

June 25, 1963

INTRODUCTION

In June of this year the American Institute of Certified Public Accountants held a "workshop" in New York dealing with, among other things, accounting aspects of filings with the Commission. On this occasion Mr. Edward Epstein, Financial Analyst at the New York Regional Office, lectured on the subject of "Financial Reporting Requirements in Regulation A Filings." A copy of his lecture is annexed. It was very well received and may soon be published in one of the professional accounting journals.

Although Mr. Epstein's lecture is aimed primarily at practicing accountants, the subject matter and method of treatment are such that it will be of interest to all members of the staff. It presents an excellent overall view of the Commission's financial disclosure requirements in Small Issues, and discusses some of the problems involved.

In view of the enthusiastic reception given Mr. Epstein's lecture, we might do well to make it available to the accountants or issuers filing with the Commission for the first time, who have only a sketchy understanding of the requirements and problems involved.

LLEWELLYN P. YOUNG  
Regional Administrator

**FINANCIAL REPORTING REQUIREMENTS  
IN REGULATION A OFFERINGS \***

At the outset I would like to state that as a matter of policy the Securities and Exchange Commission disclaims responsibility for any of the views which I may express this morning. These are my own and do not necessarily reflect the views of the Commission or of my colleagues on the staff. Naturally, I hope that my views are consistent with the policy of the Commission as contained in the Rules making up Regulation A and with its various interpretive and accounting releases. However, as they say in broadcasting, "They don't necessarily represent the opinions of my sponsor."

I think it would be well before getting into the accounting requirements of Regulation A to speak briefly about the Regulation itself and to give you a few background statistics.

You have often heard of Regulation A filings referred to as a "Short Form Registration" as distinguished from fully registered issues known as "Long Form." Actually, Regulation A refers to an exemption from registration which is permitted under Section 3(b) of the Securities Act of 1933. This authorizes the Commission to exempt securities from the registration requirements of Section 5 where the amounts are not in excess of \$300,000. This has been in effect since 1945. Before then the limit was \$100,000. Several years ago legislation was introduced to raise the limit to \$500,000 but it failed in Committee.

Most investors rarely get to see the registration statement and exhibits or the Regulation A notification and exhibits which make up the formal filing. Their contact is usually through the prospectus filed with the registration statement or with the offering circular filed as part of the Regulation A notification. Financially speaking, an offering circular is a prospectus but we use the designation to distinguish Regulation A offerings from the registered issues.

Now, you have all seen copies of offering circulars relating to issues of \$300,000 or under and I am sure in some cases it required a rather close inspection and comparison with the usual prospectuses of registered issues to detect any differences. I know that several years ago and probably today as well there was an identification in many peoples' . . . . .

\* Lecture given by Edward Epstein, Senior Financial Analyst, New York Regional Office at a Workshop on Filings with the SEC conducted by the American Institute of Certified Public Accountants, Professional Development Division on June 25, 1963 at the Barbizon Plaza Hotel, New York City.

minds of Regulation A with unseasoned stock offerings by new, speculative companies in the electronics and space age business and some of these were often this side of the lunatic fringe. I think it is also true that there were many fully registered issues in small or large amounts covering securities of the same type of companies. However, it may surprise some of you to know that during those days as well as today, many Regulation A offerings have been and are still being made by companies listed on national securities exchanges sometimes with assets of over \$100,000,000, with substantial earnings and long records of payment of income taxes and dividends. Many larger companies engaged in making offerings to employees use Regulation A as a convenient offering vehicle. As an example of a large offering I can point out a recent offering by American Surety Company, an insurance company, in connection with pre-emptive rights to minority stockholders where such stockholders were offered about \$130,000 of new securities as compared with \$4,800,000 offered to the parent Trans-America Corporation as the holder of 97% of the stock. (A special provision in Regulation A permits this type of offering where the majority holder agrees to take its shares without an intent to distribute.) Another typical offering of a large company was Arden Farms Co. which in May 1962 offered \$300,000 of stock without an underwriter. It had assets of \$138,000,000, net worth of \$54,000,000 and sales of over \$400,000,000 in its last fiscal year. So here we have multi-million dollar companies on one end of the curve and on the other end of the scale we may have offerings on behalf of partnerships still to be formed as in the case of a theatrical production where there are no assets, or even prospects except for a dream in the mind of the producer.

A few words as to number and volume of Regulation A filings with the Commission:

Up to June 1962 according to statistics in the Commission's annual reports there were 21,695 <sup>1/</sup> registration statements filed covering over \$225,000,000,000. As you can see these represent a simple average of about \$10,000,000 per file. This average may not represent the typical amount because of the inclusion of such large offerings as Ford, AT&T etc. Regulation A notifications filed since the exemption was created amounted to 26,726 up through the end of June 1962. In terms of dollar amount the totals, of course, were substantially less since the average filing is now running in the neighborhood of about \$230,000. About 25% of all these filings have been processed through the New York Regional Office. During

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<sup>1/</sup> Includes statements covering investment company offerings under Section 24(e) of the Investment Company Act of 1940 which permits registration of additional securities by amendment to a previously effective registration statement.

the recent period of the so called "hot issue" days filings in the New York office were running at a somewhat higher percentage due no doubt to the concentration of businesses as well as underwriting firms in this area. We don't have figures for the current fiscal year - as you may suspect filings dropped off sharply - I think we will show about 1/3 as much as 1960-1.

I previously spoke about the similarity of Regulation A circulars and registration prospectuses. From comparison of a typical circular and prospectus you will notice many items in common such as details of the plan of distribution, use of proceeds, listing of officers and control persons, description of business, description of property, securities being offered, names of directors, officers and their remuneration, material recent transactions, financial statements such as balance sheets and income statements, boiler plate legends in capital letters and the like. Significant differences are the requirement of certification for financial statements used in the prospectus, the longer earning period required to be shown, and the permissible use of a so called "Red Herring." There is also a filing fee in registered issues - none for Regulation A. As for the financial statements which I propose to discuss in more detail later this morning, there are a number of requirements set forth in Form S-1 which are not specifically enumerated in Paragraph 11 of Schedule 1. (The latter is the section which sets forth the financial statements to be used in the offering circular.) In practice the Commission staff often requests similar statements as supplements when such information is necessary for understanding of the issuer's financial condition.

Now for a brief summary of the Rules which make up Regulation A. I feel this is necessary for an understanding of the accountant's role in preparation for filing of a Regulation A offering. The Rules consist of Rules 251 through 263 under the Securities Act of 1933.

Rule 251 covers definitions commonly used in the Regulation. The most important definitions contained here are the ones for "predecessor" and "affiliate." 252 sets forth the type of businesses which can use the exemption as well as those who are barred from filing or use of Regulation A. The latter includes companies whose exemption was suspended or who were enjoined by a court in connection with a securities violation or now subject to a Section 8 proceeding or stop order entered within five years. A company may not offer securities under this exemption if it or any of its directors, officers, principal security holders, promoters, underwriters, partners etc. has been convicted within ten years of a securities crime or is under other specifically enumerated disabilities. There is also a five-year disability applicable to underwriters or persons in control of such underwriter who were involved in a registration stop order proceeding or Regulation A suspension.

Now Rule 253 is particularly important in Regulation A. It applies to companies who have not had an income from operations in at least one of the last two fiscal years. If the Company was organized within one year but has not had any income from operations it also falls within the Rule. Companies falling under Rule 253 must use an Offering Circular, even if the offering does not exceed \$50,000, and none of their shares can be offered on behalf of selling stockholders. Shares can be sold only on behalf of the Issuer. A further restriction provides that shares issued for assets or services as well as issued or proposed to be issued to directors, officers, promoters and underwriters, must be placed in an escrow for at least one year from the commencement of any Regulation A offering. (Many of such escrows last for 13 months. I suppose this is due to an original allowance of one month required to prepare the stock for issuance, organize the dealer group etc. Only 12 months are needed to satisfy the rule, however.) If not, they are counted as part of the \$300,000 to be offered. Rule 254 prescribes the method of computing the \$300,000 ceiling. I am necessarily being brief because long articles can be written on every Rule comprising the Regulation and I have a limited time for this presentation.<sup>1/</sup> Rules 255 and 256 prescribe the method for filing of the Notification and use of the offering circular, Rule 257 has to do with the offerings not in excess of \$50,000 where no circular is required unless the company has not had a net income from operations for one of its last two full fiscal years. It may be of interest to you to know that no financial statements at all are required. However, the staff requests copies of the profit and loss statements to insure that such companies actually have a profit and can use Rule 257. Rule 260 is of importance to accountants since it prescribes the filing of six month reports on our 2-A Form which I intend to cover in more detail later.

Grounds for suspension of the Regulation A exemption are set forth in Rule 261. Rule 262 deals with situations where non-resident persons are connected with the offering and lastly Rule 263 (adopted in November 1961) deals with delayed offerings after notice of clearance by the Commission.

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<sup>1/</sup> I would like to suggest for those of you who want to follow up the legal aspects of Regulation A further that you read a very fine article by Prof. Ezra Weiss of the New York Law School written in March 1962. Mr. Weiss prepared the article while he was head of the Branch of Small Issues here in New York and his essay is considered by many to be the last word on Regulation A interpretations.

PREPARATION AND FILING OF A REGULATION A NOTIFICATION

The specific rules covering the preparation and filing requirements of the notification and offering circular in a Regulation A offering center around Rules 255 and 256. These describe the method of filing and using the notification and offering circular. Those of you who have never seen a Regulation A notification and exhibits as filed are welcome to use the Public Reference Room of the Commission's New York Regional Office at 225 Broadway, 23rd floor, and to inspect any filing in process or already cleared by the staff. Counterparts of these files are maintained in the Public Reference Unit in Washington, D. C. Because of office filing problems, local files are retained for public reference up to a period of three years and thereafter are sent to general storage.

Filed material is required to be supplied in four copies or sets. That is, each set will contain the notification and exhibits required by Item 11 which includes, of course, the offering circular. For convenience of the issuer the notification is filed with one of the nine regional offices covering areas in which the principal business operations are conducted or proposed to be conducted. There are special regulations affecting Canadian companies. We don't get many of these. I can think of only two in the last five years filed in N. Y. Both were withdrawn at the request of the staff.

Although Rule 255 provides for a ten-day waiting period subsequent to filing and prior to offering, such offerings are rarely made until the Commission's staff has advised the issuer as to the deficiencies which need correction in order to comply with the specific terms and conditions necessary to establish the exemption. When the staff has determined that it has no further comments, a letter to that effect (which is commonly called a clearance letter) is sent to the company or its agent and the offering commences with the filing of four copies of a dated circular in the Regional Office of the Commission.

Accountants who have special problems at the pre-filing or filing stage are invited to consult with the Regional Office staff for resolution of any matters which may be pertinent. Of course, we would prefer not to review all proposed material prior to filing so that we ask that the questions be specific and necessary for determination in advance of the filing if this is the case.

Much of the material contained in the notification and offering circular will be of interest to the accountant and I think should be reviewed by him. The actual preparation of text and material comprising the notification and circular is usually the work of the attorney for the issuer of underwriter (and often a joint effort) but the accountant will or should be consulted on such items as the following:

Item 2 of the notification requires a listing of persons holding 10% or more of the outstanding securities of any class of the issuer. This requires a simple calculation based upon the number of shares held by such persons divided by the number outstanding. The latter amounts should agree or be reconcilable with the financial statements presented in the circular. We find that quite often these are obtained by the attorney from material other than the financial statements and are frequently subject to error.

Item 9 of the notification which deals with information concerning unregistered securities issued or sold within one year should also be reviewed by the accountant, since it calls for information relating to amounts of shares and dollars involved. Such information generally should be susceptible of verification in the balance sheet and surplus accounts or in the statement of cash receipts and disbursements as the case may be.

Item 10 which requests information on present or proposed offerings will often deal with disclosure as to shares covered by outstanding options or warrants which also should be keyed to agree with the balance sheet or footnotes contained in the offering circular.

Item 11 which calls for certain specified exhibits requires the filing of the underlying documents defining the rights of securities to be offered under the filing. Although these are not all specified they will be such documents as the provisions of the certificate of incorporation or articles of incorporation or association and pertinent amendments, the trust indenture or other instruments such as the form of the debt certificate or bylaws of the company where applicable. We assume that the accountant will have familiarized himself with these and taken note of the amount of authorized shares or nature of the debt securities and checked that these are properly stated on the balance sheet. Quite often the standard form of bylaws used by corporations contains a clause setting forth the fiscal period of the corporation. Since the financial statements required to be filed must cover at least two full fiscal years, it is important for the accountant to determine whether his statements cover the authorized fiscal period. I can think of a number of instances where accountants or attorneys have been embarrassed by submission of so called "fiscal year" statements where these were inconsistent with the by-laws.

Item 11(g) which calls for written consents of experts will require a consent from the accountant who certifies to the financial statements filed for use in Regulation A. (When such statements are certified). It is the practice of the staff where the certificate is later modified or the financial statements are changed subsequent to filing, to request a new dated consent from the accountant.

Now the offering circular also contains a number of sections apart from the financial statements which deserve the attention of the accountant.

For instance, the tabulation on the front cover page showing offering price of the securities, underwriters' discounts and net proceeds from the offering should be checked. We know that many attorneys know how to use calculators and adding machines. Unfortunately, some may rely on scraps of paper and stubby pencils -arithmetical errors and misplaced decimals often creep in, quite often with humorous results.

Paragraph 6 of the Schedule which requires a listing of the net cash proceeds and the proposed application of these funds should be checked by the accountant. This information will also be used to compile the report of sales on Form 2-A which is due six months after the offer begins.

Although it is not specifically required by the Schedule it is common practice to insert a capitalization table in the text of the circular similar to the kind required in a prospectus. Quite often the staff will request such a table in order that the details of the offering be made clear. Here, too, the amounts shown as authorized, outstanding, and in some cases shares held in treasury, should be checked by the accountant against the balance sheet. Sometimes the capitalization table will be as of a date later than the financial statements since it is the practice of the staff to request the most recent practicable tabulation. Here, also, and as a general rule wherever figures appear in the circular, we would expect them to be checked by the accountant.

Recently the Commission staff has followed a policy of requesting disclosure of the dilution aspects of a speculative security offering and presentation usually in an introductory section of such facts as the equity per share before and after the stock offering. For those of you who have had no experience with this concept I should explain that situations often arise in development companies where the promoters or management end up with say 75% of the outstanding stock for which they pay little in cash or assets and the public gets say 25% for their \$300,000 investment. Naturally the promoters or prior stockholders become entitled to most of the equity. Situations are typical in which the investor pays \$3 for a certificate which has a book value of 75¢ or less when he receives it. This requires calculations which best could be done by the accountant.

I will skip over problems of contingent liabilities and post balance sheet transactions in order to deal with them under the financial statements.

Now as for the financial statements required under Paragraph 11, perhaps the most important characteristic of the financial statements used in Regulation A filings is the fact that such statements need not be certified. This has been a consistent policy of the Commission in Regulation A ever since adoption of the rules making up the Regulation. I should point out that while the statements need not be certified nevertheless they frequently are and in such cases the staff insists on the same standards as



those followed by the Division of Corporation Finance, such as standards of independence, and requirements as to the content of the accountant's opinion or certificate concerning the nature of the audit, principles required in preparation of consolidated statements, etc. You will also note that although certification is not required, it is clearly stated in Paragraph 11 that the statements furnished shall be prepared in accordance with generally accepted accounting principles. There is no accounting regulation governing the form and content of financial statements for use in Regulation A such as Regulation S-X, but as you know there is a wide body of material in all libraries dealing with generally accepted accounting principles.

There are two basic types of statements required by the Paragraph 11, namely those to be furnished for development companies and those to be furnished for companies in the operational stage.

Development companies such as those in the formation stage or with no record of significant product sales will furnish statements of assets, liabilities and capital shares for a date within 90 days prior to filing, somewhat similar to those called for in Form S-2. Such statements are to be accompanied by statements of cash receipts and disbursements covering at least two full fiscal years or for the life of the company, if less, and the interim period, if any, up to the date of the statement of assets, liabilities and capital shares.

This, as you may know, is a somewhat unusual statement in that there is no balancing of assets against liabilities and capital. In other words, there is no surplus account which ties in the liabilities and capital to equal assets. It is a requirement of the rule in such statements that dollar amounts may be used only for cash transactions or transactions involving amounts receivable or payable in cash. In the case of assets such as patents or properties acquired from a promoter in exchange for stock the amounts cannot be expressed in excess of the cost of such assets to the promoter or other transferor in the asset side or capital share section. For instance, only shares issued for cash will be shown at the dollar value. Shares issued for assets or services will show only the number of shares but no dollar amount. Where the cost of such assets is traceable to the transferor's records they may be carried at such amounts, however. An example of this type of statement was furnished as workshop material: ("Fastline Inc.") Quite often the companies filing such statements have had several years of activity in the development stage with the result that substantial intangible assets are represented as capitalized promotional or developmental expenses. (I have one that's been developing since 1948 now going through processing which has \$377,000 of promotional costs and few dollars of other assets.) Such expenses should readily be reconcilable to the statement of cash receipts and disbursements which accompanies these and where they are significant in amount a separate schedule showing the make-up of the development expenses should be attached. Quite often stock will be issued for cash alone and the disbursement of

such cash may be readily traceable on the balance sheet. In such cases balance sheets are permissible. This also applies to situations where assets are acquired for capital stock but carried at values not in excess of the identifiable cash cost to the transferors.

In the case of companies no longer in the development stage - a conventional balance sheet as of a date no older than 90 days together with profit and loss statements covering a two-year period and interim period, if any, up to the date of balance sheet are required. Longer periods may be supplied if available or desirable. I've seen Regulation A circulars with ten-year summaries but this is optional and only two years are needed to satisfy the rule. In addition, an analysis of surplus, both earned and capital surplus, if applicable, is required for the same periods covered by the profit and loss statements. If there are no transactions in capital surplus the analysis can be omitted or explained by footnote. The above are the bare requirements set down in the rule and I should think that the preparation of a typical or conventional balance sheet or income statement following accepted accounting principles should present no problems.

If the statements are not to be certified, the staff will request that they should not be filed on the accountant's stationery nor should any reference be made in the circular to the fact that these were prepared by a C.P.A. If part of the statements are covered by an accountant's certificate and part are unaudited, those statements not subject to audit should be clearly identified.

Financial statements filed in Regulation A often present many special problems which I propose to deal with now. Mr. Orbach last night discussed a number of matters of concern to accountants in first filings with the Commission. Somehow I think we have more problems in Regulation A filings and I think these are due to some extent to the prevalence of uncertified statements, to the inexperience of the accountants preparing such statements and to a general unfamiliarity with the Commission's disclosure requirements.

A common fault in first filings in Regulation A is excessive detail in the profit and loss statements. This is often due to the fact that the schedules were originally prepared for internal use. The Commission's staff will accept profit and loss statements limited to the principal categories of income and expense such as the type contemplated by Rule 5-03 of Regulation S-X. The staff requires, however, as far as cost of sales goes if inventory is significant, that the inventories used in computing the amounts be shown either in the footnotes or as part of the statement. If depreciation is a significant factor, the amount and basis of computing it should also be shown. A common deficiency in profit and loss statements filed with us is the failure to include provision for federal income taxes as an expense on the profit and loss statement. Now sometimes the tax provision will be shown as a deduction from surplus. This is objected to by the staff as a deviation from accepted accounting

practice and also from the angle that unsophisticated investors might be misled as to the true profits earned by the issuing company and available for stockholders.

In balance sheets prepared in accordance with generally accepted accounting principles we naturally expect that a reserve for bad debts in an appropriate amount will be disclosed in reporting accounts receivable. The basis for pricing the principal types of fixed assets should also be shown together with the applicable reserves for depreciation. Where investments in marketable securities appear as an asset, market price should also be given on the statement or in appropriate footnote. Assets which are subject to lien or otherwise pledged should clearly be disclosed and the obligations secured thereby should be identified. Where long term liabilities exist we expect that the interest rate and maturity will be stated in each of the significant obligations. In the capital section the staff insists on a segregation of earned surplus from capital surplus and also that the amounts of capital shares authorized, issued and outstanding be clearly shown on the face of the statement together with the capital share liability. This is minimum disclosure as well as good accounting practice yet it might surprise you to learn how many statements filed here omit such basic information. In an effort to speed up our processing a few years ago when we were hit by an avalanche of new filings the New York Regional Office adopted an appendix form for use in its letters of comment. Some of you I suppose have already seen these and you will notice that many of the statements that I previously made dealing with financial statements are contained in the typical comments at pages 8 and 9. I will have a number of these appendices available for those of you who are not familiar with them, to inspect at the workshop. These comments represent some of the most typical deficiencies found by the staff in its examination of accounting statements but it must not be assumed that they are the only matters commented upon by the staff.

Time permitting I will now touch on some of the special problems which confront the staff.

As I stated earlier this morning, the New York office processes more than one-quarter of all the Regulation A files in the United States. Our Staff is a small one and as you can gather we get almost a clinical experience in the examination of financial statements. You get to recognize certain symptoms. For instance, the addition of large unexplained amounts to capital surplus indicates to the staff examiners that there has been a possible write-up or acquisition in excess of cost or sometimes the sale of securities not disclosed in the notification or offering circular. This will call for a comment and often result in pretty drastic changes by amendment. The amount of federal income tax, if any, may appear unrelated to the taxable income shown on the submitted

profit and loss statements. These indicate to us that the financial statements are not consistent with the tax returns or that expenses for tax purposes are computed on a different basis from those shown in the financial statements submitted. This situation usually calls for a provision for deferred taxes and the application of the Commission's Accounting Releases 85, 86 and sometimes 96 where it appears that an investment credit has been taken.

It should be obvious that the existence of mortgage debt on the balance sheet implies an interest charge on the profit and loss statement. Yet it may surprise you to learn that in several instances we have discovered omissions to charge interest accruals. In one case it turned out that the profit and loss statements were prepared on a cash basis. Of course this required amendment to place the accounts on the accrual basis. In another, the accountant in all seriousness explained to us that he omitted the interest expense in order to "bring expenses more in line with revenues(!)" Needless to say the statements were rejected.

We get lots of questions from accountants or come up with processing problems of the kind I shall now talk about. Among the principal areas in which information is requested from accountants as to procedure are the following:

(1) PREDECESSORS

You will note that Paragraph 11 requires statements of the issuer or of the issuer and predecessors for the required periods. "Predecessor" is defined in Rule 251 as "a person the major portion of whose assets have been acquired directly or indirectly by the issuer, or a person from which the issuer acquired directly or indirectly the major portion of its assets." Predecessor's statements need not be filed unless the predecessor had separate operations within the prescribed period. In other words, take a company which has operated since 1955 and acquires a wholly owned subsidiary, say in May 1963. That subsidiary company is deemed to be a predecessor and its income statements for two years are required. Furthermore, if it was acquired let's say - one year ago and is now part of the operation of the issuer, or its business is complementary to that of the issuer, we would request consolidated statements to be filed covering the period of actual ownership by the parent. If the acquisition was properly classified as a pooling of interests, the consolidation should be for the entire period covered by the parent's statements. If the acquisition is deemed to have been a purchase, separate income statements of the purchased company covering the period prior to acquisition may be required, depending on materiality, and qualified with respect to depreciation, interest, income taxes, etc. Sometimes an in-

dividual proprietor will form a corporation and transfer the old business or assets to the new company in exchange for stock. In such situations the income statement of the proprietor should be supplied. In addition it should be adjusted on a pro-forma basis to provide for normal corporate salaries and corporate taxes which would have been paid had the former business been operated as a corporation.

We know, of course, that some small corporations bordering upon the red will make no salary provision until the company is able to afford such payments to management, particularly in closely held situations. However, in the case of predecessor proprietorship or predecessor partnership statements we would expect that salary commensurate to the operation be reflected in the income statement.

On occasion the financial statements of the predecessor may not be available such as the case where an issuer company acquires a division or the segment of a much larger corporation by outright or arm's length purchase. If the information is not readily available to the new owner or new corporation it may be waived upon request of the Commission staff.

(2) Pro-Forma Statements are used on occasion in Regulation A circulars and will be permitted by Rule 170 under the 1933 Act only where the statement is intended to show the receipt and application of funds to be obtained in an underwritten security offering but only when such offering is on a firm commitment or "all or none basis." In such statement the assumptions underlying their preparation should be clearly set forth on the face of the statement or in an appropriate footnote. The requirement for furnishing an actual balance sheet of the issuer will not be waived. Some issuers present separate statements both actual and pro-forma. Others will show the actual statement in columnar form alongside the pro-forma statement with a separate column showing adjustments. (See Varicraft Industries included in your workshop materials). Either method is acceptable.

(3) Consolidated statements were already mentioned a short while ago. In general wherever a parent-subsidiary relationship exists, consolidated statements should be furnished since they present a more informative view of the operations and prospects to the investor. The argument is often made that a subsidiary need not be consolidated because it is small in relation to its parent. It is the staff's opinion that the size relationship by itself is not sufficient reason for failing to consolidate and the subsidiaries should be consolidated unless there is an adequate basis for exclusion, e.g., subsidiary operates in a foreign country having currency restrictions.

The staff usually requests disclosure of the principles of consolidation including the exact periods covered by the companies included in the

consolidation, and the disposition in consolidation of any difference between the parent's investment and the related equity of the subsidiary.

Where a subsidiary is properly excluded from consolidation we would expect footnote disclosure of the parent's share in the equity and profits or losses of the subsidiary as shown by the latter's books, if such amounts are significant.

(4) The problem of certified versus uncertified statements is a troublesome one. The policy of the staff is to insist, in the case of certified statements, on the same standards as those observed in registration statements. However, if a certificate itself is not acceptable by Commission standards, such as those affecting independence the statements themselves may be used provided that there has been no apparent deviation from accepted accounting principles in their preparation. Such statements should bear no reference to the fact that they were prepared by a C.P.A. or originally covered by an accountant's opinion, and references such as the words "verified" or "reconciled" should be deleted in order not to give a misleading impression. I should mention one instance of a "short form" certificate which this staff rejected which went somewhat to the effect that the financial statements were examined by the certifying accountant, who stated as part of his opinion that the accounts receivable and payable were not confirmed and that he was not present to observe the taking of inventory and did not test the amounts. But if such procedures were followed, he said, "the appended statements would fairly reflect the financial position of the company" et cetera, et cetera(!) Needless to say, the issuer was requested to delete the certificate in the next amendment.

After the Commission issued Release No. 90 dealing with the inventory disclaimer we had quite a number of filings in Regulation A using statements which could not be certified under the Commission's accounting rules but which were nevertheless fileable in Regulation A. I know that the lack of certification has been one of the most frequent criticisms of the Commission's policy in affording exemptions to companies who use uncertified statements and there are mixed feelings both within and outside of the staff. The matter of requiring certified statements has come up for discussion many times. I think it is significant though, that it has never been required in the many years in which the Commission has been concerned with financial statements in Regulation A. The argument is sometimes made that small companies can't afford the expense of a certified audit. I have noted from contact with many accountants who prepare such statements that many are in fact, certified public accountants and I have the impression as far as fees go that their charges often are not perceptibly different from what they would be for a certified audit of a small company. I suppose I should also say that attorneys' fees in Regulation A files sometime reach amazing amounts.

(5) The financial statements cannot exceed 90 days when filed. However, in certain instances such as the existence of a recently outdated certified statement or other special factor the Regional Administrator pursuant to delegated authority may permit filings of statements up to six months old. Statements older than six months, however, are not permitted at the time of filing. If at the time the circular is ready for clearance the statements contained therein may be older than six months the Commission staff will often request later financial statements as at the most recent practicable date. If the preparation of new statements will cause undue hardship they may be waived by the staff upon the representation that there has been no material change in the company's financial condition since the date of such statements. (Except in rare examples, the present processing time, even if prolonged, permits a 90 day statement to stay without updating.)

(6) Projections

Except in rare instances projections are discouraged by the staff. They are never permitted as part of the required financial statements. Sometimes in the case of a real estate or public utility company where earnings and expenses are based on contractual commitments such projections may be permitted but solely as inclusions in the text. Sufficient caveats should be inserted to indicate exactly how the projection was computed. As an example, a water or sewerage company with a fixed number of connections and nine months of actual experience was permitted to project the year end results to show interest coverage on its proposed bonds. Real estate companies can do so under certain conditions by applying a percentage to existing leases based upon historical past experience in order to project results for the balance of the year. An illustration of projections and the danger of such forecasting is contained in your work shop material. However these are tricky concepts because they are often in the realm of conjecture and the staff, if possible, would prefer that they not be used, particularly where they extend beyond a year.

(7) Appraisals and Writeups as a result of such appraisals are objected to on the principle that accounting should always be based upon cost. It is common for an enthusiastic promoter to assign a generous value to his company's assets equivalent to the par value of the stock certificates issued for them. Sometimes these are priced at the proposed offering price! Unless the cost to the transferring person can be established from his cash records or some other basis the staff will request deletion of any money values. Sometimes it is possible to use appraisals in specific situations such as where various assets are acquired by an issuer in a cash purchase and it is desired to assign component values based upon an appraisal on each of the amounts such as equipment, inventory, leasehold improvements et cetera. Sometimes the values may be determined from the market value of stock issued for such assets where the stock has established quotation records. In general, however, appraisal and writeups are

discouraged.

(8) Research and Development Costs in promotional companies as well as non-promotional companies give us, I believe our biggest headaches. In the statement of assets, liabilities and capital shares, there is often a capitalization of expenses for promotional, research and development costs. If a company is unable to show that these are based upon cash cost the staff will request revision or deletion in total. As a matter of fact the mere payment of cash does not always justify such capitalization if there is no prospect of converting such costs into earnings. Accountants should state, where possible, the method proposed to be used in amortizing such assets. If the company has any products which have been determined to have no value or which have been abandoned the cost attributable to such projects should be eliminated. If the company is already in the operational stage the research and development costs properly should be amortized by charges against earnings. Other intangible costs such as patents, goodwill, et cetera present problems. We have often noted that the less resources a company has and the poorer its prospects the larger its carrying value for patents and intangible assets. This often amounts to a reaching out for assets when a company has little else to show. Generally, well established companies will rarely carry a substantial amount of intangibles on their balance sheets, preferring to write them off as expenses in the years incurred. These are subjects of current concern to the accounting profession. There is an extended discussion of this matter in the current issue of the Harvard Business Review. I will say that our staff consistently takes the position that costs should not be deferred to future periods unless there is some reasonable expectation that they will be recovered from future earnings.

(9) Frequently a company will be recapitalized after the balance sheet date. On such statements the new amount of stock and the effect upon surplus brought about by the recapitalization should be shown either by footnote or on the face of the statement with suitable explanation to indicate the pro-forma nature of the capital section. This situation is often noticed by staff examiners from a reading of Item 9 in the notification which calls for recent stock issuances and by comparison with the balance sheet which fails to show such changed amounts. Needless to state that at least one comment can be eliminated if the accountant anticipates this requirement by the staff.

(10) Contingent liabilities often arise where there has been stock sold by a company in possible violation of the Commission's registration requirements. Where this comes to the attention of the staff it requests a disclosure in the text of the Circular and a reference to contingent liabilities on the statement or in its footnotes as the case may be. The amount of liability is figured at the purchase price not the



offer price of the stock. Other contingent liabilities such as those existing because of a pending law suit should be disclosed in accordance with accepted accounting principles.

Sometimes contingent liabilities have meanings other than the conventional kind. Some time ago we had a balance sheet filed for a Regulation A circular which showed as contingent liabilities a debt due to officers in an amount of about \$15,000. On inquiry we learned that the amount was borrowed from the officer and its inclusion among contingent liabilities was explained by the officer as a debt which would only be repaid contingent upon there being enough cash to spare from working capital(!) Naturally, this was reclassified as an ordinary liability on the next amendment.

(11) As I stated earlier, Rule 253 applies to companies who have had no income for at least one of the two past fiscal years. Frequently companies close to falling within the rule will understate expenses on the income statement by failing to provide adequate depreciation on fixed assets, or by omitting to accrue expenses on fixed obligations, or by failing to write off obsolete inventory or uncollectible receivables and a host of other improper accounting practices. Often items properly chargeable to profit and loss will be shown among the surplus charges. These are all failures to comply with accepted accounting principles and you can be sure that the staff will or should pick them up in its comment letter. Furthermore, we assume that such accounting errors are unintentional. Where a statement is fraudulent on its face we have other administrative remedies.

(12) The impact of Commission's Accounting Series Releases 85, 86, 90 and 96 has, I believe, already been discussed by prior speakers. Those of you who have not had a chance to see the May issue of the Journal of Accountancy should read the article on accounting entries for the investment credit, particularly the entries favored by the Commission on page 38.

#### Reports Under Rule 260

These reports on the prescribed Form 2-A must be filed within 30 days after the end of each 6 month period after the offering commences and account for the use of proceeds raised from the sale to the public. This is the only follow up material required in Regulation A. There is no requirement for further periodic filings or annual reports. On occasion where all funds raised have not been disbursed the staff may request supplementary reports to account for disposition of the proceeds. Although the form is not universally adaptable to all businesses and it is particularly difficult in the case of theatrical productions, nevertheless the preparation should present no great problems to accountants. The purpose is to serve as

a check by the Commission staff to see whether there has been any misrepresentation as to intended use of proceeds. If the distribution of the funds along the lines indicated by the circular appears clearly stated the report figures at paragraphs 6 and 7 will usually be accepted. I think it would be a convenience in filing these figures for the company to deposit the funds received from the offering in a special account so that the specific application can easily be determined. Otherwise in the case of a going concern problems such as commingling and application of funds have to be resolved. Some staff members would like to see the form revised as far as paragraph 7 goes. I, for one, would like to see some changes. Meanwhile, if any of you have questions on how to fill out the paragraph, please don't hesitate to phone the staff for help.

On the latter note I would like to repeat that the staff is always available to accountants who have special problems connected with the preparation and filing of financial statements or any other part of the Regulation A notification, if for no other reason than the purely selfish one of cutting down unnecessary correspondence in the future. Thank you and I will see you at the workshop.