

3-1940

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Recommended Citation

Sweet, Homer N. (1940) "Amended Requirements for Financial Statements Prescribed by the Securities and Exchange Commission in Regulation S-X," *Journal of Accountancy*. Vol. 69: Iss. 3, Article 2.
Available at: <https://egrove.olemiss.edu/jofa/vol69/iss3/2>

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Amended Requirements for Financial Statements Prescribed by the Securities and Exchange Commission in Regulation S-X

BY HOMER N. SWEET

REGULATIONS S-X, issued by the Securities and Exchange Commission on February 21, 1940, will govern the form and content of all financial statements required to be filed as part of form A-2 under the securities act and as part of most of the forms of periodic reports (10-K, for example) and of application for registration under the securities-exchange act. Prior to June 1, 1940, registrants have the option of following the existing accounting instructions or the requirements of regulation S-X; after that date regulation S-X is to be used exclusively in place of the accounting instructions it supersedes.

The purpose of this article is to point out the major differences between the accounting requirements of regulation S-X, a book of seventy pages, and the accounting instructions for forms A-2 and 10-K. Form A-2 was issued in January, 1935, form 10-K in December, 1935. It is not surprising that administrative experience gained since those two forms were first published has demonstrated to the Commission the desirability of instituting a number of changes in the accounting requirements.

The requirements for historical financial information, in item 45 of form A-2 and in item 34 of form 10, are not affected by regulation S-X. Nor does regulation S-X modify the requirements for forms 12 and 12-K, used by railroad and communication companies in registering or reporting under the securities-exchange act.

Regulation S-X prescribes special forms of financial statements and accounting instructions for commercial and industrial companies, investment

companies, insurance companies other than life and title insurance companies, committees issuing certificates of deposit, bank holding companies and banks, and natural persons. Commercial and industrial companies, as the term is used in regulation S-X, include public-utility companies that are required to use forms A-2, 10 and 10-K, 11 and 11-K.

The comments herein pertain to commercial and industrial companies, except as otherwise noted. This article draws freely on the language of regulation S-X.

DEPRECIATION, DEPLETION, OBSOLESCENCE, AMORTIZATION

Forms A-2 and 10-K have required registrants to state the policy with respect to the provisions for depreciation, depletion, and amortization, or reserves created in lieu thereof. In regulation S-X the corresponding requirement is more explicit. The new rule is as follows:

State the policy followed during the period for which profit-and-loss statements are filed with respect to—

- (1) The provision for depreciation, depletion, and obsolescence of physical properties or reserves created in lieu thereof, including the methods and, if practicable, the rates used in computing the annual amounts.
- (2) The provision for depreciation and amortization of intangibles, or reserves created in lieu thereof, including the methods and, if practicable, the rates used in computing the annual amounts.
- (3) The accounting treatment for maintenance, repairs, renewals, and betterments; and

- (4) The adjustment of the accumulated reserves for depreciation, depletion, obsolescence, amortization, or reserves in lieu thereof, at the time properties are retired or otherwise disposed of.

This required statement of policy is to be set forth in the profit-and-loss statement or in a note thereto, instead of as a footnote to the schedule of reserves as in forms A-2 and 10-K.

In the balance-sheets of all companies except public-utility companies, reserves for depreciation, depletion, amortization, or retirements, other than reserves created essentially for contingencies, shall be shown, according to regulation S-X, as deductions from the specific assets to which they apply. Forms A-2 and 10-K have no similar requirement. Regulation S-X requires that in the supporting schedule for reserves for depreciation, depletion, and amortization of property, plant and equipment, if practicable, these reserves shall be shown to correspond with the classifications of property.

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment need not be subdivided in the balance-sheet, but in a supporting schedule this asset must be subdivided, if practicable, by major classifications, such as land, buildings, equipment, or leaseholds, and the additions during the period of the report shall be segregated in accordance with an appropriate classification. However, a public-utility company shall, to the extent practicable, classify utility plant by the type of service rendered (such as electric, gas, transportation, and water) and shall state separately under each of such service classifications the major subclassifications of utility-plant accounts. In form A-2 property, plant and equipment could be shown in one amount.

Regulation S-X requires that if property, plant and equipment abandoned is carried at other than a nominal

amount, there shall be indicated in the supporting schedule, if practicable, the amount thereof and the reasons for such treatment. The writer suggests that this required information about abandoned properties should usually be set forth also in a note to any balance-sheet prepared for a prospectus.

AMOUNTS DUE FROM DIRECTORS, OFFICERS, AND PRINCIPAL STOCKHOLDERS

A new schedule prescribed by regulation S-X requires that there be reported, for each period for which the profit-and-loss statement is filed, certain information in respect of each person among the directors, officers, and principal holders of equity securities other than an affiliate from whom more than \$20,000 or 1 per cent of total assets, whichever is less, was owed at any time during the period. The information so required is the name of the debtor, the balance receivable from the debtor at beginning of the period, the total charges to the account during the period, the total amounts written off and the total collections during the period, and the balance receivable at close of the period. For the purposes of this schedule, purchases subject to usual trade terms, ordinary travel and expense advances and other such items arising in the ordinary course of business shall be excluded in the determination of the amount of indebtedness. Information in respect of debts from directors, officers, and principal stockholders has been required to be submitted as a supporting schedule in form A-2 only if the indebtedness existing at the date of the balance-sheet was in excess of \$20,000.

INDEBTEDNESS OF AND TO AFFILIATES

Form A-2 has required a schedule of indebtedness in excess of \$20,000 owed to the registrant by any affiliate at the date of the balance-sheet.

Regulation S-X requires a schedule of

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indebtedness owed to the registrant by each affiliate not only at the close, but also at the beginning, of each profit-and-loss period, and also a schedule of noncurrent indebtedness owed by the registrant to each affiliate at the close and at the beginning of each profit-and-loss period. This information may be shown in total for two or more totally held subsidiaries provided the number of subsidiaries so grouped is stated, and permission is given in regulation S-X to combine in one schedule, if desired, the required information as to indebtedness owed by and to affiliates.

INVENTORIES

In forms A-2 and 10-K it has been required that the basis of determining the amounts of inventories shall be shown in the balance-sheet. This requirement has been commonly met in practice by a parenthetical note, such as "cost or market, whichever is lower." Regulation S-X requires not only that the basis of determining the amounts of inventories shall be stated in the balance-sheet, but also—

If a basis such as "cost," "market," or "cost or market, whichever is lower" is given, there shall also be given, to the extent practicable, a general indication of the method of determining the "cost" or "market": *e.g.*, "average cost" or "first-in, first-out."

PREFERRED STOCK

Regulation S-X adopts as a rule the opinion of the chief accountant of the Securities and Exchange Commission in accounting series release No. 9, December 23, 1938, with respect to disclosure in the balance-sheet of preferences of senior stock on involuntary liquidation. When the excess of the preference on involuntary liquidation over par or stated value of the stock is significant, the following information must be set forth: the difference between the aggregate preference on involuntary liquidation and the aggregate par or stated value;

a statement that this difference, plus any arrears in dividends, exceeds the sum of the par or stated value of the junior capital shares and the surplus, if such is the case; and a statement as to the existence, or absence, of any restrictions upon surplus growing out of the fact that upon involuntary liquidation the preference of the preferred shares exceeds its par or stated value.

SURPLUS

Regulation S-X has certain requirements, not present in forms A-2 and 10-K, in respect of the showing of surplus in the balance-sheet. Surplus arising from revaluation of assets is specified as one of the classes of surplus which must be shown separately in the balance-sheet, besides paid-in surplus, other capital surplus, and earned surplus. However, unsegregated items of surplus may be stated in one amount if the company has not up to the beginning of the period of report differentiated the classes of surplus in its accounting.

If surplus is not segregated in the balance-sheet, the account titles used in the balance-sheet, in the words of regulation S-X, shall be such as will indicate the general types of surplus included. This requirement puts on registrant companies an obligation which was not specified in the instructions for forms A-2 and 10-K. Another new requirement is that the amount of any undistributed earnings of subsidiaries included in the surplus account of the parent company shall be stated parenthetically or otherwise in the parent company's balance-sheet.

PROFIT AND LOSS

Merchandising organizations, both wholesale and retail, are permitted by regulation S-X to include occupancy and buying costs in cost of goods sold. Publicity costs, however, must be included in selling, general, and administrative expenses or shown separately. The latter requirement supersedes se-

curities-exchange-act release No. 174, April 14, 1935, which has permitted merchandising organizations to include publicity costs in cost of goods sold. Industrial organizations are not prohibited by this rule, as I interpret it, from including occupancy and buying costs in cost of goods sold.

Gain from transactions in a company's own capital shares shall be carried direct to the appropriate surplus account. This accounting principle in regulation S-X accords with the opinion of the chief accountant of the Commission in accounting series release No. 6.

Regulation S-X prescribes the definite rule that dividends applicable to an issuer's own capital shares held in its treasury or in sinking or other special funds shall not be treated as income. This principle was endorsed by the chief accountant of the Securities and Exchange Commission in accounting series release No. 5.

In the schedule of supplementary profit-and-loss information, each significant item of taxes, other than income and excess-profits taxes, must be stated separately.

If any noncash dividends received from affiliates have been credited to income in an amount different from that charged to income or earned surplus by the disbursing company, the amount of the difference shall be stated and explained in the supplemental schedule, income from dividends.

OTHER BALANCE-SHEET INFORMATION

Other balance-sheet information required by regulation S-X, but not called for in forms A-2 and 10-K, is described briefly below.

When instalment receivables or inventories long in process are included in current assets in accordance with generally recognized trade practices, an estimate, if practicable, shall be given of the amount not realizable within one year.

Each pension or other special fund of

a significant amount shall be separately stated in the balance-sheet.

Reacquired bonds and other evidences of indebtedness and reacquired capital shares, if significant in amount, are not permitted to be carried among the assets, but must be shown separately as a deduction under the appropriate caption on the liabilities side of the balance-sheet.¹ Reacquired capital shares may be shown as a deduction from capital shares, or from the total of capital shares and surplus, or from surplus, at either par or stated value, or cost, as circumstances require.

Discount on capital shares, if significant in amount, shall be shown separately as a deduction from capital shares or from surplus, as circumstances require, with an indication of what provisions have been made for writing off this item.

CONSOLIDATED AND COMBINED STATEMENTS

Regulation S-X does not materially modify the requirements of forms A-2 and 10-K for consolidation of the financial statements of a registrant company and its subsidiaries. It does require that the principle adopted in determining the inclusion and exclusion of subsidiaries in each consolidated balance-sheet and in each group balance-sheet of unconsolidated subsidiaries shall be stated, and further that a statement shall be made whether there have been included or excluded any subsidiaries not similarly treated in the corresponding statement filed for the preceding fiscal period.

Regulation S-X prescribes that statements which may be filed consolidating or combining in one or more groups the

¹ However, reacquired evidences of indebtedness held for pension and other special funds not related to the particular issue may be carried as assets of such funds, provided that there be stated parenthetically the amount of such evidences of indebtedness, the cost thereof, and the amount at which carried.

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statements of majority-owned subsidiaries not consolidated with the registrant shall be pursuant to principles of inclusion or exclusion which will clearly exhibit the financial condition and results of operations of the group or groups. A consolidated or combined statement for majority-owned subsidiaries not consolidated with the registrant shall be filed if such a statement, in place of separate statements of these subsidiaries, is essential to a properly summarized presentation of the facts.

If any subsidiaries are not consolidated, it is required in regulation S-X that a statement shall be made of the amount of any difference between the investment of the registrant and its consolidated subsidiaries, as shown by their books, in the unconsolidated subsidiaries for which statements are filed and the equity of such persons in the net assets of such unconsolidated subsidiaries, as shown by the books of the latter. Forms A-2 and 10-K have no similar requirement in respect of subsidiaries not consolidated.

INFORMATION ADDITIONAL TO MINIMUM REQUIREMENTS

One of the accounting instructions for forms A-2 and 10-K is that the information specified in the instructions shall be furnished as a minimum requirement, to which the registrant may add such further information as will contribute to an understanding of its financial condition and operations. The corresponding rule in regulation S-X is as follows:

“Additional information. The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. This rule shall be applicable to all statements required to be filed, including copies of state-

ments required to be filed in the first instance with other governmental agencies.”

The last sentence just quoted is a new instruction. It has its application to railroad and communication companies whose statements in the form required by other federal commissions are filed with the Securities and Exchange Commission as part of a registration statement or annual report.

SIMPLIFICATION AND CLARIFICATION OF REQUIREMENTS

The required explanatory notes on accounting principles and practices may be presented as a single statement with cross-references thereto in the appropriate financial statements. If notes required with respect to two or more financial statements cover substantially the same subject matter, a note given in one of the statements will suffice, provided a clear and specific reference to that note appears on the other statements.

In the words of regulation S-X any schedule in support of a balance-sheet caption need contain information only as to the balances as of the related balance-sheet date if both the additions and the deductions during the period for which profit-and-loss statements are filed were not significant; or such a schedule may be omitted if the balances as of the related balance-sheet date and both the additions and the deductions during the period for which profit-and-loss statements are filed were not significant.

Information required to be presented on a consolidated basis may be shown, in the same supporting schedule with the information required in respect of the registrant itself, provided that items pertaining to the registrant are separately shown and the single schedule affords a properly summarized presentation of the facts.

The supporting schedules of funded

debt and capital shares have been clarified. Any significant changes in funded debt and capital stock since the date of the balance-sheet must be indicated in notes to the respective schedules included in registration statements filed under the securities act or in applications for registration of securities under the securities-exchange act.

Prepayments of services to be received within one year may be included under current assets or under deferred charges on the balance-sheet.

Financial statements may be filed in such form and order, and may use such generally accepted terminology, as will best indicate their significance and character in the light of the provisions applicable thereto and no entry need be made as to captions in any financial statement, or note, as to which the items and conditions are not present. That degree of flexibility, permitted by regulation S-X, is essentially the same as that which has been permitted by the instructions for forms A-2 and 10-K. Regulation S-X also states that if the amount to be shown under any caption is not significant, the caption need not be separately set forth. However, the captions or column headings of any supporting schedule required to be filed must be set forth.

OPENING BALANCES

In the analysis of surplus and in certain of the schedules required by regulation S-X, namely,

Amounts due from directors, officers, and principal holders of equity securities other than affiliates
Investments in securities of affiliates
Indebtedness of affiliates
Property, plant and equipment
Reserves for depreciation, depletion, and amortization of property, plant and equipment
Intangible assets
Reserves for depreciation and amortization of intangible assets
Indebtedness to affiliates—not current
Reserves

the balances at the beginning of the period reported on may be "as per the accounts" if the company has not previously filed financial statements under the securities act or the securities-exchange act.² As to the companies that have previously filed financial statements under either act, balances "as per the accounts" may be taken as of the close of the most recent period for which certified financial statements are on file with the Securities and Exchange Commission.

CERTIFICATION

The rule for certification in regulation S-X is contrasted below with the corresponding instructions for form A-2.

² There are a few exceptions to this rule. A special rule fixes January 1, 1925, as the latest date as of which the balance in surplus account of investment companies may be accepted. The clause "as per the accounts" does not apply to the balance in reserves at the beginning of the period of report of a bank holding company or an investment company.

As in instructions for form A-2

. . . certificate shall be dated, shall be reasonably comprehensive as to the scope of the audit made,

As in rule 2.02 of regulation S-X

(a) The accountants' certificate (1) shall be dated; (2) shall be signed manually; (3) shall identify without detailed enumeration the financial statements certified; (4) shall contain a reasonably comprehensive statement as to the scope of the audit made; (5) shall state whether there have been any changes in accounting principles or practices required to be set forth by rule 3.07 and

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and shall state clearly the opinion of the accountant or accountants in respect of, the financial statements of, and the accounting principles and procedures followed by the registrant.

In certifying to the financial statements of the registrant, independent public or independent certified public accountants may give due weight to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff.

In such case the independent accountants shall review the accounting procedures followed by the registrant and by appropriate measures shall satisfy themselves that such accounting procedures are in fact being followed.

Nothing in these instructions shall be construed to imply authority for the omission of any procedure which independent public or independent certified public accountants would ordinarily employ in the course of a regular annual audit.

The certificate of the accountant or accountants shall be applicable to the matter in the registration statement proper to which a reference is required on the balance-sheet.

Rule 3.07 in regulation S-X, to which reference is made in (a) (5) above, reads as follows:

Changes in accounting principles and practices. If any significant change in accounting principle or practice has been made at the beginning of or during any period covered by the profit-and-loss statements filed, a statement as to

shall state clearly the accountants' opinion as to any such changes; and (6) shall state clearly the opinion of the accountants in respect of the financial statements of, and the accounting principles and procedures followed by, the registrant and its subsidiaries.

(b) In certifying the financial statements, the accountants may give due weight to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff.

The accountants shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy themselves that such accounting procedures are in fact being followed.

Nothing in these instructions shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of presenting comprehensive and dependable financial statements.

(c) Any matters to which the accountants take exception shall be clearly identified and the exception thereto specifically and clearly stated.

(d) If certification is made by an individual accountant, the above provisions as to accountants shall be read in the singular.

See author's comment below on rule 5.04.

the change shall be given in a note to the appropriate statement, and if the change substantially affects proper comparison with the preceding fiscal period, the necessary explanation.

This rule is similar to one of the instructions for form A-2.

Rule 5.04 in regulation S-X requires that schedules in support of any certi-

fied balance-sheet or certified profit-and-loss statement shall be certified. It would not be inconsistent with this rule, according to my understanding, for the accountant to follow the usual practice of giving one certificate covering all the financial statements required to be certified, including the schedules as well as the balance-sheet, profit-and-loss statement and statement of surplus.

INVESTMENT COMPANIES

The accounting requirements for investment companies in regulation S-X differ in a few respects from the instructions for form 15 (issued May 15, 1935) for incorporated investment companies.

Form 15 specified that securities to be classed as marketable must have a ready market. This "ready market" rule, in as far as investment companies are concerned, has been dropped from regulation S-X.³

Form 15 did not require that a reserve for unrealized depreciation in value of investments, if provided, should be deducted from the investments in the balance-sheet. Regulation S-X allows the registrant no choice in the matter; reserves for unrealized depreciation in value of securities, if provided, must be shown in the balance-sheet as a deduction under investments.

Regulation S-X requires that the total of any management and other service fees paid by an investment company to affiliated organizations or persons shall be stated separately in the profit-and-loss statement supplemented by a statement of the name of, and amount applicable to, each affiliated organization or person accounting for 10 per cent or more of the total ex-

penses of the period for supervision and management of investments.

SUMMARY

An improvement which should prove to be especially helpful is that the accounting requirements under the securities act and the securities-exchange act are, as far as feasible, made uniform by regulation S-X. Differences which have existed in the detailed accounting regulations under the two acts have now been removed. The new regulation also clarifies many of the accounting instructions.

The amended rules for certification of financial statements by accountants add two new requirements to the old rule: accountants shall state clearly their opinion as to any significant changes in accounting principles or practices made in the period covered by the profit-and-loss statements filed; and any matters to which the accountants take exception shall be clearly identified and the exception thereto specifically and clearly stated. As a whole, the amended rules for certification do not depart from generally established standards. However, the Securities and Exchange Commission has announced that the new rules governing certification are to be reconsidered with a view to revisions deemed necessary as a result of pending proceedings.

The additional accounting information which will have to be furnished in financial statements and in supporting schedules in compliance with the new regulation is not voluminous. An important change which regulation S-X introduces into the profit-and-loss statement, in the interest of investors, is a broader requirement for an explanation of the accounting policy as to depreciation, maintenance, renewals, betterments, and retirements of properties.

³ Commercial and industrial companies, however, may include marketable securities in current assets only if the securities have a ready market.