecessary expense. It should be obvious that the accountant should know enough about the client's affairs and accounting practices to isolate the problems and be prepared to answer staff questions designed to assist

him in developing the best possible solution to the questions raised. The best results can be obtained when an agenda is prepared in advance and our staff is advised of the name of the proposed registrant, the nature of its business, the principal problems to be discussed and proposed solutions. By so doing the staff may be able to locate precedents and be prepared to cite cases which will assist you.

A written agenda is of great assistance to all parties in the conference. If the visiting group includes persons unknown to the staff, a list identifying those in attendance is very helpful. We, of course, identify our participants, too. For our part at least one member of the staff is charged with making notes of the points raised and the solutions reached. In order to avoid any misunderstanding later as the work progresses, it is desirable for the independent accountant to furnish us a copy of his memorandum on the conference so that if any differences between us show up they can be identified and clarified early in the program.

A very common problem is that of what statements to file. This is true especially when a family group of companies is brought together just prior to going public. All of our forms contain an instruction similar to 13 in Form S-1 captioned "Filing of Other Statements in Certain Cases." The text is:

"The Commission may, upon the request of the registrant, and where consistent with the protection of investors, permit the omission of one or more of the statements herein required or the filing in substitution therefor of appropriate statements of comparable character. The Commission may also

require the filing of other statements in addition to, or in substitution for, the statements herein required in any case where such statements are necessary or appropriate for an adequate presentation of the financial condition of any person whose financial statements are required, or whose statements are otherwise necessary for the protection of investors."

This is an invitation for the registrant and independent accountant to work up what they believe will provide the best possible disclosure in the circumstances. If this is your problem it will help the staff if you will prepare a description of the companies making up the enterprise, their relation to each other and an outline of your solution of the statements necessary for the filing. This should specify dates and periods, which statements are certified and which are not, which must be in the prospectus and which in Part II of the registration statement. The list should include the schedules to be furnished. If the staff has this at least the day before the conference, time can be saved. When the lay-out of the financial statements, particularly the summary of earnings, is to be discussed, statements in draft form should be furnished in advance if possible. If it is impracticable to include all the figures, enough should be included to convey a clear idea of the form and content intended.

Accounting for business combinations is a frequent subject of conferences. A memorandum of the plan, including reasons for concluding that the situation meets the tests of a pooling of interests, should be brought to the conference. Facts should be presented to support findings in regard to continuity of interests, continuity of management, relative

size, purpose of the combination and other matters discussed in Accounting Research Bulletin No. 48.

Finally, a brief word about the independence question which was a part of your program this morning. Although we have accumulated and published a substantial amount of material on this subject, the accountant is inclined to feel that his case is just a little different. Our advice here is that if there is any doubt about it among counsel, underwriters, registrant and accountant, get an answer before you proceed. This will save the parties concerned needless embarrassment. To do this a carefully prepared memorandum is desirable for your files as well as for ours. This memorandum should cover all factors bearing on the question of independence. Developing the facts on the instalment plan does not make a good impression. Accounting Series Release No. 79, published April 8, 1958, announcing the last revision of Rule 2-01 of Regulation S-X, invites you to bring marginal questions to us for a ruling.

It has not been possible in the short time at our disposal to cover more than a sample of the questions which may warrant discussion with us before filing. When you come prepared, a conference can save your time and ours in the long run.