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Disclosure in Summaries of Earnings

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THE summary of earnings required to be included in most registration statements filed with the Securities and Exchange Commission ("SEC") is recognized as being one of its most important parts. It is this summary which presents in condensed form the earnings history of the business and which gives the investor a basis for evaluating its future prospects. Equally important, the summary provides a convenient gauge as to the reasonableness of the offering price of the stock or the ability of the company to earn the interest or dividend requirements on a proposed debt or preferred stock issue. Accordingly, it is incumbent upon the CPA, who is involved in the preparation of a registration statement, to be most familiar with all aspects of the preparation of the summary.

The basic rules for preparing the summary are included in the SEC's instructions to the various registration forms, of which Form S-1 is the principal one. Item 6 (Summary of Earnings) of Form S-1 provides that the summary shall include the operating results of the registrant and its subsidiaries consolidated for "each of the last five fiscal years of the registrant (or for the life of the registrant and its immediate predecessors, if less) and for any period between the end of the latest of such fiscal years and the date of the latest balance sheet furnished, and for the corresponding period of the preceding fiscal year." As a practical matter,

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the summary of earnings is usually amplified so as to serve (as permitted under Form S-1) as the required "statement of income" and it will be discussed in that context herein. Although other problems incidental to the preparation of the summary will be referred to, it is intended that the scope of this article will be limited to the nature and extent of disclosures required.

Standards of disclosure

Before considering the specific matters that should be disclosed in a summary of earnings, it would be well to review first the basic requirements for disclosure and the standards to be met. Generally, this is approached in a negative manner by considering whether disclosure is in fact inadequate. Here the customary rule is that disclosure is inadequate "if interested and informed investors are misled as to any material item, or if they are not advised of important matters concerning which they are entitled to be apprised."

The adequacy of disclosure must be evaluated by the CPA who will be guided by the AICPA's pamphlet *Generally Accepted Auditing Standards* which states: "Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report." In this evaluation, the CPA should be guided by conventional (non-SEC) financial reporting practices, authoritative auditing texts and the pronouncements and publications of the AICPA. In reporting on the summary of earnings, he must also take into consideration the specific accounting rules of the SEC, primarily Regulation S-X as supplemented by the Accounting Series Releases, and the SEC's general requirement for the summary of earnings (Form S-1, Item 6) that it shall, whenever necessary, "reflect information or explanation of material significance to investors in appraising the results shown, or refer to such information or explanation set forth elsewhere in the prospectus."(1)

Disclosure techniques

The primary considerations in determining the best manner of conveying the various appropriate disclosures are the nature and the length of the data to be disclosed and whether such data are included in other parts of the prospectus, including the notes to the other financial statements. Generally, any of the following media of disclosure are appropriate:

(1) Standards Of Disclosure For Published Financial Reports, *The Accounting Review*, Vol. XXX, July 1955, p. 400.

1. The body of the summary as, for example, a separate caption, a part of a caption or a separate column.
2. Notes to the summary or explanations in a textual paragraph preceding or following it.
3. Other sections of the prospectus, including notes to the other financial statements, to which reference is made.

Although some flexibility exists in the manner in which specific disclosures may be made, the form of presentation should be designed to enhance the reader's understanding of the data and to minimize the possibility of misinterpretation.

It is desirable and, in fact, recommended by the SEC that information be shown only once in a prospectus and not duplicated. Therefore, when disclosures essential to the summary of earnings are included elsewhere in the prospectus, they should be referred to explicitly in the summary but not recited again. The CPA, however, should be sure that the information so referred to is complete and to the point.

Since the summary usually appears in the forepart of the prospectus whereas the other financial statements appear on the final pages, it is necessary in preparing the summary to distinguish between accounting disclosures relating to operations and essential to the proper understanding of the summary and disclosures relating to the other financial statements. With regard to disclosures to be included in notes to the summary, the SEC has stated that such disclosure may be limited to "information . . . of such special significance in appraising the summary that its omission would likely give rise to misleading inferences."(2) Accordingly, it is customary to omit from the notes to the summary the so-called compliance information required by Regulation S-X (opening and closing inventories, depreciation methods and rates and so forth), and include this information in the notes to the other financial statements.

Some accountants have followed the practice of including required financial disclosures in the notes to the financial statetments and of referring in the summary to those notes which have an important bearing on operations. Although this may simplify the drafting of the notes, it is likely to prove perplexing to the reader of the prospectus who must repeatedly turn pages back and forth in order to read the summary. In situations where a particular disclosure has a significant bearing on both

(2) Accounting Series Release No. 62 (June 27, 1947).

operations and financial position, it should be appended to the statement to which it is most pertinent and a cross reference thereto included in the other statement.

Care should be taken to segregate information and explanations relating principally to accounting matters, which ordinarily fall within the scope of an audit, from disclosures of an interpretive and non-accounting nature. Accounting-type disclosures may be included in the summary or notes thereto, while non-accounting disclosures should preferably be set off in a textual paragraph after the summary. This treatment removes any inference that the non-accounting data is covered by the accountant's report. In the discussion which follows, the various specific disclosures have been grouped in the categories (accounting or non-accounting) in which they generally fall.

Accounting disclosures

General basis of presentation—The first accounting disclosure usually made is a statement of what the summary purports to be. For example, it is customary to explain which companies' operating results are included. This can be done in an introductory paragraph or, if the explanation is lengthy (for example, where operating results of predecessor companies are included), in a note. Types of situations which require disclosure may be exemplified as follows:

1. The registrant was organized during the period of the summary or prior to the effective date of the registration statement by a combination of companies in a transaction accounted for as a pooling of interests. (A summary combining the operating results of all of the companies combined or to be combined is usually presented in these cases.)
2. The registrant succeeded to businesses previously conducted as partnerships, "Subchapter S" corporations or divisions of other corporations. (A summary including the historical operating results of such predecessors with appropriate pro forma adjustments reflected after historical net income to arrive at pro forma net income on a basis comparable to the registrant's present operations is customary in these cases.)
3. The registrant has acquired companies in transactions accounted for as poolings of interests. (The summary should be restated to include all such companies for all periods with appropriate

disclosure, if applicable, as to whether operating results of such pooled companies have been recast to a common fiscal year or combined on the basis of their differing fiscal years.)

Purchases or dispositions of businesses—Major acquisitions or dispositions of businesses subsequent to the initial year presented in the summary of earnings will have a significant effect on a registrant's five-year earnings history, except when they occur during the latest months of, or shortly after, the last fiscal period presented in the summary. In the latter situation the summary of earnings will not be representative of the registrant's business as presently constituted. In either event, disclosure will be required and this can be accomplished by several means.[3]

When significant acquisitions take place during the period covered by the summary, one of the following methods of disclosure is appropriate:

a. Segregate sales and gross profits in the summary as between the original business of the registrant and the acquired businesses. This method is especially appropriate where the acquisitions have had the effect of substantially changing the character of the registrant's business.

b. Disclose in a note the sales and operating or net income of acquired businesses for the year of acquisition. This disclosure is appropriate where the effect of acquisitions is less than in (a) above but where the comparability of one or more years is significantly distorted.

c. Include in a note a statement explaining generally the effect of the acquisitions on the summary and referring to other sections of the prospectus wherein the acquisitions are discussed. This disclosure is appropriate when the effect of acquisitions can be clearly indicated without supplementary financial data, as for example, when substantially all of the increase in sales and operating profit between years is attributable to the acquisitions.

When significant purchases of businesses occur during or shortly after the last fiscal period presented, the historical results of operations of the registrant will not be representative of the results which can be expected

(3) The SEC's Accounting Series Release No. 53 (November 16, 1945) states that "disclosure should be made as to significant known factors that might render past earnings statements, or particular items therein, not indicative of probable future operations."

in the future. In such cases, it is generally appropriate to include in a separate column in the summary, or in a note, a pro forma presentation combining the registrant's operating results for its last fiscal year or a recent twelve-month period with those of the purchased companies for a comparable period. This presentation should give effect to appropriate pro forma adjustments, such as interest on debt incurred to finance the acquisition, additional depreciation or amortization on the "stepped-up" accounting basis of assets and the related tax effect. Similarly, if the registrant sold or otherwise disposed of operating units which accounted for a material portion of consolidated sales or net income during any period presented, the results of operations of such units should be segregated to the extent practicable within the summary so as to show either complete results of operations of the discontinued units or at least the resulting operating profit or loss. If operating profits or losses of the continuing business differ materially from the related historical consolidated amounts, a presentation of pro forma net income and earnings per share of the continuing business after giving effect to allocation of income taxes and any other properly allocable expenses is customary.

Changes in accounting principles employed—For disclosure purposes, changes in accounting principles employed or in their method of application may be classified between (a) those changes for which retroactive effect is customarily given in the summary (e.g., consolidation of foreign subsidiaries not previously consolidated) and (b) those changes for which retroactive effect is not customarily given (e.g., changes in depreciation methods).

As to changes retroactively applied, disclosure is not necessary if there has been no wide distribution of the financial statements prior to the restatement; otherwise, disclosure is required as to the change in net income in each year restated. It is not necessary, however, to repeat this disclosure in statements issued in years subsequent to the one in which the change is initially disclosed.

As to changes not retroactively applied, the effect upon net income and net income per share in the year of change and, if practicable, in all subsequent years shown, should be disclosed. This disclosure should be continued in each summary of earnings in which results of operations of the year prior to the change are presented. If changes have been numerous, it may be convenient to reflect their nature and effect in tabular form with columns provided for each year in which a change has occurred.

Sales and operating revenues—Under the circumstances indicated below, additional information regarding sales and operating revenues must be disclosed.

1. Operating revenues (income from services, rents, etc.) must be stated separately from sales, if the lesser of the two exceeds 10% of the combined amounts and if the summary is intended to serve as the required "statement of income." Related costs of sales and operating expenses must also be shown separately in this case. If the registrant's accounting system makes it impracticable to segregate such costs and expenses, an explanation to this effect is customarily included in a note to the summary.
2. It is usually necessary to disclose the method of recognizing income under long-term construction contracts and other unusual methods, such as the deferral of income from installment sales and the finance method of accounting for income by equipment leasing companies.
3. Where a substantial portion of the registrant's sales are to one or two customers, this fact must be brought out. This also applies when a significant amount of sales is made directly or indirectly to the U. S. Government at prices subject to renegotiation or redetermination.

Selling, general and administrative and certain other expenses— When the summary is designed to serve as the required "statement of income", certain expenses must be disclosed even if it is not the practice of the registrant to disclose such amounts for other reporting purposes. These include:

1. Selling, general and administrative expenses: Companies using functional expense classifications for other reporting purposes will usually include information as to selling, general and administrative expense in a note.
2. Interest on bonds, mortgages and similar debt: If substantially all interest relates to such debt, this requirement may be conveniently met by inserting the suffix after interest expense, "principally on long-term debt."
3. Profit sharing and pension plan provisions: If these provisions have been made on a consistent basis throughout the period and

no major change in the plans has occurred, no disclosure is usually necessary. However, when these costs fluctuate significantly, they should be shown separately. When they have been curtailed or substantially reduced in any period, or when the plans have been recently adopted or are to be adopted and their full effect is not reflected in the summary, the effect on net income (per share and in total) should be disclosed by showing what the situation would have been if the company had contributed (a) in the case of pension plans, an amount sufficient to cover current service costs, plus interest on unfunded past service costs, if that is to be the registrant's accounting policy, and (b) in the case of profit sharing plans, the maximum contribution permitted under the plan. In the case of recently adopted or proposed plans, appropriate disclosure may frequently be made by a cross reference to information given elsewhere in the prospectus concerning these arrangements.

4. Provisions for doubtful accounts and amortization of debt discount and expense should be disclosed, if material in relation to net income or to related expense captions in which these amounts would otherwise be combined.

Significant non-recurring items (included in the determination of net income)—In Accounting Series Release No. 62 it is stated that "unusual conditions or significant non-recurring items of income or expense (should be disclosed) in the summary or by footnote." If such items cannot be adequately described and their non-recurring nature indicated in the summary, they should be explained and their per share effect on net income given in a note or in the earnings per share tabulation following the summary. Examples of items of this type are gains or losses on sales or disposition of major investments or units of property, gains on sale of inventories acquired at substantial discounts in the purchase of other companies and plant moving or start-up expenses.

Special items—Regulation S-X requires that special items (i.e., non-recurring or other items of profit and loss not included in the determination of net income) are to be separately stated and described. In situations where there is more than one special item or if required descriptions are unavoidably lengthy, it is often convenient to include the information in a note. If special items representing adjustments of prior years' transactions have been previously reported in annual reports but, for purposes

of the summary, are retroactively applied to such prior years (see "retroactive adjustments" following), the nature and amount of such items and the years affected should be disclosed.

Income taxes—Explanation is required as to income tax provisions, reductions or related tax situations which are unusual or non-recurring or which otherwise require disclosure to prevent the summary from being misleading. Some examples are:

Deferred taxes: In accordance with the concept stated in Accounting Series Release No. 85 (Footnote 7), disclosure is required of the amount of provisions for and the factors giving rise to deferred income taxes. This may be accomplished by use of a separate descriptive caption in the summary (e.g., "Provision for income taxes—deferred, relating to accelerated tax depreciation") or by a note.

Loss carry-forwards: If the tax provisions in the summary are materially reduced due to carry-forwards of tax losses from prior periods, disclosure of the effect of such carry-forwards upon net income, per share and in total, in each period is usually considered essential.(4) In cases where loss carry-forwards have the effect of substantially reducing the normal tax provision in most of the periods presented in the summary, disclosure may be accomplished either in a note or by amplifying the provision for federal income tax so as to show separately (a) the provision before giving effect to the loss carry-forwards and (b) the reduction due to such carry-forwards. The earnings per share tabulation, in this instance, would also be amplified so as to present the per share amounts before loss carry-forward benefits as well as on a historical basis. The amount of the remaining unused carry-forward, in total and by year of expiration, should ordinarily also be indicated.

Disproportionate tax provisions: Other reasons why the provision for Federal income tax does not bear the approximate normal relationship to income before such tax should ordinarily be disclosed except in instances where such abnormalities are occasioned

(4) In Securities Act Release No. 4469 (March 21, 1962), the SEC held that the summary of earnings included in the registration statement was rendered misleading by the failure to disclose, among other things, that net earnings for a recent fiscal year were higher because of the utilization of non-recurring tax loss benefits.

by percentage depletion, the dividend received deduction or other obvious causes. Losses of subsidiary companies, capital gain treatment of major items of income and individual corporate surtax benefits in multiple-corporate organizations are typical items ordinarily so mentioned.

Prior years' tax credits and adjustments: If material, these should be retroactively applied to the year(s) to which they relate, including years prior to those reported in the summary, and the resulting adjustments to net income or special items previously reported should be disclosed.

Consolidated income tax returns: If a summary of earnings relates to a company which has paid or currently pays its Federal income tax as a member of a consolidated group of companies, disclosure should be made in a note of the estimated amount of tax that would have been shown had the company filed its own tax return, if significantly different from amounts provided.

Investment tax credits: Under the provisions of Accounting Series Release No. 96, disclosure is required of the amounts of investment tax credits, if material, and the method of accounting for them. Furthermore, the SEC insists that in the summary of earnings the income deductions relating to the investment credit be classified on a basis consistent with that used in the balance sheet. For example, if the unamortized investment tax credit is applied as a reduction of the property accounts, the corresponding charge in income should be to depreciation expense or to another appropriate account but may not be to the provision for Federal income tax.

Payment of dividends and restrictions thereon—The existence of restrictions on payments of dividends is frequently a significant factor to be considered in the interpretation of earnings and dividend data in the summary. Such restrictions may usually be disclosed by a cross reference to a note to the financial statements or to a section of the prospectus wherein such restrictions are described. If no dividends have been paid during the period, that fact should be indicated in a note.

Litigation and other contingencies—Contingencies relating to income tax matters, litigation or other uncertainties which could materially affect earnings should be described or referred to in a note to the summary.

Such description should include (a) information as to the nature of the contingent items, (b) appraisal of outlook, (c) monetary estimate or a statement that no estimate is determinable and (d) the opinion of management or counsel as to outcome. Contingencies of such significance as to warrant disclosure in the summary of earnings may require a qualification in the CPA's report.

Unconsolidated subsidiaries and 50% owned companies—The amount of the registrant's equity in earnings of unconsolidated subsidiaries and 50% owned companies as compared with dividends received should be disclosed in a note to the summary if the amounts are material. If the registrant or a consolidated subsidiary had transactions with unconsolidated subsidiaries or other affiliated companies, the amount of sales to such companies and the estimated profit or loss thereon or on any other transactions with affiliates must also be disclosed.

Foreign operations—If the summary includes substantial amounts applicable to foreign operations, it is appropriate to include a note disclosing sales and earnings of such operations and the effect, if any, of foreign exchange restrictions.

Retroactive adjustments—Appropriate disclosure of such adjustments, including a brief description of the nature of the adjustment and the amounts by which previously reported earnings have been restated, should be included in a note to the summary.[5] Where adjustments are numerous and substantial, this note may take the form of a tabular reconciliation of earnings as originally reported and as restated.

Earnings and dividends per share or ratio of earnings to fixed charges—The basis on which per share amounts are computed, particularly if on other than shares historically outstanding, should be indicated in the summary or a related note.[6]

Special consideration should be given to proposed future changes in capital stock if dilution of earnings is involved. For example, if all or a

(5) In Accounting Series Release No. 62 the SEC indicated that, in preparing the summary of earnings, amounts originally reported should be recast to reflect subsequent transactions or adjustments applicable to prior years.

(6) Some typical situations in which shares historically outstanding will be retroactively adjusted for purposes of per share computations include: recapitalizations and stock splits, including those occurring shortly before the effective date; recurring stock dividends; issuance of shares in poolings of interests and substantial conversions of preferred stock or debt. In the latter situation, dividends and interest (net of tax) applicable to the preferred stock and debt converted, respectively, would be eliminated for purposes of such pro forma computation.

substantial portion of the proceeds from sale of capital stock is to be used to retire long-term debt or to replenish recently depleted working capital and if a significant dilution of earnings is indicated, it is ordinarily appropriate to disclose a pro forma earnings per share for the latest year (and any subsequent interim period). Such pro forma computation should be based on (1) the actual shares outstanding adjusted for the number of shares to be sold in so far as the proceeds therefrom are required to liquidate such debt or restore normal working capital and (2) net income after giving effect to the elimination of interest expense on the debt to be liquidated, less related income tax effect.

When the summary has been restated to include substantial amounts applicable to companies acquired in poolings of interests, dividends of such companies, which would not be included in the per share statistics because of differing dividend policies, may be disclosed in a note. Disclosure of dividends paid in a note rather than in per share statistics may also be appropriate in certain other unusual situations in order to avoid misleading inferences as, for example, where in the past dividends were paid to a parent company on the basis of the parent's requirements for funds or where dividends have been waived on shares held by controlling stockholders.

Companies registering debt securities and reflecting the ratio of earnings to "fixed charges" in lieu of earnings and dividends per share should disclose the basis of computation of such ratios in a note.

Non-accounting disclosures

As mentioned earlier, the Form S-1 instructions require disclosure of significant non-accounting matters affecting the summary of earnings. Thus, disclosure is generally required if any of the following conditions is present to a material extent.

Sales—Unusual or significant changes or trends in sales, in total or by product, during or subsequent to the end of the period should be disclosed, particularly if such change or trend is an adverse development. Also, if there has been a significant decline in the current backlog of orders as compared with the comparable figure of the prior year, this fact should be explained.

Net income, costs or gross profit ratios—Disclosure of unusual or significant changes or trends in net income, costs or gross profit ratios

is required where there have been substantial increases or decreases in the gross profit ratios in recent periods. An increase in net income in the most recent period usually need not be explained providing such increase is attributable to increased volume of revenues, but significant decreases in net income or the incurrence of a loss, particularly where an adverse trend is indicated, should be explained.[7] Recent or anticipated increases in costs not offset by comparable increases in sales prices and increases in officers' salaries, if significant in relation to net income, may require disclosure.[8]

Seasonal factors—When seasonal factors tend to make reported interim earnings not necessarily indicative of results to be expected for the full year this fact should be disclosed. In this regard, a cross reference to the section describing the company's business, including seasonal factors, is frequently appropriate. If prior historical results indicate that the balance of the year from the date of the latest interim statement presented is normally a breakeven or loss period, a specific statement to that effect is required.

Subsequent earnings data

If a significant period of time will have elapsed between the date of the financial statements included in the registration statement and the expected effective date, the SEC will generally request that updated financial information be included in the prospectus. The information most commonly requested is sales and earnings for the most recent interim period and for the corresponding period of the preceding year. Since this information may be and invariably is unaudited, it should be included in a textual paragraph following the summary to clearly delineate it from the audited information. This information is, however, merely an extension of the summary, on a condensed basis, and the foregoing comments

(7) In Securities Act Release No. 3908 (March 13, 1958) the SEC found the prospectus of the registrant to be materially misleading in including a statement describing the company's substantial increase in sales during the period of the summary of earnings without at that point also discussing the decline in earnings over the same period.

(8) In Securities Act Release No. 1961 (December 18, 1943) the SEC, in referring to anticipated increases in the registrant's interest expense, compensation paid officers and directors and certain known other costs, stated that "where such changes will have a material effect on prospective earnings, the omission to disclose those changes and their effect with relation to the profit and loss statements is as misleading as if the registrant's past earnings had been misrepresented".

as to disclosure are equally pertinent to the extent they are applicable to the data furnished.

* * * *

The foregoing comments, while not all-inclusive, should make apparent the complexity and diversity of matters which may have to be considered in the preparation of the summary of earnings. In view of this and the heavy reliance placed on the summary by the investor, the CPA who is involved in a registration statement should be prepared to apply the highest degree of professional skill and judgment to this aspect of his work.

A Teacher in C. P. A. Land

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"HERE'S another example of a teacher being spirited away by private industry." Such was the good-natured ribbing which I received from my fellow faculty members when I announced that I was taking a position with a public accounting firm.

Paradoxically enough, however, it was the decision to make teaching my career that led me to the public accounting job. You must understand that my teaching field is accounting and related business subjects and, although I had taught these subjects for several years, I felt that I lacked sufficient "practical" background in my field. Hence, my decision to work for a while in public accounting where I hoped to gather knowledge and experience which would be useful to me in my teaching position.

Why did I choose public accounting? Because I wanted a job where I could get the maximum amount of experience in the minimum amount of time. It was my understanding that most public accounting firms handle numerous varieties of clients.

The next decision I had to make was "which public accounting firm"? It should be a well-known and reputable firm, since I would be learning procedures, principles, etc., which I, in turn, would be passing on to the students.

After making my choice (Arthur Young & Company), I had to decide at which of its offices I could best achieve my objectives. After speaking with several of the partners, it was decided that one of the smaller offices would be best, for it was felt that here I would be able to work in a maximum number of auditing and accounting areas. Also, the particular office selected (Washington, D. C.) had a wide variety of clients, so that I would be able to study a number of different kinds of business systems.

Mr. Kies is a graduate of Elmhurst College, Elmhurst, Illinois and the University of Illinois where he received an M.S. degree. He had taught at Millikin University, Decatur, Illinois and Wisconsin State College, Whitewater, Wisconsin, before joining the Washington, D. C. Office of Arthur Young & Company. He has, since then, returned to teaching, and he is presently on the faculty of the University of Maryland where he is also studying for a Ph.D. degree.