

1-1975

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Recommended Citation

Nemec, Marilyn J. (1975) "Theory & Practice: Recent SEC Pronouncements," *Woman C.P.A.*: Vol. 37 : Iss. 1 , Article 10.

Available at: <https://egrove.olemiss.edu/wcpa/vol37/iss1/10>

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Theory & Practice

Recent SEC Pronouncements

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Amendment of Proxy Rules

A well-known objective of the Securities and Exchange Commission is to obtain for investors, and the financial community in general, improved disclosure by issuers of securities. Toward this end several amendments to various registration and reporting forms have been adopted in recent years. However, these amendments did not significantly affect disclosure in the Annual Report to Shareholders, the most circulated and understandable form of disclosure made by issuers. In January 1974, the SEC issued proposals designed to increase meaningful disclosure in Annual Reports. These proposals were in the form of amendments to certain of that group of 1934 Act rules which are generally referred to as the "Proxy Rules". Many of the proposals had been recommended by the SEC's Industrial Issuers Advisory Committee and by the New York Stock Exchange in its White Paper entitled *Recommendations and Comments on Financial Reporting to Shareholders and Related Matters*.

On October 31, 1974, the SEC announced adoption of many of the proposed amendments in Release No. 11079 under the Securities Exchange Act of 1934. One proposal, which was not adopted, would have required textual information on matters such as the issuer's liquidity, availability and cost of credit, purchase commitments and future financing requirements and plans. Due to a lack of objective standards for these types of disclosure, the SEC decided not to adopt such a requirement at this time.

The Proxy Rules, among other things,

require an Annual Report to precede or accompany proxy solicitations and information statements relating to the annual meeting of security holders. The Annual Report may be in any form deemed suitable by management except that certain material which is set forth in the Proxy Rules must be included. Issuers whose securities (other than an exempted security) are registered under Section 12 of the 1934 Act are required to comply with the Proxy Rules. Generally, this would include issuers whose securities are listed on a stock exchange, those whose assets exceed one million dollars and whose shareholders number 500 or more, and those who have voluntarily registered under Section 12(g). The SEC has stated that, as in the past, its staff will not review Annual Reports prior to their being furnished to security holders.

These amendments are effective December 20, 1974, with respect to issuers who have fiscal years ending on or after that date and who solicit proxies or furnish information statements on or after that date.

The additional information required by the amendments to the Proxy Rules which is to be included in Annual Reports to Shareholders or presented in a separate section or appendix which is referred to in the Annual Report consists of:

- Five-year summary of operations — prepared in accordance with the instructions to Item 2 of Form 10-K. Reconciliations, exhibits and supplemental information required by the instructions to Item 2 are to be omitted.
- Management discussion and analysis of the summary of operations — prepared in accordance with Guide 1 of Guides for the Preparation and Filing of Reports and Registration State-

ments Under the 1934 Act, if changes in revenue and expense as contemplated by the Guide have occurred.

- Brief description of the business done by the company and its subsidiaries during the latest fiscal year.
- Sales and earnings by line of business or sales by class of similar products or services — in accordance with Item 1(c)(1) and (c)(2) of Form 10-K.
- Names of directors and executive officers indicating the principal occupations of each and the name and principal business of any organization by which each such person is so employed.
- Principal trading market of the issuer's voting securities.
- Price range of the securities and dividends paid on the securities for each quarterly period during the last two years.

Also, the issuer's financial statements for the last two years, rather than only the last year, must be reported upon by the issuer's independent auditors.

The proxy statement (or information statement) or annual report must contain in bold face or prominent type a statement to the effect that a copy of the Form 10-K (or in the case of certain companies regulated by other Federal commissions, the Form 12-K), including financial statements and schedules, may be obtained without charge if requested in writing by the security holder. A reasonable fee may be charged for copies of the Exhibits requested.

The issuer is required to take certain steps to supply beneficial owners of its securities with proxies, proxy statements (information statements), and annual reports through the holder of record, such as a stockbroker or bank.

1933 Act Guide 22 and 1934 Act Guide 1

Guides for Preparation and Filing of Registration Statements (Release No. 33-4936) issued in December 1968 contained 53 guides. These guides represented practices and policies followed by the SEC's Division of Corporation Finance in administering the registration and disclosure requirements of the Securities Act of 1933. The guides are not rules of the SEC and they do not comprise complete criteria for the preparation of registration statements. Since 1968, some of the original 53 guides have been amended and Guides 54 through 59 have been added.

Several of the items of information required in 1933 Act registration statements, such as the Summary of Operations, are similar to those required in 1934 Act Forms 10 and 10-K. Form 10 is used for registration under Section 12(g) of the Securities Exchange Act of 1934 of securities which are publicly held after the registrant's assets exceed one million dollars and its shareholders number 500 or more. Form 10-K is the annual report filed by almost all companies who have securities registered under either the 1933 or 1934 Acts. In order to relate the requirements of amended Guide 22 to the Summary of Operations in Forms 10 and 10-K, Guide 1 of *Guides for Preparation and Filing of Reports and Registration Statements under the Securities Exchange Act of 1934* has been adopted.

To enable investors to appraise the "quality of earnings," Guides 22 and 1 were proposed in December 1972. Each contained substantially identical requirements for an explanation of the Summary of Operations or Statement of Earnings in registration and reporting forms. According to the SEC, investors should be in a position to assess the source and probable recurrence of net earnings or losses and to understand the extent to which accounting changes and changes in business activity affect the year-to-year comparability of a company's operations.

Guide 22 applies to the Summary of Operations or Statement of Earnings in Forms S-1, S-7, S-8, S-9, S-11 and S-14 while Guide 1 applies to the Summary of Operations in Forms 10 and 10-K. The provisions of both guides apply to registration statements and reports filed with the SEC after September 30, 1974.

The Guides provide that a separate section entitled "Management's Discussion and Analysis of the Summary of Operations" immediately following the five-year Summary of Operations should include explanations of:

- Material changes from period to period in the amounts of items or revenues and expenses.

- Changes in accounting principles or practices, or changes in the method of their application, that have a material effect on net earnings as reported.

- Favorable or unfavorable material facts which, in the opinion of management, may make historical operations or earnings as reported not indicative of current or future operations or earnings.

Certain definitions and percentage tests limit the changes which must be discussed:

- The discussion of periodic changes usually should be limited to changes between year 5 (the latest fiscal year) and year 4, between year 4 and year 3, and between the interim ("stub") periods if any are presented. However, when necessary for an understanding of the summary, explanations of changes between earlier years should also be included.

- A material change in any of the items of revenue or expense required to be presented by the instructions to the Summary of Operations in the form being filed or in any of the items of expense required to be disclosed by Rule 12-16 of Regulation S-X (Schedule XVI, Supplementary Income Statement Information) is to be explained by management. If an audited statement of earnings or of operations is presented in lieu of the summary of operations, material changes in items of revenue and expense set forth in Rule 5-03 of Regulation S-X, rather than those shown in the instructions to the Summary of Operations, would be discussed.

- The change is material if the item increased or decreased by more than 10% as compared to the prior period and increased or decreased by more than 2% of the average net income or loss for the most recent three years presented in the summary. A loss in one or two of the three years is excluded in computing average net earnings. If losses were incurred in all three years, the average net loss is used for the test. However, an item not meeting the materiality test should be discussed if management believes an explanation of the change is necessary to an understanding of the summary.

- If management is of the opinion that an item meeting the materiality test does not need to be discussed, a separate statement of the reasons for the

omission must be submitted to the SEC as supplementary information with the form being filed.

- Material facts to be discussed when historical operations and earnings are not indicative of current and future operations and earnings are limited to those facts which are disclosed and those facts which are required to be disclosed in the related prospectus, registration statement or report. The discussion would be in broad terms only and no specific quantitative estimates or projections would be required. Under certain circumstances, discussion of material facts indicating changes in either absolute amounts or in trends would also be required.

When the text of the prospectus, registration statement, or report contains a discussion of factors indicating a material change in operating results, whether favorable or unfavorable, subsequent to the latest period included in the summary of operations, management's discussion should call attention to the change and refer to the place in the text where it is discussed.

Management's discussion may be presented in any manner which management deems will best communicate the significant elements necessary for a clear understanding by the investor of the financial results. Favorable as well as unfavorable trends and changes should be discussed. Tables and charts may be used where appropriate. Use of "boiler plate" or "compliance jargon" should be avoided.

Legal Developments

(Continued from page 17)

⁵Accounting Series Release No. 146, "Effect of Treasury Stock Transactions on Accounting for Business Combinations," Washington D.C., August 24, 1973.

⁶*op. cit.*, p. 4.

⁷Accounting Series Release No. 146A, "Statement of Policy and Interpretations in Regard to Accounting Series Release No. 146," Washington D.C., April 11, 1974.

⁸SEC, "Implementing SEC Rules on 'Effect of Treasury Stock Transactions On Accounting for Business Combinations' — ASR No. 146 and 146A," Committee Memorandum, 1974.

⁹For a more complete discussion of APB Opinion No. 16, Accounting Interpretation No. 20, ASR No.'s 146 and 146A and the memorandum, see Ernst & Ernst, *Financial Reporting Developments*, Oct., 1974, Retrieval No. 38174.