

**ACCOUNTING PROBLEMS OF FIRST-TIME
REGISTRATION STATEMENTS**

ADDRESS OF

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"Going Public" has become the publicized expression generally associated with a corporation that has been closely held either by a limited group of stockholders or a family group, and files a registration statement with the Securities and Exchange Commission for the first time for a proposed public offering of its securities. ^{1/} As will be noted from the following statistics, the number of companies that have decided to "go public" shows no signs of slackening and in my opinion will continue or possibly increase in the foreseeable future.

In the four years that have elapsed from fiscal 1958 through 1961 the Securities and Exchange Commission has experienced a constantly increasing number of filings under the Securities Act of 1933 for the purpose of offering securities to the public. During the fiscal years 1958, 1959, 1960 and 1961 there were, respectively, 913, 1226, 1628 and 1830 registrations. In the first six months of this fiscal year 1224 registration statements were filed, being 515 more than the comparable period last year. In addition to the above, there is another statistic that is highly significant. In 1958, 1959, 1960 and 1961 the number of issues of companies which had not previously filed registration statements was 28%, 39%, 48% and 52%, respectively, of the total. In the first six months of the current fiscal year the

^{1/} 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.

percentage was 70%. It is this trend, I believe, that is particularly important to this audience, and I might add, creates greater problems for the staff of the Division of Corporation Finance than the company with public ownership that has previously filed with the Commission. The reasons for "going public" are varied. In a well-established company with many years of operations and profitability, the decision to "go public" may be based upon factors other than raising of new capital. Such factors could include a desire to establish a market valuation for estate planning or other purposes, older management seeking to create a company with eventual attraction for professional younger management, stock options or other benefits, and future growth possibilities through merger or acquisitions.

In the younger company the decision to "go public" is primarily a need for new capital resulting from growth and expansion and the realization that private resources and bank credit have their limitations and are not the answer to continued growth, particularly when the company has demonstrated a successful historical record of operations and an underwriting is feasible.

Although I have no statistics that are readily available, it seems to me that as the number of companies filing for the first time increases, the number of accountants who have had no previous experience with the Securities and Exchange Commission must of necessity increase also. Assuming that there may be quite a number of accountants in the audience in this category, I believe the remainder of this talk may

serve to alert these particular members of the society to some of the problems they may encounter in a first-time registration statement. These deal with independence of accountants, auditing problems, rules and regulations of the Commission and their application, generally accepted accounting principles and the "Summary of Earnings."

Rule 2.01 of Regulation S-X defines the test of independence with respect to the certifying accountant. This rule prohibits any direct financial or any material indirect financial interest in the registrant, its parents and subsidiaries, or any connection as a promoter, underwriter, voting trustee, director, officer, or employee. In addition, the rule provides that appropriate consideration to all relevant circumstances of other relationships may be given.

I think most of our inquiries relate to the latter clause. "Write up" engagements which are common in smaller firms, close family relationship between the certifying accountants and the principal stockholders and/or management and financial dealings with same would ordinarily be the basis for raising questions as to the independence of the accountants.

If there are any possible circumstances that might raise a question as to the independence of the accountants, I would suggest that the accountants prior to any engagement upon a registration statement, recite the facts in a letter to the Commission and request a ruling. I can think of no more embarrassing situation between practitioner and client than to receive an adverse ruling, after the

filing is made, which requires a new audit by a new firm of accountants.

The principal problem relating to auditing results from the fact that certified operating statements are required for at least the last three fiscal years of the registrant or the full life of the registrant if shorter.

Review of filings made by companies for the first time indicates that a great number have either had no prior audits or that the examinations made by the accountants in prior years have been so limited in scope as to preclude the expression of an opinion because inventories have not been observed nor receivables verified by independent confirmation in any period other than as of the last balance sheet date. The omission of verification of receivables in earlier periods generally poses no problem since subsequent verification at the balance sheet date and review of intervening transactions should provide the basis for a conclusion as to the validity of such accounts. However, inventories are another matter since the amounts reported in opening and closing inventories from year to year may have a drastic effect upon the earnings reported. Particular attention should be given to a review of accounting practices which may have resulted in "over-conservative" valuations in earlier periods with the resulting improvement in the last period reported upon.

Inquiries have been made as to the form of certification for the required three year period under such circumstances. When the accountant has followed alternative auditing procedures for earlier periods and concludes that an unqualified opinion is appropriate, a middle paragraph is generally included in the opinion. The following is one example:

"We observed the physical inventories as of 12/31/61 but did not observe the inventories (hereinafter referred to as the 'earlier inventories') inasmuch as these dates were prior to our engagement as auditors. We did, however, test-check the pricing and clerical accuracy of these inventories and also made certain analytical and statistical tests of related data, including review of gross profit ratios. As a result of these procedures, we have satisfied ourselves that the inventories used in the computation of cost of goods sold for the three years ended 12/31/61 are fairly stated."

In some cases, as a result of preliminary investigation by the accountants, it is readily apparent that an unqualified opinion for the three year period cannot be made because of inadequate or destroyed records or complete lack of any internal control. My recommendation in these cases is to wait until such time as properly certified statements can be presented.

Over the years the Commission has promulgated a number of forms for registration under the Securities Act of 1933, the most frequently filed being Form S-1, which form is used when no other form is

authorized or prescribed. These forms contain instructions as to the financial statements required to be filed, whether parent company, consolidated, group or combination of statements, companies acquired through pooling of interests during the period covered and companies acquired by purchase after the balance sheet date, and the required dates and periods.

In addition to the different forms, the Commission's rules regarding certification, form and content of financial statements and supporting schedules required to be filed for most purposes under the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940, as well as minimum disclosure required in supplemental footnotes, are prescribed in Regulation S-X.

Although the various forms cover in general terms the type of financial statements required to be included in a registration statement, it is obviously impossible to write rules covering every type of situation that we run into in reviewing the financial statements. As a result, Item 13 of the Instructions as to Financial Statements of Form S-1 provides for the filing of other statements in addition to, or in substitution for, the statements required by the form where it is deemed necessary or appropriate for an adequate presentation of the financial statements. The following are some of the more common examples.

It seems to be quite common that, when a family controlled enterprise decides to "go public," such enterprise consists of a group of corporations under common stock ownership; presumably because as a closely held enterprise this arrangement had certain tax benefits. However, as the first step toward public ownership, these corporations must be put together in a parent subsidiary set-up or as a single entity. Quite frequently it happens that some of the separate corporations have different fiscal closings. Under these circumstances, the most satisfactory presentation is to recast all financial statements to a common fiscal date, generally that of the parent company or the one to be adopted by the successor entity. In certain instances, it may not be feasible to recast to a common date because of lack of accounting data with respect to inventories and/or other accounts. Under these circumstances, we have accepted combined statements in which 12 months operations for each separate company are included for each year reported upon and the interim results of those companies whose fiscal closings are either prior or subsequent to the balance sheet date are shown as direct debits or credits to retained earnings with appropriate explanation. Intercompany transactions should be eliminated for the period covered and the resulting summary should present either a corporate or consolidated operating statement which has reflected retroactively and properly "pooling of interests" accounting for all periods. In the usual case, the recapitalization takes place after the date of the balance sheet furnished. Although there may be some

accountants who feel that the effect of a post balance sheet recapitalization must be discussed in a footnote, in the interest of simplicity, I can see no particular reason for not reflecting the recapitalization in the balance sheet proper provided it is so explained.

In some instances, a new corporate registrant has been organized to succeed to a partnership or group of partnerships. In reflecting the operating results for the required periods it is necessary to recast the partnership results to a pro-forma corporate basis by the introduction of additional items such as reasonable officers' salaries and corporate income taxes in order that the results be properly shown. Similar recasting would be required by a predecessor corporation or corporations which had availed themselves of the provisions of Sub-Caption S of the Internal Revenue Code. In addition, when a family group of corporations intends to merge into a single corporate entity the loss of the multiple surtax benefit in future operations would have to be explained and the effect on earnings specifically indicated. In this situation, it has been argued that there are usually offsetting benefits in a single corporation. I see no reason why a discussion along these lines should not be made, but any attempt to forecast future dollar savings is deemed in the nature of a projection and is generally disallowed.

In addition to the above, the following situations have become quite common.

A company acquired by a promotional group with a substantial step-up in fixed asset values and new debt structure would be required

to show in addition to the historical operating results (generally with no per-share data) a pro-forma statement of income for the latest 12-month period or the latest fiscal period and interim period giving effect to new depreciation charges, interest charges and related tax reduction in order that per share data in the pro-forma statement correctly reflect the operating results of the company in terms of conditions existing at the time of the public offering. In addition to the above, quite frequently a registrant will acquire by purchase a material subsidiary or division close to the balance sheet date or after such date. If it appears that the historical operating results of the registrant could be materially affected by such acquisition, pro-forma operating statements would be required showing the operating results as if the acquisition had been made as of the beginning of the latest 12-month period.

The foregoing examples are to be contrasted with situations where the underwriter wishes to present an additional statement of financial condition giving effect to the results of the public offering, particularly when the historical balance sheet shows an unbalanced working capital position or excessive debt which will be materially changed as a result of the public offering and it is felt that the prospectus prose dealing with the application of proceeds is not as easily understood as statement presentation. The use of such a statement is limited to the underwriting conditions discussed in Rule 170 of the General Rules and Regulations under the Securities Act

of 1933, the gist of such rules limiting its use to either a firm underwriting commitment or an "all-or-none" arrangement with full refund of subscriptions to stock if the underwriting is unsuccessful.

In the majority of cases of new registrants, comments by the accounting staff generally deal with revision of footnote disclosure furnished, request for additional footnotes specifically required by Regulation S-X and in certain instances revised presentation of the financial statements. However, in some filings, questions as to the application of generally accepted accounting principles have been raised by the staff even though the financial statements have been certified without qualification. This may result from any one of the following: (1) lack of knowledge of accounting bulletins promulgated by the American Institute of Certified Public Accountants, (2) unfamiliarity with accounting releases issued by the Securities and Exchange Commission, (3) conclusion that income tax rulings are necessarily acceptable for purposes of financial reporting, and (4) the use of a method of reflecting financial transactions which in our opinion may be subject to misinterpretation and have the capacity to mislead.

It is my understanding that most close corporations keep their records on a tax basis and while in the majority of cases no change is necessary, there are instances when such statements are not acceptable.

For example, statements have been presented in which all overhead has been omitted from inventories even though material in amount and have required correction to reflect such overhead in each of the years covered with provision made for the resulting tax liability.

The cash basis of accounting is acceptable for tax purposes when inventories are not a material factor but unacceptable for filing purposes and revision to accrual accounting would be required. There are a number of cases filed in which review and inquiry has revealed that losses inherent at the balance sheet date in the liquidation of certain assets has not been reflected in the accounts because of the belief that losses should be booked in the year of realization. This, of course, is contrary to generally accepted accounting principles which provide that known or anticipated losses be provided for, and in these cases correction is requested.

In some cases, a review of the accounting followed by the registrant would seem to indicate that a more realistic matching of costs and revenues might be attained if the registrant used a budgeted unit of production basis for amortization of certain deferred charges rather than an arbitrary five year time basis, particularly when the amounts involved are significant and could materially affect net income.

In addition to the above, there is another situation which has created a problem in the past. This relates to an acquisition by purchase in which an excess cost is not amortizable for tax purposes but considered as "good-will." Where it is clearly evident that such an item (even though deemed for tax purposes to be an intangible) is clearly related to an asset having a limited life, amortization of such intangible over the same life would be required.

Finally, there are some transactions, which, if presented on a tax basis, seem to be in conflict with the economics involved and are in our opinion objectionable. The following two examples illustrate the point.

The use of the sale and lease-back technique has become quite common in industry. When in our opinion, a sale and lease-back is clearly a finance transaction, it would appear that the cash profit (net of the capital gains tax) would more properly be reflected as a deferred credit in the balance sheet and amortized to income as an offset to the new rental expense.

Occasionally, a registrant will set up certain financial arrangements for older management prior to filing. In general they follow a similar pattern, i.e., payment for so-called "advisory and consulting services" for ten years after retirement to the officer or to his estate and with certain vested rights prior to retirement. It seems to us that this type of financial arrangement is clearly in the nature of deferred compensation and should be provided for, net of future tax benefits, by charges to income over the period prior to estimated date of retirement.

The above cases illustrate the types of accounting which are subject to question. However, there are a good many more cases where financial statements presented to the public for the first time show evidence of drastic change from the method reflected in the accounts prior to the time public investment was considered. As mentioned

before, close corporations generally follow tax accounting and since no company normally pays more in income taxes than is legally required, the resulting financial picture may not actually reflect the operating potential of the company. If, in our opinion, the revised statements show an attempt by the registrant to more clearly match costs and revenues or to follow an acceptable alternate method of accounting they of course can be presented as being in accordance with generally accepted accounting principles. Some of these concepts may not be familiar to all of you and therefore the following list of accounting concepts developed in certain industries should be of interest. Generally, the difference in accounting treatment is of more importance in smaller rapidly expanding companies than in older larger companies with relative stability in sales or revenues.

(1) Some companies with a heavy investment in machinery and equipment have felt it necessary to follow liberalized depreciation for tax purposes and straight line for financial purposes.

(2) The research and development costs of a particular product may be of such magnitude as to require capitalization of this item and subsequent amortization.

(3) Subscription income of publishing companies is required to be deferred over the life of the subscription. Related subscription expense has been capitalized and netted against the deferred income.

(4) Certain types of real estate developers who purchase acreage for the purpose of building a specified number of homes have felt it preferable to defer selling, general and administrative expenses connected with the development and amortize such costs as homes are sold.

(5) It is quite common for finance corporations to defer the first year of operating losses of newly opened offices and amortize such amounts over a period not in excess of three years.

(6) There is a trend in companies with multiple retail locations (particularly bowling and discount operations) to defer certain of their pre-opening costs to be recovered against future operations.

(7) Newly organized companies may defer starting up costs prior to commercial operations to be amortized over a period not in excess of five years. In my opinion, the period of amortization may be accelerated to coincide with tax carry-forward benefits resulting from the same starting-up costs.

(8) Some companies engaged in manufacturing or engineering under fixed price contracts have found that percentage of completion accounting presents a more realistic operating trend than completed contract accounting.

(9) Finally, a number of rather new companies engaged in leasing operations have presented their statements upon a finance company concept rather than as a company engaged in the rental of equipment. The financial presentation and accounting principles that I think are most realistic in this type of company would show the gross rental contract as an instalment receivable, the unearned rental income as a

deduction therefrom, the residual or salvage value of the equipment purchasable by the lessee at the expiration of the lease at the contract amount as an "other asset" and the rental income reflected in the accounts following "sum-of-the-digits" accounting in order to match the related interest cost of borrowed money to finance these leases.

In all these cases, the companies follow a different basis for tax accounting and although the general effect of these different methods has been to improve the operating picture as compared with the results shown for tax purposes, they have been accepted on the premise that they more nearly match costs and revenues and hence the financial presentation is consistent with generally accepted accounting principles.

In addition to the instructions as to financial statements, Item 6 of Form S-1 covers the instructions as to the "Summary of Earnings," the preparation of which is of particular interest to the certifying accountants since it usually is covered by their certificate. In my opinion, it probably represents the most significant item in Form S-1 insofar as the company, the public investors and the underwriters are concerned. Item 21(b) of the form provides that in lieu of the summary there may be substituted the income statement in its entirety provided the first two years of the five year requirement of the summary (which periods may be presented upon an unaudited basis) are also included. In recent years, this optional

presentation has been followed in the majority of filings and I believe is preferable since it eliminates duplication and simplifies the prospectus.

Because of the importance of the summary, particular attention is given to this item by both the group accountant and the group analyst. Particular reference is given in such review to the introductory paragraph of Item 6 which 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 following illustrates some of the comments that are repeatedly cited.

When a company goes public for the first time it is quite common to enter into new salary arrangements with management or to set up new profit sharing arrangements or pension plans. In such cases, the additional costs which are not reflected in the five year summary may be material and should be brought to the attention of the reader. Since complete information of these arrangements is included elsewhere in the prospectus, a cross reference to this information in a note will ordinarily suffice.

When a company shows an erratic sales or net income picture for the period covered or where the gross-profit percentages show an abnormal relationship from year to year, it is customary to require a brief explanation of the factors that contributed to these results.

This is particularly important in the case where the latest period or periods show a marked increase in gross profit over earlier periods and the text in the prospectus covering the history and business of the company furnishes no clue as to the reason for such improvement.

In some filings, it may appear that certain sales and/or operating revenues, although properly included in the determination of net income for the period or periods are in the nature of non-recurring items and failure to discuss these items may result in misleading inferences. In this type of situation, discussion in the notes and, where material, the per share effect would ordinarily be required.

There have been a number of filings recently where there is a decided seasonal impact of the company's operations. When the filing coincides with the close of the fiscal year no particular emphasis is necessary as to the seasonal aspects of the operations. However, some of the filings have been made based upon special audits prior to the close of the fiscal year and generally after the peak season. Although it may be argued that comparable interim periods highlight the seasonal trend, I am not sure that such a conclusion is obvious. As a result, when prior historical results show that the balance of the year from the date of audit is normally a break-even or loss period, a specific statement to that effect is required.

In addition to the above, there are a number of repeated comments made by the staff which deal with the accounting aspects of the summary. The following illustrations are some of the more important.

When a company's income is derived from both sales and operating revenues, Rule 5-03 of Regulation S-X provides that both sales and operating revenues and related cost of goods sold and operating expenses be stated separately when either sales or operating revenues are in excess of 10% of the combined total. Inquiry by the staff in certain filings has revealed that combined amounts have been shown in the original filing although in violation of the rule. In such cases, correcting amendment has been requested.

The presentation of income tax provisions in a good many cases may raise questions. Accounting Series Release #85 issued by the Commission contemplated that where material, provision for deferred income taxes be shown separately and an appropriate discussion of the circumstances included in the related notes to the financial statements. This is particularly important in those companies that follow accrual accounting for financial statement purposes and cash collection for income tax purposes. In some cases, the percentage relationship of income taxes to income before taxes may be so unusual as to require further text explanation. This could be true in a specific type of industry, a multiple corporation set-up with surtax benefits per corporation, a company whose income is based in large measure upon the lower capital gains rates and consolidated income statements which include foreign subsidiaries such as Puerto Rican which enjoy tax relief over a limited period of years and which income statements do not provide for Federal income taxes if distributed. In this latter situation, disclosure of the circumstances and the amounts

of income involved would be required.

Companies with volatile or erratic income results have an additional type of disclosure. When the last year or years of the summary have benefitted from the utilization of carry-forwards it seems clear that a misleading per share amount is presented unless a discussion is included as to the per share effect of the carry-forward benefit as well as the remaining unused amount and the year of expiration. In this connection, in a limited number of recent filings a different presentation was followed. In these cases, companies were either acquired by purchase in a tax free merger or acquired for taxable consideration and no value could be ascribed to a predecessor carry-forward benefit because of the amount of the consideration involved. In these situations, it seems to me that the fairest presentation is one in which the amount and per-share effect of such carry-forward benefits are reflected in the income statements as a special item after the determination of net income.

Because of the fact that price-earnings ratios have become such an important factor in the determination of the market value of common stock being offered, review by the staff of the method of computation of per-share earnings is done in all cases. In spite of the fact that Accounting Research Bulletin #49 issued by the American Institute of CPA's was an attempt to provide a working guide as to the methods to be followed, repeated comments for correction or expansion have been made. For instance:

Per share data should be adjusted retroactively for recapitalization after the balance sheet date, and for stock splits and stock dividends during the period covered; companies acquired by purchase for stock during the period covered by the summary should exclude the shares issued for the period prior to such acquisition in order to avoid an improper growth picture; per share amounts related to special items shown after the determination of net income should be shown separately and not included in a total with the per share amount of net income; and supplemental proforma computations of per share income for the latest period should be shown when there has been or will be a significant change in capitalization after the balance sheet date as a result of conversion of senior securities or where a material portion of the common stock sold will be used for the retirement of debt or the creation of normal working capital needs resulting in stock dilution.

In addition to the above, 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 both classes of stock outstanding. However, when appropriate, no objection has been raised to showing separately as additional footnote

disclosure the earnings coverage of the public class of stock as related to the dividend priority of such stock provided adequate disclosure is made as to the potential dilution of such coverage as a result of the convertible feature of such stock.

As a final thought, I would like to close with the following:
When a close corporation "goes public" a new factor has been added, i.e., stewardship of public money. It is this area of accounting that I believe affords the certified public accountant his greatest opportunity for professional responsibility.