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PREPARATION OF SECURITIES ACT REGISTRATION STATEMENTS AND REPORTS: MEETING THE OBLIGATION TO PROVIDE A BASIS FOR APPRAISING THE PROSPECTIVE IMPACT OF HISTORICAL FINANCIAL INFORMATION

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I. INTRODUCTION

HISTORICAL financial information about a company is meaningful to a prospective investor only to the extent such information serves to illuminate the company's prospects; for the investor who has already become a shareholder, such information should permit him to evaluate his investment decision.[1] Precisely for these reasons, Securities Act[2] registration statements[3] and annual reports on Form 10-K[4] are not meant to be, and should not be, mere settings for historical financial information.

The deficiency of mere historical reporting was noted in an early proceeding before the Securities and Exchange Commission,[5] in which undisclosed changes in a company's capital structure and business, which occurred between the filing date and the effective date of the registration statement, would have had a material effect on prospective earnings. The Commission held that failure to disclose the changes and to describe their impact on prospective earnings was as misleading as misrepresenting past earnings.[6] The Commission later codified its holding,[7] ruling that registrants could even delete summaries of earnings required by the 1933 Act registration and reporting forms where the summary no longer reflected the business and prospects of the company. Taken together these pronouncements represent an early expression of the Commission's view

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1. For similar criticism along these lines see Kripke, The SEC, The Accountants, Some Myths and Some Realities, 45 N.Y.U.L. Rev. 1151 (1970).

2. Securities Act of 1933, 15 U.S.C. §§ 77a-aa (1970) [hereinafter cited by section as 1933 Act].

3. Issued pursuant to 1933 Act §§ 5-8, 15 U.S.C. §§ 77e-h (1970).

4. 17 C.F.R. § 249.310 (1973).

5. Colorado Milling & Elevator Co., 15 S.E.C. 20 (1943).

6. Id. at 27.

7. SEC Accounting Series Release No. 62 (June 27, 1947), 4 CCH Fed. Sec. L. Rep. ¶ 72,081, at 62,149 n.1.

that financial statements, and the registration statements and reports in which they are set forth, must meaningfully reflect the present prospects of the issuing company or else be deemed deficient.

The Commission's continuing concern with meaningful disclosure has led to more sophisticated approaches, making such early rulings elementary. For example, a major study of the operation of the disclosure provisions of the securities acts was undertaken by Commissioner Wheat in 1967.[8] It resulted in substantial revision of the registration and reporting forms, including, *inter alia*, the additional requirement that companies report revenues and profits by lines of business, to provide the investor with a better basis for appraising corporate prospects.[9] Recently the Commission has again reconsidered 1933 Act disclosure with particular respect to issuers filing registration statements and reports for the first time, and has placed great emphasis on forward-looking disclosure. The disclosure required by the "hot issues" releases,[10] both those proposed and those currently adopted, is meant to convey the economic realities of the issuing enterprise and to discourage the "insurance policy approach" to preparation of registration statements.[11] This latter approach is an overreaction to the possibility of liability under the securities acts, with the result that all statements and implications which might aid in investment decision-making are dismissed with boilerplate language to the effect that no assurances can be given as to the continuation of the

8. The conclusions of this study are reported in Disclosure to Investors: A Reappraisal of Federal Administrative Policies Under the '33 and '34 Acts (1969) [hereinafter cited as Wheat Report].

9. "For many of today's corporate enterprises, the key to an understanding of the business and an appraisal of its future prospects is a breakdown of revenues and, to the extent feasible, of profits by separate lines of business." Id. at 338.

10. SEC Securities Act Release No. 5386 (Apr. 20, 1973), [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,342; and SEC Securities Act Release Nos. 5395-98 (June 1, 1973), [1973 Tranfer Binder] CCH Fed. Sec. L. Rep. ¶¶ 79,383-86. The forward-looking aspect of the reporting is illustrated by a recent amendment to the disclosure requirements for new companies (those conducting operations for less than three fiscal years). When such a company files Forms S-1, S-2 or 10 for the first time, it must disclose its plan of operations for the immediate future (at least the next six months) and opine "as to the period of time that the proceeds of the offering will satisfy its cash requirements," and whether in the next six months it will have to raise additional funds to meet operating expenses. Release No. 5395, [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,383, at 83,120.

11. "The real problem of securities work is that the caution that has gone into the disclosure process has produced items so carefully hedged that few investors can make use of them. Reams of boiler plate incantations were spawned by . . . lawyers looking out for their client companies. These doom-filled documents have become largely ignored in the fourth decade of their existence. . . ." Address by former SEC Chairman Casey before the Association of the Bar of the City of New York and the New York Law Journal, Apr. 21, 1972.

state of facts stated or implied. Under the new releases, boilerplate language cannot be deemed sufficient disclosure unless accompanied by fuller explanation.

Commentators favoring predictions and projections on a permissive or mandatory basis have advocated their use as a countermeasure to backward-looking reporting.[12] The Commission is considering the permissive use of projections for certain reporting companies but has not yet felt it necessary or advisable to require them.[13] The Commission position on projections should not obscure the fact that those preparing a registration statement or report have an obligation to provide a basis for appraising the prospects of a company; since they also have access to company projections, these can provide an analytical tool for considering whether the position and prospects of the company have been fairly described.

II. SECURITIES ACT DISCLOSURE VS. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND AUDITING PRACTICES

Accountants are justifiably concerned about, and sensitive to, questions of fair presentation of historical financial information, considering that they are subject to Securities Act antifraud actions, both civil and criminal.[14] The rash of recent actions against accountants has heightened this concern.[15] Determination of generally accepted accounting principles (and the disclosure required thereunder) has customarily been left to accountants, especially since accounting concepts are often a "foreign language" to others engaged in the registration process.[16] However, the

12. E.g., Kripke, The SEC, The Accountants, Some Myths and Some Realities, 45 N.Y.U.L. Rev. 1151 (1970); Mann, Prospectuses: Unreadable or Just Unread?—A Proposal to Reexamine Policies Against Permitting Projections, 40 Geo. Wash. L. Rev. 222 (1971); Schneider, Nits, Grits, and Soft Information in SEC Filings, 121 U. Pa. L. Rev. 254 (1972).

13. SEC Securities Act Release No. 5362 (Feb. 2, 1973), [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,211. Notes 79-85 infra and accompanying text provide a discussion of this Release. See Comment, The SEC Policy for Projections: New Problems in Disclosure, 21 U.C.L.A.L. Rev. 242 (1973).

14. For example, it has been held that accountants can violate rule 10b-5, 17 C.F.R. § 240.10b-5 (1973), if they fail to disclose after-acquired information pertinent to a financial statement they certified. Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967). See Drake v. Thor Power Tool Co., 282 F. Supp. 94 (N.D. Ill. 1967); H.L. Green Co. v. Childree, 185 F. Supp. 95 (S.D.N.Y. 1960). Note, too, that there is a statutory incentive to rely on accountants as experts. 1933 Act § 11, 15 U.S.C. § 77k (1970). See generally Note, Accountants, Financial Disclosure and Investors' Remedies, 18 N.Y.L.F. 681, 691-702 (1973).

15. E.g., Seeburg-Commonwealth United Litigation, [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,277 (S.D.N.Y. 1971); Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); see cases cited in note 14 supra; cf. Wessel v. Buhler, 437 F.2d 279 (9th Cir. 1971).

16. "Accounting concepts are a foreign language to some lawyers in almost all cases, and

certificate of an independent public accountant stating that financial information is fairly presented in accordance with generally accepted accounting principles does not provide an absolute shield against liability. The issuer, for example, can never avoid liability based on the expertise of the accountants,[17] and disclosure in accordance with generally accepted accounting principles may not meet the requirements of the Securities Acts. As expressed by a leading commentator "under the anti-fraud provisions, data in financial statements have to be accompanied by whatever additional information is necessary to avoid misleading the reader, whether or not the financial statements are prepared in accordance with generally accepted accounting principles."[18] Recently the Commission has asserted its authority when it has felt that the accounting profession has moved too slowly in areas that require more disclosure than that provided by generally accepted accounting principles, as illustrated by the Commission's release concerning off balance sheet (non-capitalized) lease financing.[19]

Problems of fair presentation arise for the issuer, the underwriters, and their counsel in situations where presentation in accordance with generally accepted accounting principles may not constitute full disclosure, or provide an adequate basis to appraise the prospects of the company. A frequent source of such problems is the historical orientation of accountants.

An early case, *Potrero Sugar Co.*,[20] illustrates the effect of such orientation on disclosure. In that case, subsequent to the date of the accountants' report, the company entered into a union wage settlement that increased wages and, consequently, the company's costs of operations. The increase was not reflected as a subsequent event in notes to the financial statements. The accountants claimed that inclusion of infor-

to almost all lawyers in some cases." United States v. Kovel, 296 F.2d 918, 922 (2d Cir. 1961) (Friendly, J.).

17. E.g., Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 683 (S.D.N.Y. 1968).

18. Posner, Developments in Federal Securities Regulation, 27 Bus. Law. 957, 1042 (1972). Posner draws this conclusion primarily from the case of SEC v. Bangor Punta Corp., 331 F. Supp. 1154 (S.D.N.Y. 1971), modified, 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 924 (1973).

19. See SEC Accounting Series Release No. 147 (Oct. 5, 1973), 4 CCH Fed. Sec. L. Rep. ¶ 72,169. The Commission stated that it had carefully considered an Accounting Principle Board opinion "to determine whether it provided for sufficient disclosure to meet the needs of investors and has concluded that it does not, although much of the disclosure called for by the Opinion will be useful to investors. Specifically, the Commission believes that disclosure of the present value of financing leases and of the impact on net income of capitalization of such leases, neither of which is required by [the Opinion], are essential to investors. Accordingly, the amendments adopted herein require such disclosure." Id. at 62,380.

20. 5 S.E.C. 982, 995-97 (1939).

mation as to the wage increases without mentioning that the increased costs might be offset by an increase in prices and other factors, where there was no known impact on the company's financial position at the time, would have been misleading. They further stated that to appraise the impact of the wage increases would be to prognosticate as to the future, a task outside the scope of their responsibility. In effect, the accountants argued that they could not be required to make value judgments where there was no immediate impact. The Commission sustained the contention of the accountants.[21] Although the case is an old one, it still expresses the law. The contentions of the accountants and the resolution of the issue by the Commission served only to reinforce the historical focus of accountants.

This orientation is accompanied by a reluctance to describe certain data that have not become firmly fixed and quantified. Another case, *Globe Aircraft Corp.*, demonstrates this point.[22] In that situation the company's registration statement, at the time the preliminary prospectus was circulated, contained an audited statement of earnings for the most recent fiscal year, showing a substantial loss due to inventory write-downs. The Commission requested the company to include in the final prospectus a summary of earnings for the month of January, the most recent period available. The reported earnings for the month of January showed further losses. The company, however, did not state that such month's earnings would be further affected by additional inventory write-downs. The Commission held that the omission was misleading.[23] The company argued that generally accepted accounting principles did not require an inventory adjustment to be made for the month of January since there were only present indications that a further write-down would be necessary, and the actual effect of the carrying value of the inventory had not yet been experienced. The Commission held that the question was one of disclosure and not of accounting procedure; the latter may in fact require accounting adjustments only at specified times to give formal recognition to the cumulative effect of prior operations,[24] but the disclosure requirement may not necessarily be satisfied thereby. In other words, the requirements of generally accepted accounting principles do not necessarily satisfy the requirements of 1933 Act disclosure.

Put another way, in such situations disclosure was obviously required,

21. However, the result may have been otherwise if "extraordinary circumstances" arose after the balance sheet was prepared. Id. at 997 n.12.

22. 26 S.E.C. 43 (1947).

23. Id. at 47.

24. Id. at 46.

but not by the accountants. In a recent case,[25] the Commission successfully argued that a company should have disclosed in its registration statement the likely effects of union organizational activities on the company's earnings and operations. Failure to be aware of the defined scope of the accountants' responsibility can cause a deficient registration statement or report, for which the issuer will be held liable.

These principles concerning disclosure under the securities acts versus the requirements of generally accepted accounting principles were more recently considered in *SEC v. Bangor Punta Corp.*[26] That court held that any differences between generally accepted accounting principles and fair disclosure required by the securities acts must be resolved in favor of the latter.[27] The court also stated that any mandated disclosure beyond that required by generally accepted accounting principles was management's responsibility and not the accountants'.[28]

At times full disclosure may require an estimate of a certain statistic. Independent accountants are reluctant to express an opinion as to fair presentation when an estimate is required; given the accountants' reluctance to make value judgments where the impact may only be prospective, this additional reluctance is understandable. Former Commission Chairman Casey has pointedly remarked that "the essence of the accrual system of accounting is estimation and prediction of future events."[29] However, anyone who has ever tried to obtain a "comfort" letter on estimates appearing in a registration statement knows that the only comfort the accountants will give is as to the arithmetic computations. The Commission, however, has requested estimates of accountants in connection with the disclosure of accounting principles followed in preparation of financial statements, and of the impact on net income of those principles when compared to alternative ones.[30]

Although accountants have limited the scope of their responsibility so that they will not be required to give estimates, the courts have insisted on estimates by the company when the information was regarded as material to an investor. In *Feit v. Leasco Data Processing Equipment*

25. SEC v. Levitz Furniture Corp., [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,510 (D.D.C. 1972).

26. 331 F. Supp. 1154 (S.D.N.Y. 1971), modified, 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 924 (1973).

27. Id. at 1163.

28. Id.

29. Address by former SEC Chairman Casey before the American Institute of Certified Public Accountants, in Denver, Colo., Oct. 2, 1972.

30. SEC Securities Act Release No. 5427 (Oct. 4, 1973), [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,519.

Corp.,[31] the court held that the failure to disclose company estimates of Reliance Insurance Company's "surplus surplus" was a material omission. According to defendants' contentions, they were reluctant to make public an estimation[32] because the estimates varied significantly depending on the assumptions used.[33] The court determined that the information was material and held that the estimates should have been made regardless of the difficulty of making them.[34] In the court's view the defendants could have protected themselves by setting out their assumptions.[35]

The disparity between disclosure required under the securities acts and generally accepted accounting principles is only one area in which the issuer, its underwriters, and their attorneys may have a heavier burden than the accountants. In addition, the scope of review required for due diligence by the underwriters and their counsel may be greater than the scope of review required of accountants under generally accepted auditing standards.[36]

In *United States v. Simon*,[37] the court touched upon that issue, among others. In *Simon* the chief executive officer of a publicly-held company was borrowing money from the company through an affiliated privately-held company controlled by him. The borrowings impaired the capital of the publicly-held company. Although the financial statements showed the full extent of the borrowings of the affiliated company from the publicly-held company, they did not show that they were borrowings for the personal use of the executive. The accountants involved were accountants for the publicly-held company only. When the accountants found out that the funds were being used for the personal benefit of the chief executive officer they did not require disclosure of the use of the funds, arguing that they had no duty to make an inquiry as to the ultimate disposition of the funds.[38] They further contended that, even when accountants know of the use of the funds, generally accepted accounting principles did not require them to make a disclosure as to disposition of the funds so long as the loans were adequately collateralized.[39] But

31. 332 F. Supp. 544 (E.D.N.Y. 1971).
32. Id. at 553-54, 578-79.
33. See id. at 568, 579.
34. Id. at 579.
35. Id. at 568-69.
36. See Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 692, 697, 703 (S.D.N.Y. 1968).
37. 425 F.2d 796 (2d Cir. 1969), cert. denied, 397 U.S. 1006 (1970). The case is discussed in Note, The Criminal Liability of Public Accountants: A Study of United States v. Simon, 46 Notre Dame Law. 564 (1971).
38. 425 F.2d at 805.
39. Id.

the collateral proved to be inadequate since it consisted substantially of stock held by the chief executive officer in the publicly-held company. As soon as this stock dropped in price, the collateral proved worthless and the company went into receivership.

The court's holding that the accountants were required to make a disclosure of the disposition of the funds by the affiliated company[40] turned on the fact that the accountants were aware of the actual disposition. If the accountants had not known that the chief executive officer was using the money for his personal benefit, the court might have ruled in the accountants' favor by not requiring inquiry as to the disposition of the funds by an affiliated corporation as to which the accountants were not the auditors.[41]

The action was based on the financial statements of the company included in the company's annual report to the Commission prior to the time Form 10-K was expanded to require disclosure similar to that required by Form S-1.[42] If such disclosure had then been required, the item dealing with certain transactions between management and the company would have required counsel to ascertain whether the funds were being used in the business of the affiliated company or whether the affiliated company was merely a conduit to the pocket of the chief executive officer. Accordingly, on the present state of the law, it follows that due diligence may exceed the responsibilities of accountants under general auditing principles.[43]

III. The Threshold Question: Fair and Meaningful Presentation

Any discussion of appraising the prospects of a company must initially consider the question of fair presentation in terms of characterization of financial data and the misleading implications that can be generated therefrom. Fair and meaningful presentation requires disclosure that

40. Id. at 806-07.

41. Id. at 806.

42. See item 20 of the present Form S-1, 1 CCH Fed. Sec. L. Rep. ¶ 7123, at 6211-12, mandating disclosure of the interests of management personnel in certain transactions.

43. See SEC Securities Act Release No. 5396 (June 1, 1973), [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,384, amending Guide 16 of the Guides for Preparation and Filing of Registration Statements, promulgated by SEC Securities Act Release No. 4936 (Dec. 9, 1968), [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,636, and found in 1 CCH Fed. Sec. L. Rep. ¶¶ 3760-813 [hereinafter cited by number as Guide], which empowers the SEC's staff, in the case of new or speculative issues, to request the underwriters to furnish supplemental information to explain the steps taken to verify the disclosure contained in the registration statement. The staff may require further investigation and additional disclosure. Release No. 5396 supra.

reflects the economic realities of the financial operations of the company. Characterization of financial information, however, will have a significant effect on reported earnings. Numbers are not hard facts; they contain as many assumptions as to a state of facts as any other descriptive presentation. Given the desire of companies issuing securities to put forward favorable earnings, questions of characterization will arise. The problems are often subtle, but an analysis of the financial information required is necessary if fair presentation is to be assured.

For example, in *Hazel Bishop Inc.*,[44] concerning a secondary offering by the holder of approximately one-half of the outstanding stock of the company, characterization of expenses meant the difference between the company showing a profit or a loss. In the registration statement initially filed with the Commission the statement of operations showed a profit of approximately $102,000 for the latest fiscal year of the company. The earnings statement did not reflect advertising expenses of approximately $1,100,000 incurred largely in the latest fiscal year. Such expenses were not reflected because, in a complex series of transactions, the principal stockholder had relieved the company of the obligation to pay such expenses by transferring certain of his shares of common stock, valued at approximately $650,000, in satisfaction of the obligation. The company treated the relief of the expenses as if the expenses had not been incurred,[45] since in its view there was no cost to the company. The Commission, however, required the financial statements to be restated to reflect the $650,000 as a contribution to capital of the company and then as a payment for advertising expenses. The remaining $450,000 difference was then treated as a reduction in advertising costs for the fiscal year.[46] The adjustments reflecting added advertising expenses turned the profit into a significant loss. The characterization required by the Commission is, of course, fairly reflective of the economics of the situation and puts an investor in a position to appraise the kinds of costs that the company has and their effect on earnings.

Emphasis on growth, often the basis for investor interest in an enterprise, may cause misleading presentation. Such was the case in *Kaiser-Frazer Corp. v. Otis & Co.*[47] A new business was involved and therefore the most recent financial information was the information that would be most heavily relied upon by the investors. The summary of consolidated sales and earnings, as presented in the prospectus, showed earnings from the inception of the business on August 9, 1945, to December 31, 1947.

44. 40 S.E.C. 718 (1961).
45. Id. at 723-24.
46. Id. at 724.
47. 195 F.2d 838 (2d Cir.), cert. denied, 344 U.S. 856 (1952).

The partial year ending December 31, 1945, and the full year ending 1946 were also set out. Since production of cars did not begin until late 1946 and full production was not realized until the spring of 1947, the presentation of information as to operating results in 1947 was the most critical for investors. The company showed results of operations for the full year ending December 31, 1947, and included a breakdown for 1947 by quarters. In addition, the company presented information for the eleven months and the two months ending November 30, 1947.

The summary of earnings did not describe the results for the month of December, 1947, but that month was, of course, highlighted by the presentation of the eleven months and the two months ending November 30. Given the presentation, the court concluded that it was reasonable to assume that an investor would subtract the profit for the two months ending November 30 from the quarter ending December 31 to determine the profit for the month of December.[48] That subtraction showed a profit of approximately $4,000,000 for the month of December when actual profits for that month were less than $1,000,000; the difference was due to a favorable inventory adjustment, allocable at least to the entire year's operations, but attributed entirely to December. Although the information furnished for the year as a whole was correct, the allocation of the adjustment to December distorted the monthly trend and the trend for the final fiscal quarter as well. The court held that a note was necessary to explain that the profit in December was actually less than $1,000,000.[49]

Under present SEC practice the inventory adjustment would have had to be made with respect to the appropriate prior periods.[50] Moreover, it is no longer clear that a note to a statement can be used to explain a misleading implication. In fact, the presentation should have been made in such a manner that it would have indicated that the results for the final quarter and the final month were disappointing.[51]

IV. Commonly Occurring Situations Requiring Disclosure Indicating the Company's Prospects

The two cases above arose in similar contexts: companies desired to

48. Id. at 842. The same result could also be obtained by subtracting the eleven-month period from the full fiscal year presentation.

49. Id. at 843.

50. Instruction 5, item 6 of Form S-1, 1 CCH Fed. Sec. L. Rep. ¶ 7123, at 6205.

51. This is analogous to the doctrine that an issuer can't "bury" material information in footnotes or notes to financial statements. E.g., Gould v. American Hawaiian S.S. Co., 331 F. Supp. 981, 996 (D. Del. 1971), modified, 351 F. Supp. 853 (D. Del. 1972), and 362 F. Supp. 771 (D. Del. 1973). The "buried facts" doctrine is discussed in Jacobs, What Is a Misleading Statement or Omission Under Rule 10b-5?, 42 Fordham L. Rev. 243, 260-62 (1973).

emphasize earnings growth. The distortions in the presentations were misleading as to the prospects of the companies. Differences in businesses and capital structures aside, there are commonly occurring situations that require certain types of disclosure, and it is useful to talk of these by category.

A. *Interim Financial Statements: Seasonality of Business Operations*

The *Kaiser-Frazer* case[52] also illustrates the problems of presentation of interim period earnings data in registration statements. Often a registration statement becomes effective between fiscal quarters; for example, a preliminary prospectus may have been circulated with the first quarter's earnings, but, by the time the Commission is prepared to make the registration statement effective, information as to the fourth month is available. The Guides call for presentation of financial information as of the latest possible date.[53] Questions usually arise as to the form of presentation.

Under ordinary circumstances companies report their results of operations on a quarterly basis and are reluctant to show, for example, the results of four- or five-month periods; but a distribution of securities is an extraordinary event requiring fuller disclosure. The monthly results should be shown separately only if the month by itself, as in the *Kaiser-Frazer* situation described above, provides material information as to the company's operations. For instance, the company may have experienced cost increases not offset by price increases and the month could indicate the changed margins. Moreover, the presentation is not considered meaningful without presentation of the comparable prior period so that a comparison can be made. Usually the comparable period is the same period in the prior year. This usual comparable presentation, however, assumes, among other things, seasonality of business operations. If the effect of seasonality is only minor then the immediately preceding period of the same length may be the only truly comparable period. For example, in the *Kaiser-Frazer* case, a start-up situation, the only meaningful period was the immediately preceding prior period (on a month-to-month basis or a quarter-to-quarter basis). A rule of thumb to use as a guide in making the determination as to the proper prior period is the kind of comparison the company makes for its internal purposes.

Where the prior period reflects seasonal variations, mere comparison with it may be insufficient disclosure. The presentation should warn the

52. Discussed at notes 47-49 supra and accompanying text.

53. See Guide 23, 1 CCH Fed. Sec. L. Rep. ¶ 3783.

investor that mere arithmetic extrapolation may not be meaningful, by explaining the effects of seasonality on the business.

B. *Effect of the Offering on Earnings Per Share*

In connection with any offering of securities there are a number of unstated assumptions that will be made if the company has a favorable history of earnings. They are: (1) the proceeds from the sale of securities will be profitably employed by the company and, as a consequence, (2) earnings per share will (at worst) not decline as an effect of issuance of the securities. These assumptions, however, have limited scope; they do not apply to situations where the company is refinancing short- or long-term debt with equity securities or debt securities having a higher rate of interest than the debt securities being refinanced. The case of *Faradyne Electronics Corp.*[54] starkly illustrates the limitations of the assumptions.

In *Faradyne* the company offered two million dollars principal amount of convertible subordinated debentures, of which amount $1.2 million were to be applied to repay an interest-free loan. The result of the offering was that the company was taking on additional interest of $18,000 per year plus the amortization costs of the offering. The Commission held that the summary of earnings of Faradyne was materially misleading because of "the failure to present . . . [the] debenture interest chargeable to the replacement of the [$1.2 million] interest-free obligation . . . ."[55] The holding is noteworthy because the Commission determined that the only way the prospective effect on earnings could be documented was by a pro forma restatement of earnings per share.[56]

Even more complex than the *Faradyne* situation is the replacement of debt with equity proceeds.[57] The reduction in interest expenses will improve operating results, but, in the short run, a decline in earnings per share may result. Any such decline has to be brought to the attention of the investor, although the impact can be ameliorated by indicating that operating results will be improved.

C. *Trends*

As a matter of course the staff of the Commission will request an ex-

54. 40 S.E.C. 1053 (1962).

55. Id. at 1061.

56. Id. at 1059.

57. This aspect of dilution of earnings also is present in Faradyne since convertible debentures were offered in that recapitalization. Id. at 1061. However, the case was decided before the dilution effects of the convertible securities were required to be reported.

planation of a decline in earnings for any period—even an interim period as compared to the comparable period—if none is supplied in the preliminary prospectus or report.[58] Conversely, a trend of increased earnings will not automatically elicit a request for explanation, and no comment would be expected unless the increase was extraordinary.

However, failure to make an investor appreciate the reasons for certain increases may be an omission that causes a misleading impression. For example, if the company had been experiencing a declining trend and has more recently experienced a turn-around or substantial abatement of losses, discussion should include the reasons for the decline, which will invariably be requested by the Commission's staff anyway,[59] and reasons for the turn-around. These reasons may in fact be inextricably linked, or they may be independent (for example, while one product line has been declining and continues to decline, another product line has more than offset the losses). A meaningful explanation calls for more than pointing out the obvious facts of the trends. It is in such situations that the strengths of the enterprise can be discussed. Such a situation is an exception to the defensive posture of presentation and to the view that good things can be left to speak for themselves.

If management has intentions of discontinuing the product line with losses by writing it off or by selling it, the intentions should be stated as intentions. However, there is no requirement that vague plans be indicated and no discussion should be made of plans that are vague or undecided.[60] If management plans to take some actions with respect to its operations within a reasonable time after the offering, then the matters should be seriously considered for discussion. The issue of presentation is, of course, more important when the company has been experiencing a declining trend and not an upward trend.

Where there has been an upward trend in earnings, but earnings as a percentage of sales have declined, indicating declining margins, comment is called for to alert the investor to the source of the problem. If the problem was caused because price increases were necessary and in fact were made, no explanation is required. Where, however, the company is for any reason not able to respond with higher prices, discussion is necessary, and where the narrower margins have been caused by competition factors, a full discussion of competition would be required.

58. SEC Securities Act Release No. 5443 (Dec. 12, 1973), [Current Binder] CCH Fed. Sec. L. Rep. ¶ 79,615, at 83,647.

59. See id.

60. See SEC v. Bangor Punta Corp., 331 F. Supp. 1154, 1160-61 (S.D.N.Y. 1971), modified, 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 924 (1973).

D. *Quality of Earnings: Material Changes in Sources of Revenue and Expenses*

The Commission has proposed an amendment[61] to Guide 22,[62] requiring an appraisal of the quality of earnings where there are material changes in sources of revenues and expenses. The proposal is an amendment to an earlier proposal[63] and will in all probability be adopted. The Commission's position is that any change by more than ten percent in sources of revenues or expenses requires discussion. This seems sound, since changes of such magnitude almost invariably foreshadow a change in an enterprise and its prospects. The Commission has specifically noted for discussion the following kinds of changes affecting revenues and expenses:

1. Material changes in product mix or in the relative profitability of lines of business;
2. Material changes in advertising, research, development, product introduction or other discretionary costs;
3. The acquisition or disposition of a material asset other than in the ordinary course of business;
4. Material extraordinary and unusual charges or gains, including charges associated with discontinuation of operations;
5. Material changes in the assumptions underlying deferred costs and the plan for amortization of such costs;
6. Material changes in assumed investment return and in actuarial assumptions used to calculate contributions to pension funds; and
7. The closing of a material facility or other material interruption, or completion of a material contract, or any event that will materially reduce revenue in subsequent periods.[64]

The Commission also requires an appraisal where a change in accounting principle or method of application thereof results in a change of five percent or more in net income or loss.[65]

Many of the items requiring discussion are usually treated anyway when a trend is indicated. However, where changes occur in one year only without causing income decline, companies are often not inclined to analyze the reasons for the changes. At the time the above amendment was proposed, bank holding companies came to the public market for debt financing. Their financial statements indicated that 1973 was a year

61. SEC Securities Act Release No. 5443 (Dec. 12, 1973), [Current Binder] CCH Fed. Sec. L. Rep. ¶ 79,615.

62. Guide 22 (Summary of Earnings), 1 CCH Fed. Sec. L. Rep. ¶ 3782.

63. SEC Securities Act Release No. 5342 (Dec. 18, 1972), [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,144.

64. Guide 22, 1 CCH Fed. Sec. L. Rep. ¶ 3782, at 3317.

65. Id.

in which both their commercial loan portfolios and their expenses (the cost of federal reserve funds and borrowed funds) increased materially; almost all of them experienced narrowed profit margins. As a result, many of them felt called upon to explain to the financial community what had happened in 1973, and what could be expected in the immediate future. The fact that the squeeze was industry-wide may have made it easier for the companies to make an analysis of their situation. The situation of the bank holding companies, however, is illustrative of the reasons why amendments to Guide 22 are needed.

E. *Changes Since Date of Financials and Items Not Fully Reflected in the Financials*

Any changes that have occurred since the date of the financial statements and the interim earning statements and that will materially affect earnings or the security[66] of debt instruments should be reflected by a statement in the financial statements.[67] Items that may have to be included are wage settlements with unions; cost increases that have not or will not be immediately passed on to the ultimate consumer; the incurring of additional short-term debt under lines of credit, which obligations will continue to be outstanding after the offering; and changes in the prime rate when obligations are tied thereto, where the change in rate has not already been reflected in the capitalization table. In addition, of course, any adjustments (such as inventory adjustments) that will be reflected at a later date must be noted or the earnings statement will be misleading. If changes are radical, such as a sale of assets,[68] the only satisfactory appraisal that may be made is to show the impact on a pro forma basis by indicating what the last fiscal year's earnings would have looked like assuming the changes made had been made at the beginning of the period.[69]

A difficult question arises where changes have occurred during the year and have been reflected in the financial statements, but the effects have not been felt for the full period. The threshold question here is the materiality of the change. If the change is material, but the full impact cannot be seen because it has only been partially reflected, then an explanation is in order. Pro forma summaries giving effect to the change for the full period to show the impact may be the most appropriate way to illustrate the change if it is substantial.

66. I.e., the ratio of earnings to fixed charges.

67. See, e.g., Guide 22, 1 CCH Fed. Sec. L. Rep. ¶ 3782, at 3318-19.

68. E.g., The Colorado Milling case, discussed at notes 5-6 supra and accompanying text.

69. This is similar to the result required by the Commission in the Faradyne case. See note 56 supra and accompanying text.

Often changes are anticipated, but have not yet been effected. These changes, of course, will not be reflected in the notes to the financial statements or in a "subsequent events" section. Since the changes are prospective, a determination has to be made as to their certainty and their effect. The fact that the events have not occurred does not mean that they can be ignored. An example of an item that companies tend to ignore is threatened litigation. Standard underwriting agreements require representations and opinions on threatened litigation; if such information is material to the underwriters, it must be deemed material to the investor. If the threatened litigation would be material, it requires mention in the litigation section. To the extent that the company is aware of matters that are material, but cannot be quantified, such as labor negotiations or pending increases in cost of supplies, the matters should be mentioned and the inability of the company to quantify their effect at the present time should be stated.

F. *Nonrecurring Items*

Many nonrecurring items will often be fully explained in the notes to the financial statements. If a nonrecurring item, such as a sale of property, contributes significantly to the bottom line or distorts a trend which would otherwise be obvious, the item should be described even though discussed in the notes.

Tax benefits will be footnoted and described. Where a company has been benefitting from a tax loss carry-forward soon to be fully used, there will usually have been an upward trend in earnings (because the loss was incurred in the early years, and earnings were sheltered by it in the later years); the future loss of this benefit should be stated so that the investor can predict its impact on the earnings of the company. Likewise, there should be discussion of other tax benefits—such as the investment tax credit[70] accounted for on a flow-through basis—which have a one-time materially distorting effect on the reporting of operations of the company.

Acquisitions also may have a distorting influence on the earnings statement. Complete discussion of acquisitions is beyond the scope of this article but certain matters deserve mention. Acquisitions cause the combining of earnings (retroactively in the case of a pooling of interests or prospectively in the case of purchase accounting) so that in many cases enterprises that have not experienced actual growth will be able to report growth on a consolidated basis. The reporting of sales and profits by lines of business was designed to be the corrective for many such cases.

70. Int. Rev. Code of 1954, §§ 38, 46, 48.

There are, of course, limitations inherent in lines-of-business reporting. Such reporting is only sensitive where the enterprises pooled are in different lines of business. In addition, many items do not show up in such reporting. Professor Briloff, an early critic of the conglomerate movement, indicated the benefits Gulf & Western Industries, Inc. derived from pooling.[71] For its fiscal year ended July 31, 1967, Gulf & Western had issued $185 million worth of securities with which it acquired several companies, including Paramount Pictures. Under the pooling of interests method, Gulf & Western recorded the properties acquired at their previous book values, at amounts less than $100 million. Professor Briloff showed that this created a pool of about $85 million that was used to increase earnings by selling the properties as needed.[72] Pooling accounting is not the only cause of this kind of increase in earnings. If a company is acquired for cash or securities at a price less than its book value (a common occurrence in the present market situation) the discount from book value, in purchase accounting, in part will be allocated to properties and to inventory. Such allocation creates a source of earnings which will guarantee growth when such properties are sold. Hence, the allocation of the discount to the properties and inventory requires noting in the context of total earnings growth.

G. *The Private Company Going Public and Secondary Sales*

The transition from private company to public company may mean many changes for the company; those which may have a prospective effect on earnings may not always be reflected in the earnings statement. The most frequent change is in the compensation of management. As holders of the equity, and in anticipation of going public, management may have been taking modest salaries, while intending to take increases after the offering. Such anticipated changes must be described. In addition, where there is a secondary sale alone or coupled with an offering by the company, the question of continuity of management will arise. If management is selling out or contemplates a less active role, full disclosure of this fact would seem necessary.

V. Presentation of Narrative Disclosure

The earnings statement is the keystone of the prospectus or periodic report. Where narrative description illuminates or explains the earnings statement, the statement under the bar (the explanatory matter appear-

71. A. Briloff, Unaccountable Accounting (1972). See also Briloff, Dirty Pooling, 42 Accounting Rev. 489 (1967).

72. A. Briloff, Unaccountable Accounting 65-66 (1972).

ing directly after the footnotes to the earnings statement) should cross-reference the material. In addition to explanatory comments in the notes, the Guides call for such cross-references when adverse changes have occurred subsequent to the period presented in the earnings statement.[73] Material clarifying the statement or explaining matters in the statement (such as trends) should be reflected under the bar. There are no hard and fast rules, but ease of reading and ready access to the information should be the guiding principles.

Often, while counsel for the company and for the underwriters would like clarifications to appear in the notes to the financial statements, the accountants are reluctant to make such changes. The reason for their reluctance usually stems from the facts that they have previously certified the statements with the notes, and their certificates have been published and circulated to the shareholders of the company in the annual report and have been filed with the Commissions in the Form 10-K. Some notes may have a long history and may have appeared in the same form for many years.

If a note is misleading, clearly it should be changed. If the note and the financial statement can be clarified by reference to the text, that alternative will probably be preferred by all parties. Such alternative can be considered sanctioned by the General Instructions to Form S-1 which states: "In lieu of restating information in the form of notes to the financial statements, references should be made to other parts of the prospectus where such information is set forth."[74]

We may consider what effect incorporation in the notes of narrative description in other parts of the prospectus, Form 10-K, or proxy statement, will have on the accountants' certification. The accountants will rightly be very senstive to the fact that they may be incorporating something that they did not prepare and that they therefore will be increasing the scope of their liability. In *Escott v. BarChris Construction Corp.*,[75] it was argued that the accountants had expertized portions of the text of the prospectus by references in the financial notes to textual materials. The court rejected the contention, stating that "[t]he cross reference in [a note] to the 'Methods of Operation' passage in the prospectus was inserted merely for the convenience of the reader. It is not a fair construction to say that it thereby imported into the balance sheet everything in that portion of the text, much of which had nothing to do with the figures in the balance sheet."[76] The scope of the court's holding is limited, how-

73. Guide 22, 1 CCH Fed. Sec. L. Rep. ¶ 3782, at 3316.
74. 1 CCH Fed. Sec. L. Rep. ¶ 7122, at 6202.
75. 283 F. Supp. 643 (S.D.N.Y. 1968).
76. Id. at 684.

ever, and care must be exercised by counsel; some negotiation on this point with the accountants and their counsel is inevitable.

VI. The Relationship of Projections and Appraisals of the Prospects of a Company

For disclosure to be meaningful, it must permit investors to draw meaningful conclusions about the enterprise's prospects. In this regard the Commission has moved in two directions: simplification of presentation for the benefit of the average investor, and (more recently) presentation of information that would only be of use to sophisticated investors.[77] This latter concern may signal the ultimate adoption by the Commission of mandatory use of projections. A concern of the Commission, as stated in the Wheat Report, has been that unsophisticated investors may give projections more significance than they deserve.[78] But if the Commission wants the registration statement or report to be a tool for professional analysts, that objective may well outweigh the Commission's other concerns.

The Commission has recently stated that it has never required a company to disclose publicly its projections and does not intend to do so now.[79] However, on the basis of information obtained in connection with its public hearings on the use of estimates, forecasts, or projections of economic performance of issuers whose securities are publicly traded, the Commission determined, in recognition of the widespread use of projections in the securities markets in connection with investment decisions, to take some steps towards integrating projections into the disclosure system.[80] The Commission proposed to permit reporting com-

77. Owens, Disclosure in a Changing Regulatory System, 170 N.Y.L.J., Nov. 14, 1973, at 1, cols. 5-7: "To the best of my knowledge, for the first time the commission has recognized that some of the information mandated by it may be of utility only to professionals and skilled analysts, and might be beyond the ability of the ordinary investor to comprehend. Lest one thinks this represents a complete turn around, I should add that there is also pending a proposal calling for revisions to the Guides for Preparation and Filing of Registration Statements to require an introductory narrative explanation of the Summaries of Earnings and Operations whenever clarification is needed to enable investors to appraise the quality of earnings." Id. at 7, col. 1.

The distinction between more and less sophisticated investors has also been drawn judicially. E.g., List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), cert. denied, 382 U.S. 811 (1965); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 565-66 (E.D.N.Y. 1971).

78. Wheat Report 12. The Report also noted that projections raised difficult questions concerning civil liability. Id.

79. Statement by former SEC Chairman Casey, pertaining to SEC Securities Act Release No. 5362 (Feb. 2, 1973), [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,211, at 82,665.

80. Id. at 82,665-66.

panies under the securities acts to disclose projections, which (at a minimum) related to sales and earnings, expressed as an exact figure or a reasonable range; underlying assumptions forming the basis for such projections also had to be included. The period of the projections would have to be for a reasonable period, such as a fiscal year.[81]

Although the disclosure of projections would be voluntary, all those issuers who elected to disclose their projections to the public through the financial media, financial analysts, or otherwise would be required to file such projections with the Commission on a form to be developed.[82] In addition, all those issuers who elected to disclose projections would be required to file in the annual report on Form 10-K a statement of the projections made for that year, the circumstances under which they were made, and a comparison of the projections with actual results, including an explanation of material variances.[83] To handle questions of liability with respect to the use of projections, the Commission stated that it contemplated a rule that "would embody the concept that a projection is not a promise that it will be achieved nor per se misleading if not achieved."[84] In furtherance of that concept the Commission stated that a projection under such a rule would not be considered a misstatement of a material fact if the projection were reasonably based in fact and prepared with reasonable care.[85]

The Commission's release came out before the decision in *Beecher v. Able*.[86] In that case a statement of Douglas Aircraft in its prospectus as to the effect of negative factors on the results of operations for the remainder of its fiscal year (for which no results were yet reported) was treated as a projection. The court did not treat the projection as a promise, but held that a high standard of care must be imposed on persons who make projections, although not required to do so. If the Commission follows this holding, the result will probably be to dampen enthusiasm for the use of projections.

Although projections are not permitted to be presented in registration statements or reports at the present time, they are an invaluable tool to management, the underwriters, and counsel for both. Projections make assumptions about sources of difficulties and areas of strength which might not be readily recognizable from a review of the historical financial

81. Id. at 82,667.
82. Id.
83. Id.
84. Id. at 82,668.
85. Id.
86. [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,450 (S.D.N.Y. Mar. 22, 1974).

information. Accordingly, projections should be used as a basis for understanding the prospects of the company.

For example, if the financial statements show a history of growth and if the projections do not indicate the growth will be sustained, the reasons for failing to continue to grow must be considered. If the basis for management's assumptions is not easily ascertainable from the financial information, then descriptive narrative may be required to make the financial information understandable.

The emphasis on presentation of forward-looking information by the Commission and, as to speculative and new issuers, on opinions as to use of cash in the immediate future, requires projections to be prepared by the company and to be reviewed by the underwriters and their counsel. The Commission has moved to the point where, as to some issuers, all but the conclusions of the projections must be presented. The "use of proceeds" section of the prospectus[87] requires companies to state their plans regarding the employment of funds raised, which plans cannot be assessed by the underwriters without a review and analysis of company projections. In other words, counsel should be aware that the Commission's present posture places the burden of reviewing the registration statement, in light of the company's projections, on management, counsel, and the underwriters, while still shielding the unsophisticated investor from the actual projections of revenues and earnings themselves.

VII. Summary

The Commission has always been concerned with disclosure that provides a basis for appraising the prospects of the reporting company. In response to frequent criticism that prospectuses and reporting documents are lifeless and meaningless "doom-filled" documents, the Commission has required, short of presentation of projections, forward-looking disclosure that requires companies to prepare financial documents, and underwriters and counsel to review them, to determine if the enterprises' prospects have been fairly presented.

87. Item 3, Form S-1, 1 CCH Fed. Sec. L. Rep. ¶ 7123, at 6203-04; Guide 21, 1 CCH Fed. Sec. L. Rep. ¶ 3781.