

**RELEASE NO. 40\***

December 22, 1942

**SECURITIES ACT OF 1933**  
Release No. 2888

**SECURITIES EXCHANGE ACT OF 1934**  
Release No. 3348

**INVESTMENT COMPANY ACT OF 1940**  
Release No. 420

Amendment to Articles 3, 5, and 12 of Regulation S-X—Simplification of reporting requirements.

**RELEASE NO. 41**

December 22, 1942

**SECURITIES ACT OF 1933**  
Release No. 2889

**SECURITIES EXCHANGE ACT OF 1934**  
Release No. 3349

**INVESTMENT COMPANY ACT OF 1940**  
Release No. 421

Conditions under which companies reporting on Forms 10-K and N-30A-1 may file copies of their regular annual reports to stockholders in place of certain of the financial statements required to be filed by such forms.

The Securities and Exchange Commission today issued an opinion in its Accounting Series dealing with certain accounting aspects of the recent amendments to Forms 10-K and N-30A-1, the principal annual reporting forms under Section 13 of the Securities Exchange Act. These amendments, which were adopted in connection with recent revisions of the rules governing proxy solicitations, permit companies to file copies of their regular annual reports to stockholders in place of certain of the financial statements required to be filed by such forms, if the financial statements included in the annual report to stockholders substantially conform to the requirements of Regulation S-X, the underlying accounting regulation of the Commission. The opinion, prepared by William W. Werntz, Chief Accountant, indicates that while the financial statements included in reports to stockholders are frequently somewhat more condensed than those filed in accordance with the requirements of those forms and Regulation S-X, such condensation, if limited to the grouping of items that are not substantial

in amount or otherwise material because of their particular origin or nature, would not prevent the filing of such financial statements in place of those required by the instructions.

The full text of the opinion follows:

"A recent amendment of Form 10-K provides that in partial response to the requirements for filing financial statements a registrant may if it wishes file a copy of its regular annual report to stockholders and incorporate by reference the financial statements contained in such report. This procedure may be followed, however, only if the financial statements included in the report to stockholders substantially conform to the requirements of Regulation S-X. Of course, any financial statements or schedules required by the instructions that are not included in the stockholders' report must also be furnished.

"A review of numerous stockholders' reports covering the year 1941 indicates that in many cases the financial statements included are identical with those filed subsequently as part of the annual report on Form 10-K except that a number of

\* Text of release omitted.

relatively minor items shown separately in the report on Form 10-K are grouped, or combined with closely similar items in the report to stockholders. Inquiries have been received as to whether, where condensation of this type exists, the statements may nevertheless be considered to conform substantially to the requirements of Regulation S-X.

"The provisions of Article 5 of Regulation S-X contain a general statement of the details to be shown in balance sheets and income statements filed by commercial and industrial companies. Such requirements are, however, supplemented by and subject to the general rules contained in Article 3. Rule 3-06 thereof provides, on the one hand, that, in applying the requirements to the circumstances of an individual case, there shall be given, in addition to the required information, such further information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. On the other hand, Rule 3-02 provides that, if the amount to be shown under any particular caption is not significant, the caption need not be separately set forth. The effect of these two general requirements is to require the disclosure of significant information not specifically called for, but to permit the omission of information, even though covered by a specific requirement, if the item involved is not significant. It should be pointed out, however, that in some cases the significance of an item may be independent of the amount involved. For example, amounts due to and from officers and directors, because of their special nature and origin, ought generally to be set forth separately even though the dollar amounts involved are relatively small. Likewise, disclosure of the various types of surplus, the important reserve accounts, and, under present conditions, the accrued liability for taxes is of importance. In the same way, in the corporate income statement of a company having large investments in subsidiaries or in the securities of unaffiliated companies, the disclosure of income from dividends and interest is necessary irrespective of the amount, since the absence or smallness of dividend and interest income is of as great importance as the exact amount thereof. In the income statement

generally, it is important that the major elements such as sales and cost of sales, substantial items of other income and income deductions, and the provision for income and excess profits taxes be separately disclosed, unless to do so would violate the provisions of the Code of Wartime Practices. Finally, care should be taken that the necessary descriptive and explanatory footnotes applicable to the particular statements are set forth.

"On the other hand, the combination under a miscellaneous caption of minor items among the current assets or liabilities resulting from the ordinary course of business, or their combination with closely similar items that are large in amount, is, in my opinion, permissible and, where minor items are numerous, would tend to improve the legibility of the statements. Similar combinations appear to be permissible within the other major categories of items customarily appearing in the financial statements, such as deferred charges, prepaid expenses, and fixed assets. Generally, however, condensation in the balance sheet would not appear appropriate with respect to an item amounting to more than 10 percent of its immediate category, such as deferred charges, or more than 5 percent of total assets. Where, however, the immediate category is less than 5 percent of total assets, it would generally appear permissible to combine all components of the category under a suitable caption.

"If such condensation as may exist in the financial statements included in the regular annual report to stockholders has been made along the lines indicated, such financial statements would in my opinion substantially conform to the requirements of Regulation S-X and could, therefore, under the recent amendment to Form 10-K, be incorporated by reference in annual reports on that form. Of course, care should be taken that the captions used are not such as to be misleading."

Form N-30A-1, the annual report form for investment companies subject to the Investment Company Act of 1940, has been amended in the same manner as Form 10-K. While the discussion above relates to the financial statements of commercial, industrial, and utility companies using Form 10-K, comparable principles are applicable to investment companies using this form.

**RELEASE NO. 42**

January 8, 1943

**SECURITIES ACT OF 1933**

Release No. 2893

**SECURITIES EXCHANGE ACT OF 1934**

Release No. 3361

**Disclosure to be made in financial statements with respect to reserves established to provide for possible losses and other contingencies arising out of existing war conditions.**

The Securities and Exchange Commission today made public an opinion in its Accounting Series indicating the disclosure to be made in financial statements with respect to reserves established to provide for possible losses and other contingencies arising out of existing war conditions. The opinion, prepared by William W. Werntz, Chief Accountant, follows:

"In view of the material effects which war conditions may have on the results of operations and the financial condition of corporations, careful consideration must be given to the need for establishing appropriate reserves intended to provide for final settlement of war production contracts, for post war readjustments, and for other possible losses or adjustments resulting from present conditions. Where such reserves are established, a full and accurate disclosure of the reserves established and the purposes thereof is required by Regulation S-X in financial statements filed with the Commission.<sup>1</sup>

"Since reserves such as those mentioned will differ in character, depending on the purpose underlying their establishment, the provisions of Regulation S-X that will be applicable depend to some extent upon the nature of the particular reserves. Reserves in the nature of valuation or qualifying reserves are required to be deducted from the assets to which they apply in conformity to Rule 3-11 of Regulation S-X. Others not relating to specific assets should properly be shown under Caption 32 of Rule 5-02—Reserves, not elsewhere shown. In still other cases the contingency or condition against which the reserve is provided may be so indefinite and problematical that the reserve is in effect no more than earmarked earned surplus and can best be shown as a subdivision thereof. Finally,

in certain cases the reserve may reflect the estimated amount of an actual liability and should be shown as such. In any case the caption of each reserve or major class of reserves should be clearly descriptive of the purpose for which the reserve has been established. It should further be noted that Rule 12-13, which asks for supporting data as to all reserves not included in specific schedules, requires that the reserves be grouped and listed according to major classes under properly descriptive titles. While the instructions permit the grouping of special contingency reserves it would be improper, in my opinion, so to group reserves of the character under discussion or to combine them with other reserves as to fail to disclose clearly the various types of war contingencies and conditions for which reserves have been established.

"Classification and description of the charges made in establishing such reserves should likewise be given careful attention. In this connection it should be noted that Rule 3-19(c) requires disclosure of the policy followed as to providing for depreciation, depletion, obsolescence, and amortization. Where establishment of a reserve of the type under discussion involves a modification of any of such policies, a clear statement is called for by the rule. Where the offsetting charges are not made to the profit and loss or income statement it will be noted that the schedules required in support of reserves call for a clear description of the circumstances. Where the offsetting charges are made to the income statement, it will be noted that Rule 5-03 requires the amounts if significant, to be stated separately and clearly described, unless properly includible under the caption "Cost of Sales," which caption the rule does not require to be subdivided.

"Particular attention is also directed to the fact that the requirements of Regulation S-X are to be considered to be minimum requirements and that

<sup>1</sup> Cf. American Institute of Accountants, Accounting Research Bulletin No. 13, "Accounting for Special Reserves Arising Out of the War," dated January 1942.

Rule 3-06 specifically requires that there "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." However, care should be taken that no disclosure of information is made which would contravene the Code of Wartime Practices.

"Reserves of the character under discussion may in some cases indicate a future need of cash, as for example in the case of reserves for separation allowances. While the provision of funds to meet

necessary expenditures is not a matter of accounting policy, it may be appropriate to point out that the mere establishment of a reserve will not of itself ensure the accumulation and availability of such liquid funds as may be required. Where such future cash requirements exist, independent consideration should be given, as a matter of financial policy, to the desirability of taking additional steps toward providing such funds, as by "funding" the reserve through accumulation and possibly segregation of cash or liquid assets equivalent to the reserves established."

### RELEASE NO. 43\*

January 26, 1943

SECURITIES ACT OF 1933  
Release No. 2896

SECURITIES EXCHANGE ACT OF 1934  
Release No. 3373

Amendment to Rules 4-13 and 5-02 of Regulation S-X, prescribing manner in which original cost data and other components of utility plant are to be shown in balance sheets of utility companies.

### RELEASE NO. 44

May 24, 1943

SECURITIES ACT OF 1933  
Release No. 2920

SECURITIES EXCHANGE ACT OF 1934  
Release No. 3436

INVESTMENT COMPANY ACT OF 1940  
Release No. 501

Amendments to Rule 2-01 of Regulation S-X, regarding qualifications of accountants certifying to financial statements required to be filed with the Commission.

The Securities and Exchange Commission today announced the adoption of two amendments to Rule 2-01 of Regulation S-X dealing with the qualifications of accountants certifying financial statements required to be filed with it.

Subsequent to the adoption, on November 7, 1942, of the present subsection (c) of Rule 2-01, representatives of the accounting profession made inquiry as to whether the language "in determining whether an accountant is in fact independent with respect to a particular company, appropriate

consideration shall be given to the propriety of the relationships and practices involved in all services performed for the company by such accountant" implied that the Commission would seek to determine the "propriety" of all such relationships in and of themselves. In discussions and conferences arising out of such inquiries, the Commission made it clear that it was interested in relationships between a certifying accountant and a registrant only insofar as the existence of particular relationships might be relevant to its determination

\* Text of release omitted.

whether the accountant was in fact independent. In order to avoid any possible misinterpretation of its policy in this respect, the Commission has amended Rule 2-01(c) so as to restate its objectives in more general terms, thus avoiding the misunderstanding apparently resulting from the use of more particularized language in the original rule.

At the same time Rule 2-01(b) has been amended to make it clear that the relationships listed therein are not the only relationships which would prevent an accountant from being independent in fact. In this connection, attention is directed to Accounting Series Releases Nos. 2, 22, 28, and 37 which contain statements of administrative policy and opinions of the Chief Accountant on the question of independence. Release 22, moreover, includes a summary of the principal Commission decisions involving independence of accountants. A summary of informal decisions on the question will be issued at a later date.

The text of the Commission's action follows:

The Securities and Exchange Commission, acting pursuant to authority conferred upon it by the Securities Act of 1933, particularly Sections 7 and 19(a) thereof, the Securities Exchange Act of 1934, particularly Sections 12, 13, 15(d), and 23(a) thereof, and the Investment Company Act of 1940, particularly Sections 8, 30, and 38(a) thereof, and deeming such action necessary and appropriate

in the public interest and for the protection of investors and necessary for the execution of the functions vested in it by the said Acts, hereby amends Regulation S-X as follows:

I. Paragraph (b) of Rule 2-01 of Regulation S-X is amended by inserting the words "For example" at the beginning of the second sentence. As amended, paragraph (b) reads:

(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

II. Paragraph (e) of Rule 2-01 is amended to read as follows:

(c) In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships between the accountant and that registrant, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

The foregoing action shall be effective May 24, 1943.

## RELEASE NO. 45

June 21, 1943

SECURITIES ACT OF 1933  
Release No. 2926

HOLDING COMPANY ACT OF 1935  
Release No. 4366

SECURITIES EXCHANGE ACT OF 1934  
Release No. 3447

INVESTMENT COMPANY ACT OF 1940  
Release No. 512

### Treatment of premiums paid upon the redemption of preferred stock.

The Securities and Exchange Commission today made public an opinion in its Accounting Series regarding the treatment of premiums paid upon the redemption of preferred stock. The opinion indicates that if the redemption price exceeds the amount paid in on such shares, the excess should ordinarily be charged to earned surplus.

The opinion, prepared by William W. Werntz, Chief Accountant, follows:

"Inquiry has frequently been made as to whether a premium paid on the redemption of preferred stock in excess of the amounts paid in thereon may properly be charged against capital contributed by another class of shareholders or whether, when

earned surplus is present, the excess premium should be charged thereagainst. The following case is typical. The A Corporation has outstanding 10,000 shares of \$100 par value 6 percent cumulative preferred stock which was sold at 105 and is redeemable at the option of the company on any dividend date at 110. There are also outstanding 40,000 shares of \$50 par value common stock which were sold at \$60 per share. At the time the corporation proposes to call the preferred shares for redemption, the balance sheet reflects earned surplus of \$300,000 and capital surplus of \$450,000. The capital surplus consists of \$50,000 paid in by preferred shareholders and \$400,000 paid in by common shareholders.

"The case presented involves a fundamental principle of accounting maintenance of the distinction between capital and income. In recognition of this principle, it has long been agreed that paid-in capital may not be used to absorb expenses or charges that should be deducted from gross income or revenue to determine net income.<sup>1</sup> While the charge involved in the instant case is not relevant to a determination of the amount of net income, it does raise the cognate question of whether payment of redemption premiums in excess of the amount paid in on the shares being retired should first be considered to be distributions of available earned surplus, rather than of amounts paid in on shares still outstanding.

"In order to maintain a proper distinction between capital and income, it is my opinion that it is necessary to consider the entire amount contributed by shareholders as capital regardless of whether reflected in the accounts as capital stock or as capital or paid-in surplus. When a corporation by appropriate legal action classifies its share capital, with resulting distinctions in dividend rights, assets priorities, voting powers, and other matters, adherence to the principles mentioned, in my opinion, requires appropriate accounting recognition of the classification of shares not only in respect of the legal or stated capital but also in respect of the related contributions in excess of legal or stated capital. In my opinion, reflection of a redemption premium paid to one class of share-

holders as a diminution or utilization of amounts contributed by another class, or by shares of the same class still outstanding, would ordinarily be inconsistent with recognition of these principles in that the capital contribution shown for outstanding shares would thenceforth be less than the amount actually paid in on such shares although (1) no amounts were in fact repaid in respect of the outstanding shares; (2) at the time of the disbursement there existed accumulated earned surplus; and (3) such earned surplus would therefore be available for distribution as apparently earned dividends, although in fact capital contributed in respect of the outstanding shares had not been maintained intact.

"It is, therefore, my opinion that in the case cited the amount paid preferred shareholders in excess of the amounts contributed by them should be charged to earned surplus. Also, if at the time of redemption any amounts are paid on account of accumulated unpaid dividends, such amounts should likewise be charged to earned surplus.

"In the above example an entire issue of preferred shares was assumed to have been redeemed. If less than an entire issue were redeemed it would not, in my opinion, ordinarily be proper, in the light of the above discussion, to charge against capital surplus contributed by the preferred stock an amount per share in excess of the pro-rata portion of such capital surplus applicable to each share of preferred stock outstanding prior to the redemption in question.

"In the case cited all of the capital surplus represented amounts paid in on shares still outstanding. In some cases a part of capital surplus may have resulted from the prior reacquisition and retirement of preferred or common shares at less than the amounts paid in thereon.<sup>2</sup> Such capital surplus does not therefore represent any amounts paid in on shares still outstanding. Where this condition exists, I would ordinarily see no objection to utilizing such capital surplus for the purpose of absorbing the excess of the redemption price over the amounts paid in on the shares being retired.

"There remain to be considered cases in which

<sup>1</sup> In the course of a formal reorganization, or a quasi-reorganization, a deficit in earned surplus may be charged to capital surplus. See Accounting Series Releases Nos. 1, 15, 16, and 25.

<sup>2</sup> When capital stock is reacquired and retired, it is recognized that any surplus arising therefrom is capital and should be accounted for as such. See Accounting Series Release No. 6 (1938); American Institute of Accountants, Accounting Research Bulletin No. 1 (1939).

outstanding preferred stock is retired and replaced by new preferred stock, usually bearing a lower dividend rate. In such case, of course, a saving to junior security holders is accomplished which will be reflected in increased earnings applicable to junior securities, and unless distributed, in increased balances of earned surplus. In a number of such cases arising under the Public Utility Holding Company Act of 1935, where earned surplus was

absent or inadequate, the Commission has as a matter of administrative policy raised no objection to a procedure designed to offset the redemption premiums against subsequent earnings. However, in such cases it has ordinarily been required that the annual offset be not less than the savings effected by the lower dividend rate on the new stock and that in any case the premiums be fully offset within a reasonably short period."

### RELEASE NO. 46\*

December 9, 1943

SECURITIES ACT OF 1933  
Release No. 2961

SECURITIES EXCHANGE ACT OF 1934  
Release No. 3512

Amendments to Rule 5-04 and Rule 12-06 of Regulation S-X.

### RELEASE NO. 47

January 25, 1944

SECURITIES ACT OF 1933  
Release No. 2973

SECURITIES EXCHANGE ACT OF 1934  
Release No. 3526

INVESTMENT COMPANY ACT OF 1940  
Release No. 615

**Independence of certifying accountants—Summary of past releases of the Commission and a compilation of hitherto unpublished cases or inquiries arising under several of the Acts administered by the Commission.**

The Securities and Exchange Commission today announced the publication of an additional release in its Accounting Series dealing with the independence of certifying accountants.

Various statutes administered by the Securities and Exchange Commission recognize the necessity of independence on the part of an accountant who certifies financial statements. In administering these Acts the Commission has consistently held that the question of independence is one of fact, to be determined in the light of all the pertinent circumstances in a particular case. For this reason it has not been practicable, and the Commission has made no attempt, to catalog all of the relationships or situations that might prevent an account-

ant from being independent. However, in Rule 2-01(b) of Regulation S-X the Commission has indicated certain relationships such as those of officer, director, or employee which it believes are so likely to prevent a completely objective review of the financial statements of a registrant as to preclude its recognizing an accountant occupying such a position as independent.

In addition to summarizing past releases of the Commission on the question of independence, the new release includes a compilation of hitherto unpublished rulings in cases or inquiries arising under the Securities Act of 1933, the Securities Exchange Act of 1934, or the Investment Company Act of 1940. Preparation of this compilation,

\* Text of release omitted.

announced in Accounting Series Release No. 44, was undertaken as a result of a suggestion by representatives of professional accounting societies that knowledge of informal rulings would be of particular assistance to accountants and others interested in determining the circumstances under which a certifying accountant is likely to be considered to be not in fact independent.

The release, prepared by William W. Werntz, Chief Accountant, follows:

"The requirement of the Securities and Exchange Commission that an accountant be in fact independent with respect to a company whose financial statements he certifies is grounded on the conviction that the existence of certain types of relationships between a company and its certifying accountant might bias the accountant's judgment on accounting and auditing matters. Certain relationships between an accountant and his client appear so apt to prevent the accountant from reviewing the financial statements and accounting procedures of a registrant with complete objectivity that the Commission has taken the position that existence of these relationships will preclude its finding that the accountant is, in fact, independent. Accordingly, Rule 2-01(b) of Regulation S-X provides that 'The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.' In addition, Accounting Series Release No. 2 indicated that an accountant was not to be considered independent with respect to a particular company when his holdings of the capital stock of that company were substantial in amount and were significant with respect to the company's total capital or the accountant's personal fortune. A test of 1 percent was suggested in the latter connection. Also, Accounting Series Release No. 22 indicated that an accountant would not be considered to be independent if the company whose financial statements he certified had indemnified him against all losses, claims, and damages arising out of such

certification other than as a result of the accountant's willful misstatements or omissions.

"In a number of its *Findings and Opinions* the Commission had occasion to discuss the question of independence in the light of the facts of a particular case. The earlier Commission decisions and releases have been summarized in Accounting Series Release No. 22. Subsequent to the issuance of this release several other decisions involving the question of independence have been issued. In *In the matter of Southeastern Industrial Loan Company* (Securities Act of 1933, Release No. 2726) it was held that the nature of the business relationships between the accountant on the one hand and the registrant, its parents, and its affiliates on the other were such as to destroy the accountant's independence. In *In the matter of Kenneth N. Logan* (Securities Exchange Act of 1934, Release No. 3111; Accounting Series Release No. 28) the Commission held an accountant to be not independent where he had a substantial investment in the registrant, the cost of which amounted to about 8 percent of his net worth, and where he had approved or acquiesced in procedures that were designed to conceal a speculative use to which funds of the registrant had been put. While in *In the matter of Associated Gas and Electric Company* (Securities Exchange Act of 1934, Release No. 3285A) the question of the independence of the certifying accountants was not raised in the order for hearing and so no finding was made on this point, yet the Commission did state in the course of its discussion that '\* \* \* an accountant who consistently submerges his preferences or convictions as to accounting principles to the wishes of his client is not in fact independent.' Finally, in adopting Rule 2-01(c) of Regulation S-X, the Commission said in Accounting Series Release No. 37:<sup>1</sup> 'Perhaps the most critical test of the actuality of an accountant's independence is the strength of his insistence upon full disclosure of transactions between the company and members of its management as individuals \* \* \*.'

"In the case of the great majority of financial statements filed with the Commission no question

<sup>1</sup> The language of Rule 2-01(c) was subsequently clarified by an amendment announced in Accounting Series Release No. 44 (1943). (See p.57.)



has been raised as to the independence of the certifying accountant. However, in addition to the formal decisions referred to above there have been many informal rulings in cases arising under the Securities Act of 1933, the Securities Exchange Act of 1934, or the Investment Company Act of 1940. It is not feasible to present adequately in summarized form the circumstances existing in particular cases in which it was determined not to question an accountant's independence. The following compilation therefore includes only representative examples of cases in which an accountant was considered not to be independent with respect to a particular company.

"1. An accountant held an investment of about \$200,000 in the capital stock of a registrant. This investment constituted about 25 percent of the accountant's personal fortune and was about 2 percent of the company's total outstanding capital stock. *Held*, the accountant could not be considered independent for the purpose of certifying the financial statements of this registrant.

"2. An accountant's wife held a trust certificate issued by an investment trust on which had been paid an amount equal to 3 percent of the combined personal fortunes of the accountant and his wife. The withdrawal value of the trust certificate was less than \$1,000 and was about 1½ percent of their personal fortunes. The accountant certified the financial statements of the investment trust as well as the financial statements of the corporation that sponsored the trust. The sponsor had no equity in the assets of the trust, but derived virtually all of its income from its activities as sponsor. *Held*, the accountant could not be considered independent with respect to the investment trust. *Held*, the facts given tended to indicate that the accountant was not independent with respect to the sponsoring corporation.

"3. An accountant had some years earlier invested a substantial amount of money in securities of a registrant. The fair current value of this investment exceeded 50 percent of the accountant's personal fortune. *Held*, the accountant could not be considered independent for the purpose of certifying the financial statements of this registrant.

"4. An account had loaned \$5,000 to a registrant. A business associate of the accountant had loaned an additional \$15,000 to the registrant.

These loans bore interest and were secured by a 2½-percent share in the net profits of the registrant. A son of the accountant was an officer of the registrant. *Held*, the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant.

"5. An accountant had for some time endeavored to persuade a department store that was his client to add a new department to its business. The registrant finally agreed to set up the department provided the accountant would finance the cost thereof. The accountant advanced the necessary funds and the department proved successful. The new department contributed less than 5 percent of the total revenues of the registrant. *Held*, the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant.

"6. An accounting firm had rendered services to a registrant for which the registrant had not been able to pay. To guarantee payment of the account the registrant had pledged shares of its own stock. In addition it had given the accountants an option to purchase the pledged securities at the market price existing at the date the option was given. *Held*, the accounting firm could no longer be considered independent for the purpose of certifying the financial statements of the registrant.

"7. A registrant owned a small percentage of the stock of a sales company that sold some of the registrant's products. The accountant who certified the financial statements of the registrant was the treasurer and one of the stockholders of the sales company. *Held*, if the shares held by the registrant and the nature of the sales relationship were such as to give the registrant a significant element of indirect control over the sales company, the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant.

"8. A partner in an accounting firm was serving as a member of the board of directors of a registrant. This accountant did not participate in any way in the accounting firm's audit of the registrant. *Held*, the accounting firm could not be considered independent for the purpose of certifying the financial statements of the registrant.

"9. A partner in an accounting firm was serving as a member of the board of directors of a registrant. Another partner in the same accounting

firm conducted the audit of the registrant and certified the financial statements in his own name, not the firm name. *Held*, the certifying accountant could not be considered independent for the purpose of certifying the financial statements of the registrant.

"10. A partner in an accounting firm had served on the board of directors of a registrant but had resigned from that position prior to the close of the most recent fiscal year. This accountant had not participated in any way in the accounting firm's audits of the registrant. *Held*, that the accounting firm could not be considered independent for the purpose of certifying financial statements of the registrant covering any period during which a partner of the accounting firm was a director of the registrant.

"11. A partner in an accounting firm was serving as a member of the board of directors of a registrant, having been appointed to that position by a Federal court following a reorganization. *Held*, the accounting firm of which this individual was a member could not be considered independent for the purpose of certifying the financial statements of the registrant.

"12. A partner in an accounting firm was a member of the board of directors of a registrant and was also one of the voting trustees of the registrant's stock. The voting trust had been established at the request of a lending bank that desired thereby to assure continuity of the registrant's management. *Held*, the accounting firm of which this accountant was a member could not be considered independent for the purpose of certifying the financial statements of this registrant.

"13. A partner in an accounting firm was one of three trustees of a voting trust in which shares of preferred stock of a registrant had been deposited. Dividends had not been paid on the preferred stock and it had become entitled to elect a majority of the board of directors. The voting trust had been set up to assure continuity of the existing management, and was in a position to exercise ultimate control over the registrant. *Held*, the accounting firm, of which one of the voting trustees was a member, could not be considered independent for the purpose of certifying the financial statements of the registrant.

"14. The board of directors of a registrant had established an 'operating committee' in which had been vested all powers necessary and appro-

priate to the supervision of the management of the business. It was intended that the principal duty of the committee would be the making of recommendations to the board of directors. The committee consisted of two members of the board of directors and a member of the accounting firm that regularly certified the financial statements of the registrant. *Held*, neither the individual accountant nor his firm could be considered independent for the purpose of certifying the financial statements of the registrant.

"15. A registrant filed certified financial statements of two subsidiary companies. The financial statements of one subsidiary had been certified by a member of an accounting firm who also served as assistant secretary of the subsidiary. The financial statements of the other subsidiary had been certified by a member of another accounting firm who served as assistant secretary and assistant treasurer of that subsidiary. Neither accountant received any remuneration for serving as officers of these subsidiaries. *Held*, the accounting firms involved could not be considered independent for the purpose of certifying the financial statements of the company in which one of their members served as an officer.

"16. An individual serving as assistant treasurer and chief accountant of a registrant was the son of a partner in the accounting firm that certified the financial statements of the registrant. The son was living with his father at the time. The son served the registrant under the direction and supervision of the treasurer of the company. *Held*, the accounting firm could not be considered independent for the purpose of certifying the financial statements of the registrant.

"17. A senior staff member of an accounting firm was appointed controller of a registrant as successor to a controller who had entered the armed forces of the United States during the war emergency. This employee, who had formerly been in charge of the audit of the registrant, remained on the staff of the accounting firm but relinquished all responsibility for the audit of the registrant, and did no work for the accounting firm in connection therewith. *Held*, the accounting firm could not be considered independent for the purpose of certifying the financial statements of this registrant. *Held*, further, the accounting firm could not be considered independent for the purpose of certifying the financial statements of

the registrant if the senior staff member were to leave the employ of the accounting firm and be paid by the registrant, but this arrangement was subject to the understanding among the several parties that upon the termination of the war emergency he would return to the staff of the accounting firm.

"18. The accountant who audited the financial statements of an investment trust had been given office space in the office of the sponsor of the investment trust. The accountant regularly gave advice concerning the internal accounting policies of the trust. The sponsor of the trust had agreed to pay the accountant a stipulated amount per year less whatever the accountant was able to earn from the investment trust and his other clients. *Held*, the accountant could not be considered independent for the purpose of certifying the financial statements of the investment trust.

"19. The accounting firm that certified the financial statements of a particular registrant had in the past followed the practice of drawing up the monthly journal records of the company from underlying documents that had been prepared by the registrant's staff. These journal records were posted to the appropriate ledgers by the certifying

accountants. At the end of the year the audit engagement was undertaken by personnel of the certifying accountant that was not connected with the original recording of the accounting data. *Held*, the accounting firm could not be considered independent for the purpose of certifying the financial statements of this registrant.

"20. A small loan company kept its accounting records on a cash basis. The primary records of the company consisted of daily cash reports that were prepared by the cashier and signed by the manager. The accountant who certified the financial statements of this company took no part in the preparation of these basic records. However, he did audit these cash reports each month and then proceeded to enter the totals in a summary record which he in turn posted to the general ledger. The certifying accountant also made adjusting journal entries each month with respect to insurance, taxes, depreciation, and similar items. The company was small and did not require the services of a full-time bookkeeper. The certifying accountant devoted about 1 day a month to the clerical or bookkeeping tasks described above. *Held*, the accountant could not be considered independent for the purpose of certifying the financial statements of this registrant."

## RELEASE NO. 48

February 12, 1944

SECURITIES ACT OF 1933  
Release No. 2977

SECURITIES EXCHANGE ACT OF 1934  
Release No. 3534

**Findings and Opinion of the Commission In the matter of C. Cecil Bryant, proceeding pursuant to Rule II (e), Rules of Practice—Permanent disqualification of accountant from practice before the Commission.**

### ACCOUNTING--PRACTICE AND PROCEDURE

#### Permanent Disqualification of Accountant from Practice Before the Commission.

In a proceeding under Rule II(e) of Commission's Rules of Practice, where the evidence shows that the respondent, a certified public accountant, had falsely certified financial statements forming part of a registration statement filed under the Securities Act of 1933, had made no audit of registrant's affairs and had not examined its books but had accepted without

question the financial statements prepared by registrant's own employee, with whom he had a practice of splitting fees in other matters and certifying other statements likewise without audit or examination; and where respondent is wholly unfamiliar with the Commission's rules concerning financial statements and the certification thereof and, after 20 years' practice, shows lack of familiarity with and has violated rules of State board of accountancy and standards of professional conduct adopted by American Institute of Accountants; held that respondent does not possess

the requisite qualifications to represent others, has engaged in unethical and improper professional conduct, and should be disqualified from and permanently denied the privilege of appearing and practicing before the Commission.

**APPEARANCES:**

*Edmund H. Worthy*, for the Corporation Finance Division of the Commission.

*Allen H. Gardner*, for the respondent.

**FINDINGS AND OPINION OF THE COMMISSION**

This is a proceeding under Rule II(e) of our Rules of Practice to determine whether or not the respondent C. Cecil Bryant, a certified public accountant, should be disqualified from or denied, temporarily or permanently, the privilege of appearing or practicing before this Commission.<sup>1</sup>

The present proceeding arises from the activities of the respondent in connection with a registration statement filed with us on January 28, 1942, by a certain corporation which will be referred to hereinafter as "the corporation." This registration statement became the subject of a stop-order proceeding instituted by us pursuant to Section 8(d) of the Securities Act of 1933. In that proceeding the respondent, who had certified to financial statements filed as part of the registration statement, was called as a witness and testified. Other witnesses included W. F. Williams, bookkeeper of the corporation, and John Kohlhepp, an accountant on our staff. After the hearing the corporation withdrew its registration statement, with our consent, and the stop-order proceeding was discontinued.

Thereafter, on the basis of the testimony of the three witnesses above named, this proceeding was instituted. A hearing was held before a trial examiner, wherein the respondent was represented by counsel. Pursuant to stipulation, the testimony

<sup>1</sup> Rule II(e), provides:

"The Commission may disqualify, and deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to, any person who is found by the Commission after hearing in the matter

"(1) Not to possess the requisite qualifications to represent others; or

"(2) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct."

mentioned above was incorporated into the record of this proceeding.

The trial examiner filed an advisory report in which he made specific findings of fact and concluded that the respondent lacks the requisite qualifications to represent others and has engaged in unethical and improper professional conduct, within the meaning of Rule II (e). He recommended that the respondent be disqualified and permanently denied the privilege of practicing as an accountant before this Commission. A copy of the trial examiner's report was duly served upon the respondent. Since no exceptions or objections to such report have been filed, and the time for filing them has long since expired, we might properly adopt the trial examiner's advisory findings as our own without further inquiry. We have, however, thought it advisable to make an independent review of the record, and on the basis of such review we are satisfied that the trial examiner's findings and conclusions are amply supported by the evidence.

In brief, the examiner found as follows:

1. The respondent has been practicing accounting in Ocala, Florida, since 1920. Until the early part of 1942 he was a member of the American Institute of Accountants.

2. Appended to the financial statements filed with the registration statement of the corporation was a certificate signed by the respondent, stating:

"I hereby certify that I have verified the foregoing balance sheet and its supporting schedules attached, and that the same are in agreement with the books and in my opinion reflect the true condition of affairs as of December 31, 1941."

3. It is uncontested in the evidence, and respondent admits in his testimony, that he made no audit of the books of the corporation and that he prepared and signed the foregoing certificate without ever having seen the books. He had no knowledge of the corporation's methods of operation or of the items reflected in the financial statements to which he certified.

4. The financial statements had been prepared by Williams, who at the time was employed by the corporation as bookkeeper. Respondent knew this, and also knew that Williams was neither a certified public accountant nor a licensed public accountant. It is clearly established that Williams

was in no way acting for the respondent in preparing these financial statements. Williams made no representation that he had performed an audit. Respondent made no inquiry as to the nature of the work performed by Williams.

5. Williams had previously been in the respondent's employ, and respondent seeks to explain his signing of the certificate on the ground that he had faith in William's work. It is clear, however, that respondent's certification under these circumstances violated not only our own rules<sup>2</sup> but also the standards of professional conduct and rules defining unethical practice for persons holding certificates under Chapter 16537, Comp. Laws of Fla. 1931, adopted by the Florida State Board of Accountancy. The certificate was false and the circumstances under which it was made establish a complete lack of independence on the part of the respondent.<sup>3</sup>

6. The financial statements covered by the aforesaid certificate contained material misstatements and misrepresentations. For example, accounts receivable shown as "not yet due" (representing the corporation's principal asset) were found to comprise items for the most part due or past due. In addition, substantial payments received by the corporation for services to be performed in future years were credited in their entirety to income when received, and the result was an overstatement of the income and surplus of the corporation. The financial statements were deficient in other respects also. Respondent admitted that he made no inquiry regarding these matters and had no knowledge of them.

7. The record establishes a course of dealing between Williams and respondent whereby Wil-

liams, after leaving the employ of the respondent in 1933, repeatedly performed accounting work (usually for certain municipalities in Florida) which he secured on his own initiative by placing bids therefor in the name of respondent or by causing respondent to enter such bids. When certification by a certified public accountant was required, respondent would look over Williams' work, sometimes rendering advice and counsel about it, would type the reports on his stationery, and would certify them without actually seeing the books. In return respondent would receive approximately 20 percent of the fee, while Williams received 80 percent thereof.

8. Respondent states that when he signed the above certificate he was, and still is, wholly unfamiliar with our rules with respect to preparation of financial statements and certification thereof. The record also discloses his unfamiliarity with the standards of professional conduct and the rules defining unethical practices promulgated by the Florida State Board of Accountancy, and the standards of professional conduct adopted by the American Institute of Accountants. It is plain that he has engaged in practice inconsistent with these rules and standards.

In view of the foregoing, we find that the respondent (a) does not possess the requisite qualifications to represent others, and (b) has engaged in unethical and improper professional conduct. He should be disqualified from, and permanently denied the privilege of, appearing and practicing before this Commission.

An appropriate order will issue.

By the Commission: (Chairman PURCELL and Commissioners HEALY, PIKE, O'BRIEN, and McCONNAUGHEY).

Orval L. DuBois,

Secretary.

<sup>2</sup> *E. g.*, Regulation S-X, Rule 2-02.

<sup>3</sup> Compare, *e. g.*, *American Terminals and Transit Company*, 1 S.E.C. 701 (1936), *National Boston Montana Mines Corporation*, 2 S.E.C. 226 (1937).

**RELEASE NO. 49\***

October 18, 1944

**SECURITIES ACT OF 1933**  
Release No. 3020**SECURITIES EXCHANGE ACT OF 1934**  
Release No. 3613**INVESTMENT COMPANY ACT OF 1940**  
Release No. 693

Amendment to Rule 1-01 of Regulation S-X.

**RELEASE NO. 50**

January 20, 1945

**SECURITIES ACT OF 1933**  
Release No. 3041**SECURITIES EXCHANGE ACT OF 1934**  
Release No. 3648**INVESTMENT COMPANY ACT OF 1940**  
Release No. 740**HOLDING COMPANY ACT OF 1935**  
Release No. 5560**The propriety of writing down goodwill by means of charges to capital surplus.**

The Securities and Exchange Commission today made public an opinion of its Chief Accountant in its Accounting Series discussing the propriety of writing down goodwill by means of charges to capital surplus. The opinion, prepared by William W. Wertz, Chief Accountant, follows:

"Inquiry has been made as to whether in a financial statement required to be filed with the Commission goodwill may be written down or written off by means of charges to capital surplus. The goodwill in question resulted from the acquisition during the year of the assets and business of a going concern at a price of \$2 million, payable in cash or its equivalent. It was determined that \$1,750,000 was paid for the physical assets acquired and \$250,000 for goodwill. It is now proposed to write off this goodwill by a charge to capital surplus.

"In my opinion the proposed charge to capital surplus is contrary to sound accounting principles. It is clear that if the goodwill here involved is, or were to become, worthless, it would be necessary to write it off. Preferably such write-off

should have been accomplished through timely charges to income, but in no event would it be permissible, under sound accounting principles, to charge the loss to capital surplus. The procedure being proposed would, however, evade such charges to income or earned surplus and would consequently result in an overstatement of income and earned surplus and an understatement of capital.

"This position was expressly taken in the following paragraph of the Commission's opinion in *In the Matter of Associated Gas and Electric Company*, 11 S.E.C. 1025:

"[the] position [taken] with respect to intangibles not subject to amortization assumes that as long as the write-off is made because of conservatism before actual realization of the loss, the write-off may be made to capital surplus. This practice would permit a corporation to circumvent charges which should be made against income or earned surplus by recognizing them in advance as a charge against capital surplus and, in our opinion, it is not consistent with the fundamental principle that a distinction should be maintained between capital and income."

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\* Text of release omitted.

## RELEASE NO. 51

January 26, 1945

## SECURITIES EXCHANGE ACT OF 1934

Release No. 3651

**Disposition of Rule II(e) proceedings against certifying accountant failing to observe appropriate audit requirements as to financial statements of broker-dealer under Rule X-17A-5.**

The Securities and Exchange Commission today made public the following information concerning private proceedings involving a certified public accountant. The accountant in question had certified the financial statements of a registered broker-dealer filed as part of a report pursuant to the requirements of Rule X-17A-5, adopted under Section 17(a) of the Securities Exchange Act of 1934. The proceedings were instituted to determine whether, pursuant to Rule II(e) of the Commission's Rules of Practice, the accountant in question should be temporarily or permanently denied the privilege of practicing before the Commission.

The statement of the broker-dealer in question, a corporation, was required to include financial statements certified by an independent certified public accountant or independent public accountant. The certificate of the respondent in these proceedings read, in part, as follows:

"I have reviewed your accounting records and procedures, analyzed and verified all accounts with debit as well as credit balances and examined or verified all securities and cash items, underlying customers, brokers, officers, and inventory or trading accounts in accordance with the generally accepted audit standards applicable to brokers.

"I hereby certify that the Balance Sheet headed Exhibit A together with the supporting schedules and details corresponding to the questions contained in S.E.C. Form X-17A-5 entered in on the Table of Contents attached to my report herewith, in my opinion correctly reflects the financial status of your corporation as at \* \* \*."

Subsequent examination of the records of the broker-dealer by the Commission's staff indicated that as of the date the above report was filed the corporation was insolvent; that customers' free securities had been wrongfully hypothecated in connection with notes payable to banks;

other customers' free securities had been treated as securities of officers pledged to secure such officers' debit balances due to the corporation; and that certain notes payable to banks, secured by customers' free securities, and the collateral thereto were not recorded on the books of the broker-dealer and were not included in the liabilities shown in the certified statement of financial condition filed with the Commission.

The certifying accountant stipulated that his testimony given during the course of the Commission's investigation of the broker-dealer involved could be made a part of the record in these proceedings. From his testimony, the following facts were established as to the circumstances of his engagement and the scope and nature of his audit:

The auditor was a certified public accountant of some 30 years' experience, but was actually engaged mostly in income and other tax work; only twice before had he made audits of a broker-dealer;

He had met the broker-dealer's president through another client some months before he obtained the present engagement but had done no work for the broker-dealer previously; arrangements for the engagement were made by an officer of the broker-dealer who was also the firm's bookkeeper;

Prior to his audit in connection with the Form X-17A-5 filed by the broker-dealer he had read the instructions applicable to the form including the minimum audit requirements prescribed therein;

His "audit" consisted primarily of (1) the preparation of a trial balance of the general ledger, (2) the examination of securities on hand at a date several days subsequent to the date of statement, (3) comparison of such securities with a purported inventory of securities handed him by the bookkeeper, (4) reconciliation, as of the date

of the audit, of two bank statements which were given to him, together with the applicable cancelled checks, by the firm's president; and (5) examination of some correspondence in the firm's files and of certain "confirmations" of bank loans and the underlying collateral obtained by the president.

The audit made thus failed to include a number of procedures and safeguards which are prescribed in the instructions to Form X-17A-5 as *minimum* audit requirements for the proper substantiation of a statement of the financial condition of a broker-dealer. The more important procedures omitted in this case were:

(a) Verification of securities in transit or transfer;

(b) Obtaining of written confirmations by direct correspondence in respect of bank balances, money borrowed and collateral pledged there against, accounts and securities carried for others, securities borrowed and loaned, securities failed to deliver and failed to receive, and accounts with customers, officers and directors; and

(c) Review of the methods of internal accounting control of the broker-dealer and its procedures for safeguarding securities.

In the course of his testimony the accountant stated that he "didn't complete the thing, perhaps, the way I should have \* \* \* perhaps not as thoroughly as I should \* \* \* I was anxious to

get away. I went down to Florida and this engagement was the last one I had prior to going, and I was more or less in a hurry \* \* \* We agreed on a price of \$125 to do the work in connection with the balance sheet audit and I believe I did \$125 worth of work. That is about the size of it \* \* \* I did what I would ordinarily do unless there was something that came up that was peculiar or different or I suspected anything, but in this case I didn't and actually I had only this short experience in connection with brokers \* \* \* If I suspected there was anything wrong one thousand dollars wouldn't have covered the thing. I mean, whatever you have to go through I—in other words, I wouldn't have taken the engagement at all because I was in a hurry to get away \* \* \*"

It does not appear that the failure of the certified public accountant to perform a satisfactory audit contributed to the fraud perpetrated by the broker-dealer involved, nor apparently did his extreme laxity occasion losses to investors of the brokerage firm. For these reasons and since the accountant has filed a stipulation in which he has admitted that he was familiar with the Commission's Rule X-17A-5 and with Form X-17A-5; that he had not observed the minimum audit requirements prescribed by that form; and that he would never again practice before this Commission as an accountant, the proceedings with respect to him were discontinued.

## RELEASE NO. 52\*

May 10, 1945

SECURITIES ACT OF 1933  
Release No. 3064

SECURITIES EXCHANGE ACT OF 1934  
Release No. 3690

**Presentation in financial statements of Federal income and excess profits taxes in cases where a company for which individual statements are filed pays its tax as a member of a consolidated group of companies.**

\* Text of release omitted.