

**RELEASE NO. 20\***

December 20, 1940

SECURITIES ACT OF 1933  
Release No. 2431SECURITIES EXCHANGE ACT OF 1934  
Release No. 2719

Amendment of Rule 12-16 of Regulation S-X.

**RELEASE NO. 21**

February 5, 1941

SECURITIES ACT OF 1933  
Release No. 2460SECURITIES EXCHANGE ACT OF 1934  
Release No. 2776

Amendment of Rules 2-02 and 3-07 of Regulation S-X.

The Securities and Exchange Commission today announced the adoption of amendments to Rules 2-02 and 3-07 of Regulation S-X, which are designed to correct certain defects disclosed by the Commission's studies of accountant's certificates. Regulation S-X governs the form and content of financial statements required to be filed on Form A-2 under the Securities Act of 1933 and most of the forms promulgated under the Securities Exchange Act of 1934. The amendments become effective March 1, 1941.

At the time of the adoption of Regulation S-X it was stated that "in view of the pending proceedings in the matter of McKesson and Robbins, Incorporated, and several other cases, the rules governing certification by accountants, although altered and clarified in some respects, have been retained in substantially the form now found in the General Rules and Regulations under the Securities Act of 1933 and the several major forms under the 1933 and 1934 Acts. Upon completion of these proceedings, however, such rules are to be considered with a view to revisions deemed necessary as a result of these cases."

The form of the accountant's certificate was considered at some length in the Report of Investigation, In the matter of McKesson & Robbins, Inc. The following conclusions reached

on this subject are quoted from pages 434-435 of the report:

"\* \* \* it appears to us that the following principles should be adopted respecting the form and content of accountant's certificates in order to avoid possibility of confusion in the future.

"The work done should be described as the auditor sees fit and any desired information concerning the accounts may be stated. While we do not think that each audit step should necessarily be set forth, it is to be hoped that really descriptive language will be used as distinguished from a standard form based upon procedures set forth in a bulletin neither of which is referred to in the certificate. While the road is left clear to the auditor to describe in his own language what he has done and what he has found, we suggest one positive requirement in this connection. The certificate should state as part of the description of the scope of examination every generally recognized normal auditing procedure which has been omitted and the reasons for the omission.

"We believe that, in addition to the present expression of opinion that the company's position and results of operations are fairly presented by the accounts, the accountant should certify that the examination conducted was not less than that necessary in order to form the foregoing opinion. This statement may well replace the one generally in use in certificates

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\* Text of release omitted.

prior to the present hearing in which the only reference to the examination in the opinion paragraph was in the words 'based upon such examination' or 'subject to the foregoing' following 'In our opinion.' Besides not definitely stating whether the examination was sufficient in scope, these words would seem to incorporate all prior references to the examination in the preceding paragraphs of the certificate and base the auditor's opinion thereupon without specifically stating whether those references were purely descriptive or in the nature of exceptions. Exceptions to the scope of the audit or to the accounts should be expressly so stated in the same sentence as the certification as to the scope of the audit and the opinion as to the accounts, respectively. Exceptions may be incorporated by reference in such sentences but must be specifically designated as 'exceptions.' If any required information has been withheld by the client or access to records denied these facts should, of course, be treated as exceptions.

"We said above that the auditor should certify that the examination was not less than the required minimum of accepted practice both as to procedures and the manner of their application. While accountants may not be able to certify as to the correctness of the figures appearing on the financial statements in the sense of guaranteeing or warranting their correctness but can merely express their opinion with respect to them, we do think they can and should certify that the examination, on which their opinion as to the financial statements was based, was at least equal to professional requirements."

Amendments of the rules as to accountants' certificates have for some time been the subject of correspondence and discussion between committees representing the American Institute of Accountants, the Controllers Institute of America, and the American Accounting Association, and numerous individual accountants and members of the Commission's staff. During this time the suggestions made by individuals as well as by the committees have been given careful consideration and a number of them embodied in drafts of the rules which have been made available to the cooperating committees and

individuals for further criticism. Successive revisions and criticism have resulted in the revised rules now adopted by the Commission.

The revised Rule 2-02 sets forth requirements as to the contents of the accountant's certificate and is divided into four sections.

Section (a) states certain technical requirements and involves no change from previously existing rules.

Section (b) contains the requirements for the accountant's representations as to the nature of the audit which he has made. Under subsection (i) the accountant must give a reasonably comprehensive description of the scope of the audit which he has performed. In accordance with the opinion of the Commission in the McKesson report, the subdivision also requires that, if any generally recognized normal auditing procedures have been omitted with respect to significant items in the financial statements, such omissions shall be stated with a clear explanation of the reasons for such omission. It is contemplated that designation of procedures omitted would be confined to the primary auditing requirements which have been recognized as normal auditing procedure, as for example, the circularization of receivables and would not extend to detailed or mechanical steps. Since in particular circumstances such omissions may be proper, the specification of such omissions and the reasons therefor in connection with the description of the audit would not be considered as exceptions or qualifications unless specifically so noted in connection with subsection (ii) which requires that the accountant shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances. In referring to generally recognized normal auditing procedures the Commission has in mind those ordinarily employed by skilled accountants and those prescribed by authoritative bodies dealing with this subject, as for example, the various accounting societies and governmental bodies having jurisdiction. In referring to generally accepted auditing standards the Commission has in mind, in addition to the employment of generally recognized normal auditing procedures, their application

with professional competence by properly trained persons. The Commission further recognizes that the individual character of each auditing engagement and the facts disclosed through a vigilant, inquisitive, and analytical approach by the auditor may call for the extension of normal procedures or the employment of additional procedures. Therefore, subsection (iii) requires that the accountant also state whether he omitted any procedure deemed necessary by him under the circumstances of the particular case.

Paragraphs 2 and 3 of Section (b) incorporate provisions of previous rules and add the requirement that "appropriate consideration shall be given to the adequacy of the system of internal check and control," thus emphasizing the importance of this basic element.

Section (c) concerning the opinion of the accountant as to the financial statements covered by the certificate and the accounting principles followed is for the most part a restatement and clarification of previous rules.

Section (d) includes an important change from previous rules, in that it requires in addition to a clear identification of all exceptions that, to the extent practicable, the effect of each exception on the related financial statements be given. A clear explanation of the effect on the financial statements of the use of accounting principles to which exception is taken is deemed necessary if the statements are not to be misleading to investors.

Rule 3-07 incorporates the new requirement that if "any significant retroactive adjustment of the accounts of prior years has been made at the beginning of or during any period covered by the profit and loss statements filed, a statement thereof shall be given in a note to the appropriate statement, and if the \* \* \* adjustment substantially affects proper comparison with the preceding fiscal period, the necessary explanation."

The text of the Commission's action follows:

AMENDMENT NO. 3 TO REGULATION S-X

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, and the Securities Exchange Act of 1934, particularly Sections 12, 13, 15(d), and 23(a) thereof, and finding 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 Rules 2-02 and 3-07 of Regulation S-X to read as follows:

**Rule 2-02 Accountants' Certificates**

(a) **Technical requirements.**—The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the financial statements covered by the certificate.

(b) **Representations as to the audit.**—The accountant's certificate (i) shall contain a reasonably comprehensive statement as to the scope of the audit made including, if with respect to significant items in the financial statements any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (ii) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (iii) shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case.

In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The accountant shall review the accounting procedures followed by the persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed.

Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit

made for the purpose of expressing the opinions required by paragraph (c) of this rule.

(c) **Opinions to be expressed.**—The accountant's certificate shall state clearly: (i) the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein; (ii) the opinion of the accountant as to any changes in accounting principles or practices, or adjustments of the accounts, required to be set forth by Rule 3-07; and (iii) the nature of, and the opinion of the accountant as to, any significant differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review.

(d) **Exceptions.**—Any matters to which the accountant takes exception shall be clearly

identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

#### **Rule 3-07. Changes in Accounting Principles and Practices.**

If any significant change in accounting principle or practice, or any significant retroactive adjustment of the accounts of prior years, has been made at the beginning of or during any period covered by the profit and loss statements filed, a statement thereof shall be given in a note to the appropriate statement, and, if the change or adjustment substantially affects proper comparison with the preceding fiscal period, the necessary explanation.

*The foregoing action shall be effective March 1, 1941.*

### **RELEASE NO. 22**

March 14, 1941

**SECURITIES ACT OF 1933**  
Release No. 2498

**SECURITIES EXCHANGE ACT OF 1934**  
Release No. 2820

#### **Independence of Accountants—Indemnification by Registrant**

The Securities and Exchange Commission today made public an opinion in its Accounting Series Releases regarding the independence of certifying accountants who have been indemnified, by the company whose statements are certified, against all losses, claims and damages arising out of such certification other than as a result of their willful misstatements or omissions. The opinion, prepared by William W. Werntz, Chief Accountant, follows:

"Inquiry has been made as to whether an accountant who certifies financial statements included in a registration statement or annual report filed with the Commission under the Securities Act of 1933 or the Securities Exchange Act of 1934 may be considered to be independent if he has entered into an indemnity agreement with the registrant. In the particular illustration cited, the board of directors of the registrant formally approved the

filing of a registration statement with the Commission and agreed to indemnify and save harmless each and every accountant who certified any part of such statement, 'from any and all losses, claims, damages or liabilities arising out of such act or acts to which they or any of them may become subject under the Securities Act of 1933, as amended, or at 'common law,' other than for their willful misstatements or omissions.'

"The Securities Act of 1933 requires statements to be certified by independent accountants and the Securities Exchange Act of 1934 gives the Commission power to require that the certifying accountants be independent. The requirement of independence is incorporated in the several forms promulgated by the Commission and is partially defined in Rule 2-01 (b) of Regulation S-X which reads: 'The Commission will not recognize any certified public

accountant or public accountant as independent who is not in fact independent. 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.'

"This concept of independence has also been interpreted in Accounting Series Release No. 2<sup>1</sup> and in several stop-order opinions. In the matter of *Cornucopia Gold Mines*, 1 S.E.C. 364 (1936), the Commission held that the certification of a balance sheet prepared by an employee of the certifying accountants, who was also serving as the unsalaried but principal financial and accounting officer of the registrant, and who was a shareholder of the registrant, was not a certification by an independent accountant. In the matter of *Rickard Ramore Gold Mines, Ltd.*, 2 S.E.C. 377 (1937), an accountant was held to be not independent by reason of the fact that he was an employee or partner of another accountant who owned a large block of stock issued to him by the registrant for services in connection with its organization. In the matter of *American Terminals and Transit Company*, 1 S.E.C. 701 (1936), conscious falsification of the facts by the certifying accountant was held to rebut the presumption of independence arising from an absence of direct interest or employment. In the matter of *Metropolitan Personal Loan Company*, 2 S.E.C. 803 (1937), it was held that accountants who completely subordinate their judgment to the

desires of the client are not independent. In the matter of *A. Hollander & Son, Inc.*, Securities Exchange Act of 1934, Release No. 2777 (1941), the Commission held that an accountant could not be considered independent when the combined holdings of himself, one of his partners, and their wives in the stock of the registrant had a substantial aggregate market value and constituted over a period of 4 years from 1½ percent to 9 percent of the combined personal fortunes of these persons. It was also held to be evidence of lack of independence, with respect to the registrant, that the accountant had made loans to, and received loans from, the registrant's officers and directors. In the same case, the evidence showed that registrant's president, over a period of years, had used the accountant's name as a false caption for an account on books of an affiliate not audited by such accountant and that upon learning of these facts the accountant protested and procured a letter of indemnification in connection with such use. It was held that this continued use of the accountant's name, after his protest, and the overriding attitude apparently assumed by the registrant's president in this matter, constituted additional evidence of lack of independence.

"I think the purpose of requiring the certifying accountant to be independent is clear. Independence tends to assure the objective and impartial consideration which is needed for the fair solution of the complex and often controversial matters that arise in the ordinary course of audit work. On the other hand, bias due to the presence of an entangling affiliation or interest, inconsistent with proper professional relations of accountant and client, may cause loss of objectivity and impartiality and tends to cast doubt upon the reliability and fairness of the accountant's opinion and of the financial statements themselves. Lack of independence, moreover, may be established otherwise than solely by proof of misstatements and omissions in the financial statements. As was said in a recent opinion of the Commission:<sup>2</sup>

<sup>1</sup> Accounting Series Release No. 2 reads in part:

"... the Commission has taken the position that an accountant can not be deemed to be independent if he is, or has been during the period under review, an officer or director of the registrant or if he holds an interest in the registrant that is significant with respect to its total capital or his own personal fortune.

"In a recent case involving a firm of public accountants, one member of which owned stock in a corporation contemplating registration, the Commission refused to hold that the firm could be considered independent for the purpose of certifying the financial statements of such corporation and based its refusal upon the fact that the value of such holdings was substantial and constituted more than 1 percent of the partner's personal fortune."

<sup>2</sup> In the Matter of *A. Hollander & Son, Inc.*, *supra*.

"We cannot, however, accept the theory advanced by counsel for the intervenors that lack of independence is established only by the actual coloring or falsification of the financial statements or actual fraud or deceit. To adopt such an interpretation would be to ignore the fact that one of the purposes of requiring a certificate by an independent public accountant is to remove the possibility of impalpable and unprovable biases which an accountant may unconsciously acquire because of his intimate nonprofessional contacts with his client. The requirement for certification by an independent public accountant is not so much a guarantee against conscious falsification or intentional deception as it is a measure to insure complete objectivity. It is in part to protect the accounting profession from the implication that slight carelessness or the choice of a debatable accounting procedure is the result of bias or lack of independence that this Commission has in its prior decisions adopted objective standards. Viewing our requirements in this light, any inferences of a personal nature that may be directed against specific members of the accounting profession depend on the facts of a particular case and do not flow from the undifferentiated application of uniform objective standards."

"While Rule 2-01(b) quoted above designates certain relationships that will be considered to negative independence, it is clear from the opinions cited that other situations and relationships may also so impair the objectivity and impartiality of an accountant as to prevent him from being considered independent for the purpose of certifying statements required to be filed by a particular registrant.

"In the particular case cited the accountant was indemnified and held harmless from all

losses and liabilities arising out of his certification, other than those flowing from his own willful misstatements or omissions. When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, it is my opinion that one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened.<sup>3</sup> Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies. In such difficult matters, for example, as the determination of the scope of audit necessary, existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed. In other cases it may result in a failure to appraise with professional acumen the information disclosed by the examination. Consequently, on the basis of the facts set forth in your inquiry, it is my opinion that the accountant cannot be recognized as independent for the purpose of certifying the financial statements of the corporation."

<sup>3</sup> It may be noted that Section 152 of the English Companies Act (1929) makes comparable indemnity agreements void:

"152. Subject as hereinafter provided, any provision, whether contained in the article of a company or in any contract with a company or otherwise, for exempting any director, manager or officer of the company, or any person (whether an officer of the company or not) employed by the company as auditor from, or indemnifying him against, any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company shall be void."

**RELEASE NO. 23\***

April 9, 1941

SECURITIES ACT OF 1933  
Release No. 2524SECURITIES EXCHANGE ACT OF 1934  
Release No. 2853

Treatment of Federal income and excess profits taxes.

**RELEASE NO. 24\***

May 23, 1941

SECURITIES ACT OF 1933  
Release No. 2566SECURITIES EXCHANGE ACT OF 1934  
Release No. 2903INVESTMENT COMPANY ACT OF 1940  
Release No. 134

Amendment to Articles 1, 6, and 12 of Regulation S-X.

**RELEASE NO. 25**

May 29, 1941

SECURITIES ACT OF 1933  
Release No. 2574SECURITIES EXCHANGE ACT OF 1934  
Release No. 2912INVESTMENT COMPANY ACT OF 1940  
Release No 137**Procedure in Quasi-Reorganization.**

The Securities and Exchange Commission today made public an opinion of its Chief Accountant in its Accounting Series discussing certain implications of the term "quasi-reorganization" as used to describe the corporate procedure in the course of which a deficit resulting from operations or the recognition of losses is charged to capital surplus previously existing or arising in the course of the quasi-reorganization. The opinion, prepared by William W. Werntz, follows:

"Inquiry has been made from time to time as to the conditions under which a quasi-reorganization

may be said to have been effected. The term quasi-reorganization has come to be applied in accounting to the corporate procedure in the course of which a company, without the creation of a new corporate entity and without the intervention of formal court proceedings, is enabled to eliminate a deficit whether resulting from operations or the recognition of other losses or both and to establish a new earned surplus account for the accumulation of earnings subsequent to the date selected as the effective date of the quasi-reorganization. Certain aspects of the problem have

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\* Test of release omitted.

previously been discussed in published opinions of the Commission<sup>1</sup> and in three published opinions of the chief accountant.<sup>2</sup> In the amendments to Rules 6-02, 12-19, 12-20, 12-21, and 12-22 of Regulation S-X which were recently adopted in conjunction with the promulgation of a form for registration of investment companies under the Investment Company Act of 1940, the term is used in definition of circumstances under which there may be shown in lieu of the cost of securities the written-down amounts resulting from quasi-reorganization.

"It has been the Commission's view for sometime that a quasi-reorganization may not be considered to have been effected unless at least all of the following conditions exist:

"(1) Earned surplus as of the date selected is exhausted;

"(2) Upon consummation of the quasi-reorganization no deficit exists in any surplus account;

"(3) The entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with the applicable law and charter provisions;

"(4) The procedure accomplishes with respect to the accounts substantially what might be accomplished in a reorganization by legal pro-

ceedings—namely, the restatement of assets in terms of present conditions as well as appropriate modifications of capital and capital surplus, in order to obviate so far as possible the necessity of future reorganizations of like nature.

It is implicit in such a procedure that reductions in the carrying value of assets at the effective date may not be made beyond a point which gives appropriate recognition to conditions which appear to have resulted in relatively permanent reductions in asset values; as for example, complete or partial obsolescence, lessened utility value, reduction in investment value due to changed economic conditions, or, in the case of current assets, declines in indicated realization value. It is also implicit in a procedure of this kind that it is not to be employed recurrently but only under circumstances which would justify an actual reorganization or formation of a new corporation, particularly if the sole or principal purpose of the quasi-reorganization is the elimination of a deficit in earned surplus resulting from operating losses.

In the case of the quasi-reorganization of a parent company it is an implicit result of such procedure that the effective date should be recognized as having the significance of a date of acquisition of control of subsidiaries. Hence dividends subsequently received from subsidiaries should be treated as income only to the extent that they are declared by subsidiaries out of earnings subsequent to the effective date. Likewise, in consolidated statements, earned surplus of subsidiaries at the effective date should be excluded from earned surplus on the consolidated balance sheet.

<sup>1</sup> See particularly *Associated Gas and Electric Corporation*, 6 S.E.C. 605 (1940).

<sup>2</sup> Accounting Series Releases Nos. 1, discussing the propriety of charging losses to capital surplus rather than earned surplus; 15, discussing the nature of the disclosure to be made in subsequent statements; and 16, discussing the disclosure necessary where consent of stockholders was not obtained, such action being permissible under the applicable State law.



## RELEASE NO. 26

July 1, 1941

SECURITIES ACT OF 1933  
Release No. 2600

SECURITIES EXCHANGE ACT OF 1934  
Release No. 2944

**Interpretation of Rule 5-02 of Regulation S-X regarding the omission of an analysis of registrant's surplus accounts.**

The Securities and Exchange Commission today made public an opinion in its Accounting Series relating to the requirements of Regulation S-X as to the analysis of a registrant's surplus account. The opinion states that such analysis may not be omitted although, under special conditions set forth in a particular form, a registrant is permitted to file in lieu of its individual profit and loss statement a consolidated profit and loss statement for the registrant and certain totally held subsidiaries.

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

"You inquire whether the instruction relative to an analysis of surplus set forth in paragraph 34(b) of Rule 5-02 of Regulation S-X implies that an analysis of the registrant's surplus accounts may be omitted when, pursuant to instructions such as those set forth under Item 8-I-A (2) (a) in the instruction book for Form 10-K, there may be filed in lieu of an individual profit and loss statement of the registrant, a consolidated statement of the registrant and certain totally held subsidiaries. The portion of the above instruction here pertinent reads as follows:

*'Provided, however,* That in lieu of such profit and loss statement there may be filed a profit and loss statement consolidating the accounts of the registrant and one or more of its subsidiaries (hereinafter called 'included subsidiaries'), if all the following conditions exist:

'(i) The registrant is primarily an operating company;

'(ii) Other than directors' qualifying shares, all classes of outstanding securities, other than those evidencing long-term or funded debt, of the included subsidiaries are owned in their entirety by the registrant and/or the included subsidiaries;

'(iii) No one of the included subsidiaries owes

to any person other than the registrant any long-term or funded debt of an amount which is significant in relation to the particular subsidiary;

'(iv) The included subsidiaries are, in practical effect, operating divisions of the registrant; \* \* \*

"The above permission, you will note, extends only to the registrant's profit and loss statement and does not permit the omission of the registrant's balance sheet. Therefore, pursuant to such instructions, it would be permissible to omit supplementary schedules required to be filed in support of detailed items in profit and loss statements; but it would not be permissible to omit schedules required to be filed in support of particular balance sheet items, nor to omit analyses of the surplus accounts appearing on such balance sheet. Such balance sheet schedules and analyses should be filed for each period covered by the substituted consolidated, profit and loss statements.

"Item 34(b) of Rule 5-02 of Regulation S-X to which you specifically refer reads in part as follows: "An analysis of each surplus account setting forth the information prescribed in Rule 11-02 shall be given for each period for which a profit and loss statement is filed \* \* \*." As indicated in its preface, Regulation S-X relates to the form and content of financial statements, while the instructions to the applicable forms determine what financial statements are to be filed. The cited portion of Item 34(b) of Regulation S-X must therefore be read in the light of the pertinent instructions, in the applicable form, as for example those quoted from Item 8 of Form 10-K.

"Accordingly, it is my opinion that the language of Item 34(b) should be considered as indicating the period or periods for which the required information must be set forth and may not be construed as permitting the omission of an analysis of the registrant's surplus accounts."

## RELEASE NO. 27

December 11, 1941

## INVESTMENT COMPANY ACT OF 1940

Release No. 279

**The nature of the examination and certificate required by paragraph (4) of Rule N-17F-1 and paragraph (7) of Rule N-17F-2 under the Investment Company Act of 1940.**

The Securities and Exchange Commission today made public an opinion of its Chief Accountant in its Accounting Series discussing the nature of the examination and certificate required by paragraph (4) of Rule N-17F-1 and by paragraph (7) of Rule N-17F-2 under the Investment Company Act of 1940. These rules require that where registered management investment companies retain custody of their portfolio investments, or place them in the custody of a member of a national securities exchange, such investments shall be verified at least three times each year by an independent public accountant.

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

"Inquiry has been made as to the nature of the examination and certificate required by paragraph (4) of Rule N-17F-1 and paragraph (7) of Rule N-17F-2 promulgated under the Investment Company Act of 1940.

"Rule N-17F-2 sets up certain standards to be followed by management investment companies registered under the Investment Company Act of 1940 which maintain in their own custody their portfolio securities and similar investments. Paragraph (7) of that rule is as follows:

'Such securities and investments shall be verified by complete examination by an independent public accountant retained by such registered company at least three times during the fiscal year, at least two of which shall be chosen by such accountant without prior notice to such company. A certificate of such accountant, stating that he has made an examination of such securities and investments and describing the nature and extent of the examination, shall be transmitted to the Commission promptly after each such examination.'

"The securities and investments referred to in the quoted paragraph are identified by paragraphs (1) and (2) of the rule as (a) securities

on deposit in a vault or other depository maintained by a bank or other company whose function and physical facilities are supervised by Federal or State authority; (b) securities which are collateralized to the extent of their full market value; (c) securities hypothecated, pledged, or placed in escrow for the account of such registered company; and (d) securities in transit. The examination and certificate required by the quoted paragraph should therefore cover all of the securities listed in paragraphs (1) and (2).

"In order to make a complete examination of the securities, it is, in my opinion, necessary for the accountant not only to make a physical examination of the securities themselves, or in certain cases to obtain confirmation, but also to reconcile the physical count or confirmation with the book records. Furthermore, in my opinion it is a necessary prerequisite to such a reconciliation that there have been made an appropriate examination of the investment accounts and supporting records, including an adequate check or analysis of the security transactions since the last examination and the entries pertaining thereto. While the certificate filed must describe the nature and extent of the examination made, it is not necessary that each step taken be set out; instead, there should be included in the certificate in general terms an appropriate description of the scope of the examination of the accounts and the physical examination or confirmation of the securities.

"Finally, in order to meet the requirements of paragraph (7) of Rule N-17F-2 the certificate should comply with the usual technical requirements as to dating, salutation and manual signature and, in addition to the description of the examination made, should set forth:

"(a) the date of the physical count and verification, and the period for which the investment

accounts and transactions were examined;

“(b) a clear designation of the depository;

“(c) whether the examination was made without prior notice to the company; and

“(d) the results of the examination.

“Rule N-17F-1 specifies the conditions under which a registered management investment company may place or maintain its securities and investments in the custody of a company which

is a member of a national securities exchange. Paragraph (4) of that rule calls for periodic examinations of the securities and investments so placed or maintained and for certificates as to the verification thereof. In my opinion the requirements of such paragraph (4) involve substantially the same considerations as those of paragraph (7) of Rule N-17F-2 and the above discussion is therefore likewise applicable to the examination and certificate required by such paragraph (4).”

## RELEASE NO. 28

January 8, 1942

SECURITIES ACT OF 1933  
Release No. 2754

SECURITIES EXCHANGE ACT OF 1934  
Release No. 3111

**Findings and Opinion of the Commission In the Matter of Proceeding under Rule II (e) of the Rules of Practice, to determine whether the privilege of Kenneth N. Logan to practice as an accountant before the Securities and Exchange Commission should be denied, temporarily or permanently.**

### ACCOUNTING.

#### Accountant's Certificate.

##### Independence of Accountant.

Where accountant certifying financial statements in registration statements filed with Commission owns securities of registrant of a substantial aggregate value, the cost of which amounted to an estimated 8 percent of his net worth, accountant, *held*, not independent with respect to registrant.

#### Accountant's Certificate.

##### Independence of Accountant.

Where accountant, with the knowledge of only two or three members of registrant's staff, allowed his name to be used in a trading account in the securities of the registrant, and either approved or acquiesced in procedures which effectively concealed the existence of such account, *held* such accountant is not independent with respect to registrant.

#### Financial Statements.

##### Concealment of Material Items by Improper Classification. Definition of "Accounts Receivable—Trade."

Where funds of registrant are employed in a trading account in registrant's securities, *held* such

funds not properly classified in financial statement under items "Subsequent Year Expenditures—Farming Operations" or "Accounts Receivable—Trade."

### SALE OF SECURITIES

#### Security Trading Accounts in Third Party's Name.

Response to items calling for sales of securities by registrant must include securities sold from stock trading account carried on with registrant's funds, even though the account is nominally held in a third party's name.

### ACCOUNTING.

#### Financial Statements.

##### Reacquired Securities.

Where securities of registrant have been bought for registrant's benefit in a security trading account carried on with registrant's funds, although not in registrant's name, *held* such securities must be shown on financial statements as reacquired securities.

### PRACTICE AND PROCEDURE.

#### Accounting.

##### Proceedings Under Rule II(e) of Rules of Practice.

Where accountant in financial statements filed

with this Commission sanctioned the classification of funds advanced by registrant to a trading account in registrant's securities under the heading "Subsequent Year Expenditures—Farming Operations" and "Accounts Receivable—Trade," and otherwise concealed the use that had been made of registrant's funds, *held* accountant acted improperly in certifying that he had followed correct accounting procedures, and *held* further that he was guilty of unethical and improper professional conduct under Rule II(e) of the Rules of Practice.

**Suspension of Privilege to Practice.**

**Proceedings Under Rule II(e) of Rules of Practice.**

Where accountant has certified financial statements filed with this Commission as an independent public accountant at a time when he was chargeable with knowledge that he was not in fact an independent public accountant, *held* that such accountant has engaged in improper professional conduct; and that accountant's privilege to practice before this Commission be suspended for a period of 60 days from the date of issuance of this opinion.

**APPEARANCES:**

*John G. Sobieski*, of the San Francisco Regional Office of the Commission.

*Wallace Sheehan*, for *Kenneth N. Logan* (*Gregory, Hunt* and *Melvin* on the brief).

*Grove J. Fink*, for *Edmunds Lyman*.

**FINDINGS AND OPINION OF THE COMMISSION**

This proceeding was instituted under Rule II(e) of our Rules of Practice to determine whether *Kenneth N. Logan*, a certified public accountant practicing before this Commission, is lacking either in the requisite qualifications to represent others or in character or integrity, or has engaged in unethical or improper professional conduct. If we find *Logan* to be thus deficient, or to have engaged in such improper conduct, we must then determine whether he should be disqualified or whether his privilege to appear or practice before this Commission should be denied, temporarily or permanently.<sup>1</sup>

<sup>1</sup> Rule II(e) reads as follows:

"The Commission may disqualify, and deny, temporarily

The charges made against *Logan* can be discussed under two major heads:

(1) It is alleged that *Logan* wrongfully represented himself as an independent public accountant in certifying to various reports filed with this Commission by his corporate client, the *Union Sugar Company*, when as a matter of fact he was not an independent public accountant with respect to the company;

(2) It is alleged that *Logan* improperly classified various accounts of the *Union Sugar Company*, and by means of such improper classifications misstated the use that had been made of the company's funds and concealed the fact that those funds had been used in connection with trading transactions in the company's own stock. These improper entries, it is contended, made misleading and erroneous not only the balance sheets filed in connection with *Union Sugar's* financial statements, but also the certificates filed by *Logan* attesting to the correctness of the accounts and the accounting procedures used therein. Furthermore, counsel for the Commission contends that *Logan's* personal participation in the stock transactions constitutes additional proof that *Logan* was not in fact independent.

Hearings were held before a trial examiner and his advisory report was duly filed. The trial examiner found against *Logan* on both major issues but, in view of what he deemed to be mitigating circumstances, made no recommendation with respect to the denial of *Logan's* privilege to practice as an accountant before the Commission. Exceptions to the report were taken by both counsel for *Logan* and counsel for the Commission. No request was made for oral argument before us, and under our Rules of Practice oral argument must therefore be deemed waived.

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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."

Practice before the Commission is defined under subsection (g) of Rule II to "include the preparation of any statement, opinion or other paper by any attorney, accountant, engineer or other expert, filed with the Commission in any registration statement, application, report or other document with the consent of such attorney, accountant, engineer or other expert."

Most of the exceptions taken by counsel for the Commission consist of minor factual corrections and efforts to render more explicit and forceful the findings made by the trial examiner. Commission counsel's principal ground of exception is with respect to the trial examiner's failure to make any recommendation for the denial of Logan's privilege to practice.

The exceptions tendered by counsel for Logan raise more substantial issues. They are in effect traverses of specific findings made by the trial examiner in support of his conclusion that the accounting entries were materially improper and misleading, and requests for positive findings that the entries adequately reflected the situation. In addition, the exceptions ask for the exclusion of certain evidence, and the elimination of certain findings, relating to Logan's personal stockholdings in Union Sugar. These exceptions are based on the contention that the entire issue of Logan's lack of independence (which this evidence was offered to prove) is irrelevant to the present proceeding, instituted under Rule II(e), and we therefore think it advisable to deal first with that contention.

The determination basic to our decision to take action under Rule II(e) is either that the practitioner does not possess "requisite qualifications to represent others" (subsection (1)), or that he is "lacking in character or integrity" or has "engaged in unethical or improper professional conduct" (subsection (2)). It may be conceded that, in certain circumstances, an accountant may be lacking in independence with respect to his client and yet be possessed of the highest professional qualifications and most complete integrity.<sup>2</sup> When, however, an accountant who is in fact lacking in independence represents, by his certifications to be filed with us, that he is independent, we consider that circumstance *relevant* to the issue of his character and integrity and the propriety and ethics of his professional conduct, and we sustain the trial examiner's ruling in admitting the evidence. However, to say that the evidence

<sup>2</sup>"... any inferences of a personal nature that may be directed against specific members of the accounting profession depend upon the facts of a particular case and do not flow from the undifferentiated application of uniform objective standards." *A. Hollander & Son, Inc.*, 8 S.E.C. 586 (1941).'

is *relevant* to the question of Logan's character and integrity is not necessarily to say that it *proves* him to be lacking in character and integrity or to have engaged in improper professional conduct. Thus, if the evidence showed that Logan in good faith held himself out as an independent accountant, we should not hold him to be lacking in character or integrity or to have engaged in improper and unethical professional conduct merely by reason of the fact that he was found to be not in fact independent. It accordingly becomes our duty to weigh the relevant evidence and to determine whether, in its cumulative effect, it supports the conclusion that Logan is lacking in character and integrity, or has engaged in unethical or improper professional conduct.

*Logan's Holdings of Union Sugar Company's Common Stock*—The record shows that Logan, on each of five separate dates, to wit, April 23, May 14, August 6, 1936, and October 14 and 20, 1937, bought 100 shares of Union Sugar Company's common stock; on November 18, 1936, by exercising a subscription right, he bought 39 shares, and on October 4, 1937, 15 additional shares. Since he never sold any of these shares, Logan, from October 1937 to the end of 1939, when he terminated his services as accountant for Union Sugar, owned 554 shares of its stock, purchased at a total cost of \$10,754.14. This latter amount was, on the basis of Logan's own figures, equivalent to about 8 percent of the net worth of himself and his immediate family.<sup>3</sup> It is abundantly clear, for the reasons indicated in prior opinions of this Commission, that the possession of an interest by an accountant in the stock of his corporate client that is so substantial with respect to the accountant's total net worth is, of and by itself, sufficient to render the accountant

<sup>3</sup> Logan calculated his total net worth by (1) taking an average of his annual earnings from his accounting business for the 3 years before and after 1936, (2) assuming that one-half was the result of his own services, (3) capitalizing the other one-half at 10 percent, and (4) adding to item No. 3 his other forms of investment.

Another indication of the comparative importance of Logan's stockholdings may be found in contrasting the cost of these stockholdings with his annual auditing fee from Union Sugar which was, by continuing agreement, \$600 plus expenses, plus relatively small charges for other incidental services such as preparation of tax returns.

lacking in independence with respect to that client.<sup>4</sup>

The defense interposed that Logan's 554 shares were but a negligible portion of the total of 122,718 shares of Union Sugar stock outstanding might be a more relevant factor if the issue were whether Logan's corporate client was independent of Logan. However, since the issue we have to determine is whether Logan was independent of Union Sugar and its management, an equally if not more important consideration is how large a proportion of his personal fortune was tied up with the destiny of the corporate enterprise.

It is urged in Logan's defense—apparently in support of the claim that he acted in good faith—that he did not know of the existence of Rule 650 of the General Rules and Regulations under the Securities Act of 1933,<sup>5</sup> dealing with the qualifications of independent public accountants, until on or about November 1, 1937, and that he purchased no stock after that date. It is also pointed out that Logan made his certifications to Union Sugar's 1936 and 1937 annual reports on Form 10-K on May 10, 1937, and on April 29, 1938, respectively, and that Accounting Series Release No. 2, the first authoritative general pronouncement of this Commission dealing solely with the disqualifying nature of an accountant's ownership of a substantial interest in a client, was not re-

<sup>4</sup> *Cornucopia Gold Mines*, 1 S.E.C. 364 (1936); *Rickard Ramore Gold Mines, Ltd.*, 2 S.E.C. 377 (1937); *A. Hollander & Son, Inc.*, 8 S.E.C. 586 (1941); Accounting Series Release No. 2, published May 6, 1937. (see p. 1 of this publication.)

Further militating against Logan's lack of independence is the fact that he held these shares in a margin account and had paid in cash only about \$6,000; as margin calls were made, borrowing was resorted to as a means of making up the deficiency. The necessity for such borrowing placed Logan in a position still further removed from the objectivity requisite for an independent accountant. It should also be noted that the acquisition of these 554 shares was the result of seven different transactions spread over a period of 18 months, during which period Logan was enlarging his interest in the corporation and his consequent susceptibility to pressures deriving from his position as a stockholder.

<sup>5</sup> Rule 650(b) reads as follows:

"The Commission will not recognize any certified accountant or public accountant as independent who is not in fact independent. 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 connected as an officer, employee, promoter, underwriter, trustee, partner, director, or person performing similar functions."

leased until May 6, 1937.<sup>6</sup> The inference that we are presumably asked to draw is that the requirements of the Commission with respect to certifications by independent public accountants were in advance of what a member of the accounting profession should be chargeable with knowing, independently of explicit clarification by this Commission.

We do not find that we can draw that inference. In the first place, any common sense interpretation of the word "independent" would have covered Logan's case. Had there been any doubt in Logan's mind as to the meaning of the requirement for certification by an independent public accountant, the General Rules and Regulations, our opinions, and informal advice of our staff would have been available to Logan at any time he requested them. Furthermore, it should be pointed out that Logan engaged in stock transactions, both directly in his own behalf and indirectly as a dummy for the Union Sugar Company, subsequent to the time that Accounting Series Release No. 2 was issued; and, more important, that he continued to hold himself out as an independent public accountant in the 1937 Form 10-K annual report of the company and in amendments to the 1936 Form 10-K annual report, both of which were filed after the date of Accounting Series Release No. 2.<sup>7</sup>

<sup>6</sup> Counsel also urges that our most recent opinion amplifying the concept of independence, *A. Hollander & Son, Inc.*, 8 S.E.C. 586, was not decided until February 6, 1941. This suggestion overlooks the fact that there are at least two opinions, issued several years prior to the *Hollander* case, in which we enunciated the proposition that possession by an accountant of a substantial amount of his client's stock precludes him from being independent, *Cornucopia Gold Mines*, 1 S.E.C. 364 (1936); *Rickard Ramore Gold Mines, Ltd.*, 2 S.E.C. 377 (1937).

<sup>7</sup> Accounting Release No. 2 was given wide publicity in the June 1937 issue of the *Journal of Accountancy*, which is sent to all members of the American Institute of Accountants (of which Logan has been a member since 1937) and which is widely read by nonmember accountants as well. Logan's original certificate to Union Sugar's Form 10-K report for period ended December 31, 1936, was dated April 30, 1937 (before the issuance of Accounting Series Release No. 2), but subsequent amendments thereto were filed on January 4, 1938, and September 16, 1939. The Form 10-K report for the year ended Dec. 31, 1937, was certified by Logan on April 25, 1938, and

Our conclusion that Logan was properly chargeable with notice of the requirements of this Commission for independence on the part of certifying accountants is reinforced by the fact that the great importance of preserving an accountant's independence, and the adverse effect which ownership of a client's securities has upon such independence, had been the subject of considerable discussion by the accounting profession prior to the issuance of Accounting Series Release No. 2.<sup>9</sup> There is nothing in the record to suggest why Logan should not have been aware of the interest of the accounting profession in this topic. He had practiced public accounting continuously since 1914, except for 1 year, and had been a certified public accountant in California since 1922. Not only had he taken preliminary law courses at the University of California, but his general testimony indicates him to be a man of considerable intelligence, and renders it unlikely that he should not have been aware of the fact that he was not, at the time he certified Union Sugar Company's annual reports, in fact independent.

The case against Logan's independence is made even more conclusive by what remains to be said concerning his participation in further stock transactions, initiated at the same time as his personal stock account but, according to the testimony, carried on not in his own behalf but as a dummy for the Union Sugar Company, and his accounting treatment of these transactions.

*The Kenneth N. Logan Special Account.*—The second major impropriety of which Logan is

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subsequent amendments were certified on April 18, and September 16, 1939. These dates are even more significant when it is borne in mind that Logan testified that he kept currently informed of this Commission's accounting regulations, a claim which seems to be supported by his rather detailed references to the Instruction Book for Form 10-K as a justification for his treatment of the items to be considered in the next section of this opinion.

<sup>9</sup> See American Institute of Accountants, *Rules of Professional Conduct*, Resolution Adopted October 15, 1934; Sterrett, *Professional Ethics*, Twentieth Anniversary Yearbook of the American Association of Public Accountants (1907) pp. 108, 117; Montgomery, *Auditing Theory and Practice* (1st ed. 1912), pp. 18-19; May, *The Accountant and the Investor*, appearing in *Ethical Problems of Modern Accountancy* (1933), pp. 38-39. See also Hurdman, *Ethics of the Accounting Profession*, 72 *Journal of Accountancy* 412, 420 (1941).

alleged to have been guilty derives from his activities in concealing the fact that over a period of 21 months, from September 1936 to May 1938, Union Sugar Company's funds were used to carry on a trading account, in Logan's name, in its own securities.<sup>9</sup> The circumstances surrounding the inception of this account are particularly illuminating because they illustrate how closely identified Logan was with the management.

When the Union Sugar Company resumed factory operations in 1934 after a shut-down that had commenced in 1927, it secured open credits from one Los Angeles and one San Francisco bank. When the vice president of the Los Angeles bank told Edmunds Lyman, the president of Union Sugar at that time, that the bank had been criticized for allowing the loan to Union Sugar to become frozen, the company's board of directors cast about for a method of financing that would enable them to retire the bank loans. Logan & Logan, Kenneth N. Logan's accounting firm, was asked by the board to suggest possible means of placing the company's capital structure on a more permanent basis. Pursuant to this request, Logan and Lyman discussed with Charles Blyth, a San Francisco investment banker, the matter of issuing more common stock. Blyth told them that the expenses in connection with such an issue would amount to about \$20,000, and advised that the company's refinancing be accomplished by converting the company's preferred stock into common. This advice was relayed back to the board of directors, who thereupon asked Lyman and Logan to review the possibilities further. Acting pursuant to the board's instruction, Lyman and Logan held conferences with representatives of this Commission, who informed them that the issuance of subscription rights to the common stockholders and the conversion plan would require registration under the

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<sup>9</sup> During this period, a total of 8,925 shares were bought for the account and 7,725 shares were sold, leaving a balance of 1,200 shares when the account was transferred on May 16, 1938, to Edmunds Lyman Account No. 2. With the exception of 500 shares sold subsequently to November 10, 1937, all of these transactions took place at prices ranging from 21½ to 28½. The peak of trading in the account may be said to have been reached on November 10, 1936, when the account was long 2,715 shares. At that time, in addition to \$35,000 which had been advanced by Union Sugar, the account showed a debit balance of \$34,603.50.

Securities Act of 1933. Cross, the attorney for Union Sugar, and Logan prepared the data required in order to (a) amend the articles of incorporation of the company so as to permit the conversion of the preferred, (b) obtain the consent of the corporation commissioner of California to the conversion, and (c) file the appropriate form for the registration of the proposed issue under the Securities Act.

Thus far Logan's activities had been specifically authorized and directed by the board of directors of the company, and had involved collaboration with the company's attorney. Thereafter, both the board and company's attorney dropped completely out of the picture, and Logan became the associate of the president of the company in stock transactions of dubious import to which only two or three insiders were privy. In July or August 1936 a conference took place in the office of Holmes, the secretary-treasurer of the company, at which were present, in addition to Holmes and Logan, Lyman, the president, and Braverman, one of the directors and now deceased.<sup>10</sup> According to the testimony of Logan and Lyman, Braverman, relying on the good prospects of the company,<sup>11</sup> suggested that it could reimburse itself for the expenses of the whole recapitalization program, which it was estimated would amount to between \$6,000 and \$8,000, by purchasing the company's common stock and holding it for a rise in the market. There was testimony to the effect that one of the parties present at the conference expressed the opinion that the account could not be carried in the company's name, on the ground that there was a legal prohibition against the company trading in its own stock. Despite apparent qualms about the propriety of the transaction, Lyman, who had consulted outside brokers as to its validity, did not consult

<sup>10</sup> Logan was not sure whether Martin, the assistant secretary and treasurer of the company, had been present, but there seems to be no evidence in the record impugning Martin's testimony that he was not there and knew about the account only in a vague way.

<sup>11</sup> Braverman felt that there was in prospect a good sugar year and the possibility of oil development on the company's property. In addition, the recapitalization plan would relieve the company from the burden of the interest payments on its bank loans, its current cumulative dividend obligations on the preferred stock and its liability for accrued preferred dividends.

Cross, the company's attorney. Logan testified that it was also felt to be undesirable to have the trading account in the name of an officer of the company, since the purpose of the account might be misinterpreted if an officer's name were used. That there was considerable uneasiness about the entire plan of trading activity is, in our mind, conclusively evidenced by the decision reached at this four-man conference (and never communicated to the board of directors) to place the account in the name of Kenneth N. Logan rather than in the name of the company or one of the company's officers.<sup>12</sup>

It is not within the purview of the present proceedings to unravel the motives underlying this transaction<sup>13</sup> or to inquire into the California law relating to such trading by a corporation in its own securities.<sup>14</sup> It is sufficient for us to say that decision to employ a corporation's funds in extensive stock trading activities is unquestionably one which, regardless of considerations of legality,<sup>15</sup> would normally be referred to the company's board of directors or the company's counsel, and Logan should have realized that fact. Apart from the general presumption that a corporation is not established for the purpose of trading in its own stock, there were several unusual and unexplained circumstances that should have indicated to Logan the dubious propriety of the proposed plan of trading activity.

In the first place, it is difficult to understand why, after Logan and Lyman had reported back to the board on alternative refinancing plans and the costs thereof and had secured approval

<sup>12</sup> Lyman testified that Logan volunteered his name for the account, but Logan denies this.

<sup>13</sup> Holmes testified that the trading account was entered into in order to keep the market up, but the implication that stabilization was the motive for the account was repudiated by both Lyman and Logan.

<sup>14</sup> Logan testified that there was no discussion of the legality of a company acquiring its own shares; he also testified that he recalled that the California Code said that such shares could only be purchased from available surplus but that Union Sugar had such a surplus.

<sup>15</sup> Cf., *Levy Purchase by a Corporation of Its Own Stock*, 15 Minn. L. Rev. 1, 8, 15, 22 (1930); *In re Tichenor-Grand Co.*, 203 Fed. 720 (S. D. N. Y. 1913); *Dacovich v. Canizas*, 44 So. 473, 474 (Ala. 1907); *Dupont v. Dupont*, 242 Fed. 98 (D. Del. 1917).



to go ahead with this particular recapitalization plan (which the board must have known could not be self-financing), the president, treasurer, and a single director of the company should have assumed sole and unguided responsibility for meeting the expenses of the recapitalization plan, without consulting the company's counsel, a fellow director. It is also strange that no one present at the conference thought of the necessity of any documents to protect the company in case the account suffered a loss. Even without the hindsight realization that the account actually did culminate in a loss, the excuse that loss was not contemplated on the account is obviously inadequate.<sup>16</sup> Logan, by his own testimony, appears to have realized the dangerous nature of the transaction, for he apparently imposed three conditions on the use of his name: (1) that he would have no personal responsibility for buying or selling the securities in the account, since he was busy and in no position to follow the trend of the market; (2) that all records pass through his hands to the offices of Union Sugar; and (3) that neither he nor the company would be out-of-pocket on any expenses. In response to this last condition, Lyman stated that he would personally guarantee the account both to Logan and to Union Sugar. We are of the opinion that no independent accountant would have lent his name to a transaction which so obviously required corporate authorization without procuring that authorization, on the flimsy rationalization (advanced by Logan) that obtaining corporate approval would be inconvenient. Furthermore, the secrecy with which this transaction was inaugurated is irreconcilable with Logan's later testimony that he assumed the account was an open company matter.

The evidence which we have outlined with respect to the initiation of the trading account indicates that Logan was not independent but

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<sup>16</sup> Also not adequately accounted for in the record before us is the disposition that would be made of any surplus profits above the \$6,000 or \$8,000 necessary to cover the recapitalization expense. Lyman testified that such surplus profit was all to inure to the company, and that this would be accomplished by Logan doing additional work for the company and not billing the company for same, but instead retaining the excess profit on the trading account. Logan contradicted this testimony.

was under the domination of the management. As a matter of fact, it would be even more accurate to say that he was under the domination of one or two members of the management. Lyman's guarantee to Logan that he would suffer no loss from allowing his name to be used in the account emphasizes the extent to which Logan was under obligation to Lyman and was removed from the position of accountability for his acts that is necessary for an independent public accountant.<sup>17</sup> In this state of affairs, Logan was not only not preserving the requisite position of impartiality between the management and the stockholders, but was an accomplice of one or two members of the management in a transaction putting the parties privy to it in a position of potential conflict with the stockholders of the enterprise and the rest of the management.<sup>18</sup>

Not only was the Kenneth N. Logan Special Account initiated with the idea in mind of concealing, from the stockholders and the board of directors of the company, the speculative use that was being made of the funds of the company, but the mechanics whereby the account was conducted and the manner in which it was recorded on the company's books were calculated to keep up the concealment indefinitely.<sup>19</sup> In those mechanics and in that scheme of recording Union Sugar's funds, Logan was a necessary

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<sup>17</sup> See *A. Hollander & Son, Inc.*, 8 S.E.C. 586 (1941); S.E.C. Accounting Series Release No. 22, March 14, 1941. (See p.28.)

<sup>18</sup> "The importance of independence is emphasized when there may be apparent conflict of interest between management and stockholders, or between classes of security holders; the auditor must be independent to insure his arriving at an unbiased opinion in the face of conflicting interests. His duties may often necessitate differing strongly with the management regarding the accounting treatment or presentation of an item or transaction; in extreme cases the reporting of irregularity or outright dishonesty in his task. Such duties cannot be performed to the best advantage of either the client or the auditor unless the latter is truly independent." Montgomery, *Auditing Theory and Practice* (6th ed. 1940), p. 18.

<sup>19</sup> Apparently knowledge of this security trading was not brought home to the company's directors (other than the insiders) until the company's annual meeting in 1938, when, by reason of the disclosure of these transactions, Lyman was forced out of the presidency. It was not until April 1940 that there was a partial repayment of the \$23,000 still due the company, with Logan and Lyman paying \$5,500 apiece. Lyman's note of \$12,000 for the balance was paid off with interest on May 31, 1940.

actor. Checks, for example, were deposited in the Kenneth N. Logan Special Account by a circuitous route. Lyman would have a check drawn by Union Sugar to the order of Logan; Logan would deposit Union Sugar's check in his personal banking account; and Logan would then draw his personal check to the order of Leib, O'Connor & Co., the brokerage house with which the account was held. Logan never informed Leib, O'Connor about the company's interest in the account because, according to him, he was a pure dummy and Lyman was to give the instructions to Leib as to how to proceed; Lyman did not recall that Leib was advised that the funds came from the company. It appears, as a matter of fact, that Leib really ran the account and that Lyman paid no attention to it. Regardless of whether Leib did or did not know the source of the funds for the Special Account, it is clear that the roundabout method whereby the funds were deposited in the account was calculated to conceal from the company's management and its stockholders (other than the insiders) the fact that the company was engaged in extensive activity in its own stock.

The evidence further established that the vouchers pursuant to which the checks to Logan were drawn were marked "a/c Services," a notation calculated to give the impression that Union Sugar had issued the checks to Logan as compensation for his accounting services. Logan testified that he did not know of this misleading notation until it was called to his attention about March 1940.<sup>20</sup> The evidence is of the effect that the checks and vouchers were prepared by either Holmes or Martin at Lyman's request. Under the circumstances of this case it is not necessary for us to determine whether Logan in fact knew of the way in which the vouchers were drawn.<sup>21</sup> The fact that the secretary-treasurer, or

<sup>20</sup> At another point in his testimony, Logan testified that he was not aware of the existence of these vouchers until confronted with them in the present hearing, which would place the time of his awareness about a year later.

<sup>21</sup> Watrous, the member of Logan's staff who apparently handled most of the detail on the Union Sugar audit and affixed the Logan firm auditing stamp on the vouchers, was consequently in a position where he should have noted the voucher notations. However, he had contradictory and unsatisfactory explanations for his failure to notice them.

assistant secretary-treasurer, of the company should have uncritically placed these notations on the vouchers in question, merely because they were so requested by the president of the company, emphasizes once more the need for having accounts audited by an accountant in fact independent and not susceptible to such intramural pressure.

According to Logan's testimony, when the issue first arose as to how Union Sugar's checks to Logan should be entered on its voucher and disbursement record, the checks were, on Logan's instructions, distributed to an account labeled "Betteravia Suspense Account."<sup>22</sup> The justification for distributing these funds in the Betteravia Suspense Account will be discussed later, but it should be noted here that this was the only suspense account which the company had on its books and that there was nothing to apprise anyone that the account covered items not connected with the ordinary business operations of Union Sugar Company, *i.e.*, the production of sugar. Distribution to this account obviously had the effect of concealing the fact that company funds were being used to carry on stock market transactions. Logan himself admitted that one would have to go to the supporting evidence or documents, *i.e.*, the confirmation slips as to purchases and sales and the monthly statements which were received from Leib, O'Connor & Co., to find out that Union Sugar's monies were being used to conduct stock exchange transactions. It is our view that trading in its own stock was so foreign to the ordinary corporate endeavors of the company that its account should have unequivocally reflected the fact that the corporate funds were employed in such an enterprise.

Still another thread in the curtain of concealment woven around this transaction is supplied by the treatment of this item in the company's financial statements. The financial statement accompanying the company's report to us for the year ending December 31, 1936, carried these advances out of Union Sugar funds, then totaling \$35,000, under the heading "Subsequent Year

<sup>22</sup> This account, which had been on the company's books for some time and derived its name from the branch office of the company at Betteravia, Calif. included rentals, salaries, and other items relating to the ranch and factory operations of the company.

Expenditure—Farming Operations.” Later financial statements filed with us in connection with the Form 10-K reports for the years ending May 31, 1938, and May 31, 1939, carried this item, then totaling \$23,000, under the heading of “Accounts Receivable—Trade.”<sup>23</sup> The business of the company was the production of sugar. In our judgment, neither entry constituted an honest effort to apprise current stockholders or potential investors that the funds therein referred to were in fact being used to carry on a speculative stock trading account.

In addition, on the hypothesis adhered to by Logan that the Kenneth N. Logan account was Union Sugar’s account carried on for its own benefit, sales of securities made from that account should have been listed under item 12 of Form 10-K requiring information as to all sales of securities by the registrant unless insignificant in amount.<sup>24</sup> This was not done. Proceeding on the same hypothesis, the securities which were bought for the Kenneth N. Logan account should have been shown on registrant’s balance sheets as reacquired securities.<sup>25</sup>

Logan has urged, and still rests on, the following defenses for these accounting treatments which we have found in their entirety to constitute a complete course of concealment:

(1) With respect to the roundabout method whereby the checks were issued: That he was a pure dummy acting pursuant to instructions;

(2) With respect to the misleading “a/c Serv-

ices” on the vouchers: That he did not see those vouchers until 1940 or 1941;<sup>26</sup>

(3) With respect to the entries in the Betteravia Suspense Account: That the stock trading activity was a continuing transaction intended to reduce capitalization expenses, and that until the transaction had been liquidated and it could be determined whether it would result in profit or loss, the item has to be placed in a suspense account. The Betteravia Suspense Account was the only suspense account on the company’s books and it was therefore utilized;

(4) With respect to the financial statement accompanying the 1936 report: That he had originally intended to enter the item under a heading entitled “Subsequent Year Expenditures and Farming Operations” [emphasis supplied], and that only lack of space had induced him to substitute a dash for the word “and”;<sup>27</sup>

(5) With respect to the entering of these advances in subsequent financial statements under “Trade Accounts Receivable”: That the situation had by this time changed in that the likelihood of a profit was remote. The account was awaiting liquidation and the company was entitled to reimbursement. The only item specifically enumerated in the Instruction Book for Form 10-K under which Logan felt these advances could be placed was the item relating to trade accounts receivable. Although Logan admitted that he would now add an explanatory footnote or clause describing the specific nature of these advances, he still felt that he had classified the account properly since, in his view, any account the purpose of which was

<sup>23</sup> The financial statement for the year ending December 31, 1937, does not cover this item at all, ostensibly because the advances were liquidated by some year-end transactions, the dubious accounting treatment of which is discussed at p.44 *infra*.

<sup>24</sup> That Logan actually considered these shares to be Union Sugar property is evidenced not only by his direct testimony, but by his further testimony that the amounts advanced to the account could not be classified as amounts due from officers, because they were in no sense loans to those officers but were direct company transactions.

<sup>25</sup> See Instruction Book for Form 10-K, pp. 16, 18-19. Cf. Regulation S-X, Rule 3-16; American Institute of Accountants, Examination of Financial Statements (1936), pp. 28-29; Montgomery, *Auditing Theory and Practice* (6th ed. 1940), pp. 350-354.

<sup>26</sup> Martin, the assistant secretary and treasurer of Union Sugar, testified that these notations had been made either by Lyman or pursuant to Lyman’s instructions within a day or so after issuance of the checks. Watrous, Logan’s employee, who affixed the Logan firm auditing stamp to the vouchers and should have noticed the entry, testified that he noticed nothing.

<sup>27</sup> In the annual report of the company, unlike the report filed with this Commission, the word “and” was actually inserted. Even assuming a typographical lapse here, however, inasmuch as \$35,000 out of the \$45,000 total constituting this item covered advances made exclusively for stock exchange transactions, the reference to “farming operations” still impresses us as an inaccurate and misleading description of the funds in the Special Account.

to create a profit could be described as trade account;<sup>28</sup>

(6) With respect to the failure to list the securities sold from the account under item 12 of Form 10-K: That he thought the item applied only to new issues; and

(7) With respect to the failure to list the securities bought in as reacquired securities: That they were not permanently reacquired but were bought only with the idea in mind of making a temporary profit.

We must confess that these justifications impress us as disingenuous, highly technical, and, for the most part, implausible.<sup>29</sup> The transactions whereby the company's funds were used in stock trading have been traced through their major bookkeeping and accounting stages; it appears that in each of those stages the records of the transaction were kept in such a way as to conceal the use made of corporate funds from all but two or three corporate insiders; and the same accountant is directly implicated in all but one or two of those stages. On the evidence before us, we think it clearly demonstrated that the accountant was a conscious ally of the insiders in a deliberate attempt to conceal the use that had been made of the company's funds.<sup>30</sup> That demonstration becomes even more conclusive when

<sup>28</sup> Martin testified that he believed trade accounts to cover only accounts connected with the sugar business. We think this view is clearly the correct one. Montgomery, *Auditing Theory and Practice* (6th ed. 1940), p. 105; Kester, *Advanced Accounting* (3d ed. 1933), pp. 119-120; Couchman, *The Balance-Sheet* (1924), pp. 61-62.

<sup>29</sup> We must stress once more that our specific instructions are but minimum requirements and that there is incumbent on the accountant the obligation of making adequate disclosure of all transactions that deviate from the norm. "The information specified in these instructions shall be furnished as a minimum requirement, to which the registrant may add such further information as will contribute to an understanding of its financial condition and operations." Instruction Book for Form 10-K, p. 13 D.

<sup>30</sup> As Circuit Judge Learned Hand has said in a recent case discussing whether a number of questionable accounting entries might properly justify an inference of bad faith on the part of the accountant effecting such entries: "... logically the sum is often greater than the aggregate of the parts and the cumulation of instances, each explicable only by extreme credulity or professional inexpertness, may have a probative force immensely greater than any one of them alone." *United States v. White* (C. C. A. 2d, 1941), decided December 1, 1941. See also *Castle v. Bullard*, 23 How. 127, 187 (1860)

we bear in mind the fact that in his subsequent amendments to the company's earlier reports and in the financial statements for the years ending May 31, 1938, and May 31, 1939, when he admittedly knew the true facts, Logan did not make the appropriate corrections. Such an ally of the management cannot be said to be an independent public accountant, and we must conclude that Logan acted improperly in thus concealing the true nature of these advances.

There is still another circumstance in connection with this account which must be considered together with the other evidence in the record bearing on Logan's cooperation with Lyman in concealing the fact that the account had been opened and the nature of the subsequent transactions in it. Lyman had, at the end of 1937, in response to Logan's request and with the help of a \$1,500 contribution by Logan, caused checks totaling \$39,000 to be issued to Union Sugar ostensibly for the purpose of repaying in full Union Sugar's advances to the trading account as of December 31, 1937.<sup>31</sup> Immediately thereafter, because the source (Lyman's father) from which Lyman expected the cash to cover the above-mentioned checks failed him, Lyman caused Union Sugar to issue checks to his own order, one dated January 3, 1938 (the first business day of the new year) for \$12,000, one on March 17, 1938, for \$6,000, and one on March 31, 1938, for \$5,000. These checks had the effect of restoring the *status quo* (to the extent of \$23,000) obtaining just before the end of the year, *i.e.*, there was left still tied up in the Kenneth Logan stock account \$23,000 of Union Sugar's funds. These transactions were entered in a special account labeled Betteravia Suspense Account No. 2.

Here again there was nothing to show the relationship that this item bore to the Kenneth N. Logan stock trading account. In connection with the verification of balance sheet items, customary auditing practice calls for the review of transactions recorded in the voucher and disbursement record subsequent to the balance sheet date, including a particular scanning of cash entries and checks dated the first few days after the close of the accounting period. Such a review during the

<sup>31</sup> \$24,000 of this amount was paid in two checks for \$12,000 each, dated December 30 and December 31, 1937, respectively; the other \$15,000 had been paid on October 8, 1937.

course of the December 31, 1937, audit would have disclosed the \$12,000 check of January 3, 1938. However, the testimony is that Logan & Logan did not check the cash records at that time to determine whether any so-called "overlap" items appeared and so did not become aware of these items until it performed its audit for the period ending May 31, 1938.<sup>33</sup> As it was, according to Logan's testimony, these checks did not come to his attention until the end of July or August 1938 when Watrous, his employee, in the course of reconciling the company's books, came across them in connection with the January to May 1938 audit.<sup>33</sup> To the extent that the accounting firm of Logan & Logan did not engage in this precautionary check, its certificate that appropriate accounting procedures were employed was subject to qualification, and we believe that its statement that it had verified cash and bank balances was not justified without some additional explanation.<sup>34</sup> Even if we accept Logan's testimony that he was not aware of these checks until July or August 1938, there is no explanation of his failure to disclose the irregularity in the certifications made subsequent to that date.

#### CONCLUSION

Logan's personal stockholdings in the Union Sugar Company and our analysis of the history of the Kenneth N. Logan Special Account clearly show that Logan was not an independent accountant with respect to the Union Sugar Company. We find that Logan was not an independent public accountant at the time he certified the financial statements filed with us and that he was aware that his representations of independence were untrue and improper. Over and above the impropriety of these misrepresentations, we find that the entries on the company's ledger records and financial statements were part of a concerted

effort to conceal from the board of directors and stockholders of the company and the general public the fact that funds of the company were being used for the purpose of carrying on trading transactions in the company's own stock. Logan was responsible for almost all of those entries and had a major part in that concealment. We hold, therefore, that he acted improperly in sanctioning the misleading entries recorded on the company's books and in certifying that the company had followed correct accounting procedure when, as a matter of fact, he knew that it had not done so.<sup>35</sup>

Under the circumstances, we find that Logan engaged in improper professional conduct within the meaning of Rule II(e) of our Rules of Practice. In view of Logan's prior good character and reputation, and in view of mitigating circumstances present in the case, the trial examiner made no recommendation for the denial of the privilege of respondent to practice as an accountant before this Commission. It has been pointed out that, compared with the extent of the business of Union Sugar, which amounted to several million dollars a year, the total amount invested in the Kenneth N. Logan Special Account appears slight.<sup>36</sup> Furthermore, Union Sugar Company has been fully repaid by Logan and Lyman, so that it cannot be said that it has suffered any loss through their conduct. Logan has paid out, personally, approximately \$7,250 and has lost the accounting business of Union Sugar Company. It was not established by the evidence that Logan intended to profit personally from the account, and there is no evidence contradicting his statement that he relied in good faith upon Lyman's guarantee that he would make good any loss that might otherwise be suffered by the company. No evidence has been produced to indicate that Logan has been guilty of other improprieties than the ones discussed in this opinion, and two uncontradicted character witnesses have testified to his general good character and reputation.

We think that the record demonstrates beyond question that Logan's conduct in the transactions

<sup>33</sup> The defense advanced by Logan was that procedures which would reveal such "overlap" items were not followed in this case because Logan & Logan carried on a continuing audit of the accounts of Union Sugar.

<sup>34</sup> Even Holmes, chief financial officer of the company and its employee for 34 years, did not know about the issuance of these 1938 checks, which circumstance presents additional evidence as to the company's need for a public accountant whose status of independence was entirely clear.

<sup>35</sup> Accountants' Handbook (2d ed. 1940), p. 222.

<sup>36</sup> *Montgomery, Auditing Theory and Practice* (6th ed. 1940), p. 454.

<sup>37</sup> \$39,000 of the company's funds were used in the account; in addition, there was a debit balance in the account which amounted to \$34,603.50 at the peak of the trading on November 10, 1936.

described herein was grossly improper. We attach great importance to the requirement that financial statements filed with us be certified by independent accountants and that certifications by such accountants state the truth. Nor can we condone the studied concealment of the use made of a company's funds, merely because it involves a relatively small amount of money.<sup>37</sup> However, we do agree with the trial examiner that Logan has already been heavily punished by the after-

math of his acts, and we think that we may properly take that fact and the fact of Logan's prior reputation for good character into consideration in making our final determination herein.

We hereby order, pursuant to Rule II(e) of the Rules of Practice, that the privilege of Kenneth N. Logan to appear and practice before this Commission, in any way, be suspended for a period of 60 calendar days from the issuance of this opinion.

By the Commission: (Chairman EICHER, Commissioners HEALY, PIKE, PURCELL, and BURKE).

FRANCIS P. BRASSOR,  
*Secretary.*

<sup>37</sup> Cf. *In re Ball*, 184 App. Div. 18, 171 N. Y. S. 489, 493 (1919); *In re Steinberg*, 193 App. Div. 502, 184 N. Y. S. 450 (1920); *In re Hendrick*, 229 App. Div. 100, 241 N. Y. S. 50 (1930); *Joseph H. Van Dorn*, 3 S. E. C. 267, 227 (1938).

### RELEASE NO. 29\*

January 9, 1942

SECURITIES ACT OF 1933  
Release No. 2757

SECURITIES EXCHANGE ACT OF 1934  
Release No. 3114

INVESTMENT COMPANY ACT OF 1940  
Release No. 293

Amendment of Rule 1-01 of Regulation S-X and adoption of Article 6A and the related rules of Article 12 of Regulation S-X pertaining to Unit Investment Trusts.

### RELEASE NO. 30\*

January 22, 1942

SECURITIES ACT OF 1933  
Release No. 2764

SECURITIES EXCHANGE ACT OF 1934  
Release No. 3133

Auditing of Inventories under Wartime Conditions.

### RELEASE NO. 31\*

February 5, 1942

SECURITIES ACT OF 1933  
Release No. 2774

SECURITIES EXCHANGE ACT OF 1934  
Release No. 3145

INVESTMENT COMPANY ACT OF 1940  
Release No. 310

Amendment to Articles 5, 6, and 12 of Regulation S-X.

\* Text of release omitted.

**RELEASE NO. 32**

March 10, 1942

**SECURITIES ACT OF 1933**  
Release No. 2793**SECURITIES EXCHANGE ACT OF 1934**  
Release No. 3170**INVESTMENT COMPANY ACT OF 1940**  
Release No. 327

**Accountants' certificates—Application of Rules 2-02, 3-07, 4-02, and 4-04 of Regulation S-X regarding requirements as to disclosure by independent public accountants of the principle followed in including or excluding subsidiaries in consolidated statements.**

The Securities and Exchange Commission today made public an opinion of its Chief Accountant in its Accounting Series relative to certain requirements of Regulation S-X. The opinion discusses the requirements as to disclosure by independent public accountants of the principle followed in including or excluding subsidiaries in the consolidated statements and the requirements when a subsidiary previously included is in the current statements excluded in order to exhibit clearly the financial condition and results of operations of the registrant and its subsidiaries.

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

"Inquiry has been made whether, under the rules of the Commission, it is necessary for an independent public accountant to indicate in his certificate that generally accepted accounting principles and practices have not been applied on a basis consistent with that of the preceding year where a wholly owned subsidiary consolidated in the preceding year is not to be consolidated in the year under review. The inquiry assumed that the registrant's policy in the past had been to consolidate all wholly owned subsidiaries and that the current exclusion of the subsidiary from consolidation was due to changed conditions and was made with a view to more fairly presenting the financial condition and results of operations of the registrant and its subsidiaries.

"The portions of Regulation S-X which seem directly involved are Rules 4-02, 4-04, 3-07, and 2-02(c). Rule 4-02 provides, in part, that:

"The registrant shall follow in the consolidated statements principles of inclusion or exclusion which will clearly exhibit the financial condition

and results of operations of the registrant and its subsidiaries.'

"Rule 4-04(a) requires that:

"The principle adopted in determining the inclusion and exclusion of subsidiaries in each consolidated balance sheet and in each group balance sheet of unconsolidated subsidiaries shall be stated in a note to the respective balance sheet."

"Rule 3-07 requires disclosure of any significant change in accounting principle or practice and, if the change substantially affects proper comparison with the preceding fiscal period, the necessary explanation. Finally, subdivision (ii) of Rule 2-02(c) requires the accountant's certificate to state clearly 'the opinion of the accountant as to any changes in accounting principles or practices required to be set forth by Rule 3-07.'

"To my mind it would be necessary under the rules of the Commission, unless the subsidiary involved was so small as to be immaterial, for the accountant to indicate in his certificate that generally accepted accounting principles and practices had not been applied on a basis consistent with that of the preceding year. In stating the principles of inclusion or exclusion followed in a particular consolidation it is not sufficient under Rules 4-02 and 4-04(a) merely to indicate that the registrant is following in the consolidated statements principles of inclusion or exclusion which will clearly reflect the financial condition and results of operations of the registrant and its subsidiaries. A statement such as this would give no satisfactory information to the reader and, indeed, would permit the use of widely different and shifting consolidations without constituting a change in the principles followed. Instead, the

language of Rule 4-02 should be considered as setting a test which the specific principles adopted in a given case must meet. The specific principles followed should be objective and definite, such as, for example, that the registrant includes in consolidation all wholly owned subsidiaries, or all domestic wholly owned subsidiaries or all wholly owned manufacturing subsidiaries. Any such principles would, of course, have to meet the general test prescribed in Rule 4-02. Furthermore, unless all subsidiaries which fall within the class designated by the specific principles of consolidation are, in fact, consolidated, the specific statement is clearly inaccurate and misleading. It is therefore my opinion that the exclusion of the subsidiary in the case under discussion constitutes a change in the principles of consolidation followed.

"I think the operation of the rules referred to can best be indicated by the following illustration. Let us assume that a given registrant in its 1940 statements consolidated all of its wholly owned subsidiaries. In the 1941 statements one significant wholly owned foreign subsidiary was excluded by reason of the registrant's inability to obtain statements therefor. Under such circumstances Rule 4-04(b) would require that the name of the excluded subsidiary be given. The statement of the principles of consolidation required by Rule 4-04(a) would have to be appropriately modified to indicate that the wholly owned subsidiary was not consolidated. Rule 3-07 would require, if the change substantially affected comparison with prior years, an appropriate ex-

planation. Rule 2-02(c) (ii) would require a statement in the certificate of the accountant's opinion as to the change in the principles of consolidation employed.

"Thus it would not be proper, in my opinion, for the accountant to represent that the statements presented fairly the financial condition of the company and its consolidated subsidiaries and the results of their operations for the fiscal year, in conformity with generally accepted accounting principles and practices applied on a basis consistent with that of the preceding year. Instead, it would, in my opinion, be necessary to indicate that the principles of consolidation had been changed. If the new basis met with the approval of the accountant, as it presumably would, a positive statement to that effect should be made. If it did not, it would seem necessary to take an exception which would run to the fairness of the presentation.

"The above conclusion may be contrasted with a case similar in all respects except that the subsidiary is dropped from consolidation because of sale of the investment therein. In cases such as this no change in the principles of consolidation results, since all subsidiaries wholly owned at the date of the statement are included in the consolidation. Disclosure that the former subsidiary is not included would, however, be required by Rule 4-04(b) and, under certain circumstances, Rule 3-06 might require that additional information, such as the reason for the change, be included either in the financial statements or in the accountant's certificate."

### RELEASE NO. 33\*

April 28, 1942

SECURITIES ACT OF 1933  
Release No. 2824

SECURITIES EXCHANGE ACT OF 1934  
Release No. 3209

INVESTMENT COMPANY ACT OF 1940  
Release No. 348

Amendment to Articles 1, 6, 6A, and 12 of Regulation S-X.

\* Text of release omitted.



**RELEASE NO. 34\***

August 28, 1942

**SECURITIES ACT OF 1933**  
Release No. 2863**SECURITIES EXCHANGE ACT OF 1934**  
Release No. 3302**INVESTMENT COMPANY ACT OF 1940**  
Release No. 389**Amendment to Rule X-13A-2 of the General Rules and Regulations under the Securities Exchange Act of 1934 and amendment to Article 1 of Regulation S-X.**

\* Text of Release omitted.

**RELEASE NO. 35**

September 3, 1942

**Disclosure to be given to certain types of provisions and conditions that limit the availability of surplus for dividend purposes.**

The Securities and Exchange Commission today made public an opinion of its Chief Accountant in its Accounting Series relative to the disclosure to be given to certain types of provisions and conditions that limit the availability of surplus for dividend purposes. The opinion describes some of the more common restrictions of this kind and outlines the necessary disclosure in financial statements filed with the Commission.

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

"Inquiry has been made from time to time as to the necessity of disclosing, in financial statements filed with the Commission, provisions and conditions which in the particular case materially limit the availability of surplus for dividend purposes. The following are characteristic situations:

- "1. Treasury stock has been acquired.
- "2. Dividend arrearages exist on cumulative preferred stock.
- "3. The preference of preferred shares upon involuntary liquidation exceeds the par or stated value<sup>1</sup> of such shares.

<sup>1</sup> Cf. Rule 3-18(d)(3) of Regulation S-X, and also Accounting Series Release No. 9 (see p. 9), which requires that in most cases an opinion of counsel be given as to whether this condition constitutes a restriction on surplus.

"4. The provisions of a trust indenture or loan agreement permit dividends on common or preferred stock to be paid only from earnings accumulated subsequent to a specified date or if surplus exceeds a certain amount.

"5. The provisions of a trust indenture or loan agreement prohibit the payment of dividends when such payment would reduce the margin of current assets over current liabilities below a stated minimum.

"6. The articles of incorporation require that an amount equivalent to a certain percentage of the par value of the greatest number of preferred shares outstanding at any one time is to be set aside semiannually out of surplus or net profit before dividends may be paid on common stock.

"7. A loan agreement provides that dividends may only be paid after securing the consent of the lender.

"8. An order or requirement of a regulatory agency having jurisdiction limits the right to declare or pay dividends.

"In my opinion, generally accepted and sound accounting practice requires the disclosure of these and similar restrictions on surplus.<sup>2</sup> Otherwise, an

<sup>2</sup> Cf. American Institute of Accountants, *Examination of Financial Statements* (1936), p. 29.

erroneous impression is likely to be given the reader of the financial statements. Since Rule 3-06 of Regulation S-X provides that—

“The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading,”

it is clear that in all statements filed with the Commission appropriate disclosure of material restrictions on surplus should be made.

“Minimum disclosure, in my opinion, would consist of a description of the restriction, indicating briefly its source, its pertinent provisions, and,

where appropriate and determinable, the amount of the surplus so restricted. Such disclosure should be made either in a note to the balance sheet or in an appropriate place in the surplus section of the balance sheet. Also, any statement of surplus, such as is prescribed in Rule 11-02 of Regulation S-X, should contain similar information or should refer to the disclosure made in the balance sheet. Since the declaration and payment of dividends depends on many factors, other than the mere absence of restrictions of the type under discussion, disclosure pursuant to the above requirements should not be made in such a way as improperly to leave an inference that dividends will or may necessarily be declared from surplus in excess of the restrictions noted.”

### RELEASE NO. 36

November 6, 1942

SECURITIES ACT OF 1933  
Release No. 2877

SECURITIES EXCHANGE ACT OF 1934  
Release No. 3327

INVESTMENT COMPANY ACT OF 1940  
Release No. 402

**Treatment by an investment company of interest collected on defaulted bonds applicable to a period prior to the date on which such bonds and defaulted interest were purchased.**

The Securities and Exchange Commission today announced the issuance of an opinion in its Accounting Series Releases regarding the treatment by an investment company of interest collected on defaulted bonds applicable to a period prior to the date on which such bonds and defaulted interest were purchased. The opinion indicates that collections on account of the principal of the bonds and the defaulted interest coupons should not be treated as income until such time as the full purchase price has been recovered.

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

“Question has been raised as to the treatment by an investment company of interest collected on defaulted bonds applicable to a period prior to the date on which such bonds and defaulted interest were acquired. In the particular case an investment company purchased, at a ‘flat’ price of \$260,000, \$1 million principal amount of bonds

with attached defaulted interest coupons amounting to \$250,000. The company subsequent to the purchase received an interest payment of \$40,000 on account of defaulted interest coupons for periods prior to the purchase.

“Where a purchase is made of defaulted bonds with defaulted interest coupons attached, it is clear that the purchase price covers not only the right to receive the principal of the bond itself, but also the right to receive any payments made on the defaulted interest coupons purchased. Under these circumstances the price paid cannot be deemed to reflect only the cost of acquisition of the issuer’s obligation to pay the principal sum, but must instead be considered to reflect as well the cost of acquisition of the issuer’s existing obligation to pay the interest coupons already matured. In the usual case, moreover, there is no satisfactory basis on which to allocate the total price between the bond on the one hand and the defaulted

interest coupons on the other. Under such circumstances the bond and defaulted coupons should be treated as a unit for accounting purposes, and collections on account of the defaulted interest coupons should be treated not as interest on the sum invested, but rather as repayments thereof. Moreover, in view of the uncertainty of eventually receiving payments in excess of the purchase price, it is my opinion that ordinarily no part of any payment, whether on account of principal or the defaulted interest, should be considered as profit until the full purchase price has been recovered.

"In the instant case, therefore, the receipt of the \$40,000 interest payment should, in my opinion, be treated as a reduction of the cost of the

investment and not as interest income, or as a profit on the investment. After payments are received on account of the principal and defaulted interest in an amount equal to the purchase price, any further collections thereon should be treated, in my opinion, not as interest, but as profit on securities purchased. On the other hand, it seems clear that collection of interest coupons covering periods subsequent to the purchase may be treated as interest income unless the circumstances of a particular case are such as to indicate that, despite the apparent nature of the payment, recovery of the cost of the investment through sale or redemption is so uncertain as to make it necessary to treat the payment as a reduction of the investment."

### RELEASE NO. 37

November 7, 1942

**SECURITIES ACT OF 1933**  
Release No. 2878

**SECURITIES EXCHANGE ACT OF 1934**  
Release No. 3328

**INVESTMENT COMPANY ACT OF 1940**  
Release No. 403

**Amendment of Rule 2-01 of Regulation S-X—Qualifications of accountants certifying to financial statements required to be filed with the Commission. Superseded by Release No. 44**

The Securities and Exchange Commission today announced the adoption of an amendment to Rule 2-01 of Regulation S-X dealing with the qualifications of accountants certifying financial statements required to be filed with it. The amendment makes it clear that, in determining whether certifying accountants are in fact independent as to a particular company, there should be taken into account the circumstances surrounding not only the work done in certifying statements filed with the Commission, but also other work done for the particular company by such accountants, including the certification of any financial statements which have been published or otherwise made generally available to security holders, creditors, or the public.

The new rule codifies principles to be applied by the Commission in considering questions of independence. It appears desirable to incorporate these principles in the published rules and regulations, in view of cases in which substantial

amounts due from officers and directors were shown separately in balance sheets filed with the Commission but, in the balance sheet contained in the annual report to stockholders, were included without disclosure under the caption "Accounts and notes receivable, less reserves."

Underlying the Commission's requirement that clear disclosure be made of the amounts due from officers, directors, and principal stockholders<sup>1</sup> is the principle that such persons have obligations and responsibilities comparable to those of a fiduciary, and that therefore the financial statements should clearly reveal amounts due from such persons, accompanied, where the amounts involved are substantial, by appropriate supporting details. Where an indebtedness results from a

<sup>1</sup> The requirements of Rule 5-02 (7) and Schedule II of Rule 5-04 of Regulation S-X except trade accounts subject to the usual trade terms, ordinary travel and expense advances, and other such items arising in the ordinary course of business.

transaction between the company and one or more of the management, as individuals, the certifying accountants should employ every means at their disposal to insist upon full disclosure by the company and, failing persuasion of the company, should as a minimum qualify their certificate or disclose therein the information not set forth in the statements. 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; accession to the wishes of the management in such cases must inevitably raise a serious question as to whether the accountant is in fact independent. Moreover, in considering whether an accountant is in fact independent, such accession to the wishes of the management is no less significant when it occurs with respect to the financial statements included in an annual report to security holders or otherwise made public than when it occurs with respect to statements required to be filed with the Commission.

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:

Rule 2-01 of Regulation S-X is amended by adding thereto the following new subsection (c):

(c) 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, including the furnishing of a certificate or report as to any financial statements of such company which have been published or otherwise made generally available to security holders, creditors, or the public.

### **RELEASE NO. 38\***

**December 19, 1942**

**Treatment in financial statements of postwar refunds of Federal excess profits taxes.**

### **RELEASE NO. 39**

**December 19, 1942**

#### **HOLDING COMPANY ACT OF 1935**

**Release No. 3992**

**Amendments to Uniform System of Accounts for Public Utility Holding Companies.**

The Securities and Exchange Commission today announced the adoption of certain revisions, effective January 1, 1943, to its Uniform System of Accounts for Public Utility Holding Companies. Since printed copies of the system of accounts as revised will not be available for distribution for sometime, the amendments in mimeographed form

are attached to this release. Under the provisions of Rule U-26 the revised system, subject to certain exceptions, is applicable to all registered public utility holding companies and their subsidiary holding companies. The principal exception covers holding companies which are also operating companies.

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\* Text of Release omitted.

The original system of accounts prescribed for public utility holding companies was adopted August 8, 1936, became effective January 1, 1937, and has continued in effect without change up to the present revisions. Experience with the system over the past 6 years, however, indicated that certain changes might profitably be made. Accordingly, amendments proposed by the staff and others were transmitted for consideration and comment to representatives of the utility industry, professional accounting societies, State and Federal regulatory bodies, and others. After careful consideration of the replies received the proposed amendments have been revised and adopted by the Commission. In addition to certain technical changes and other minor changes designed to improve and clarify the system of accounts, revisions of a substantive character were made in the following accounts:

The revised text of Account 100, Investment Securities and Advances, includes a new paragraph relating to investments now carried at unsegregated book amounts. Where it is not possible to determine from the accounts and supporting records the amount applicable to each of such investments, it is provided that they may be stated at one amount but, hereafter, upon sale or disposal of any such investment, the unsegregated amount is required to be allocated to each investment unless the Commission otherwise approves or directs, the method of allocation being subject to the approval or direction of the Commission.

The revised texts of Account 120, Discount on Capital Stock; Account 121, Commissions and Expense on Capital Stock; Account 130, Re-acquired Capital Stock; and Account 150, Capital Stock, now provide that premiums and assessments on one class of capital stock may not generally, without approval of the Commission, be used to absorb discount and repurchase premium on capital stock of a different class.

The text of Account 200, Dividends, in the original system has been substantially changed by notes A and B in the revised system. Note A now

prohibits the taking up of stock dividends as income or surplus if the stock received as a dividend is of the same class as the stock on which the dividend in stock is paid. Under the original system stock dividends might be taken into income or surplus under certain conditions if the recipient company chose to do so. A new note B provides that if the dividend received in stock is of a class different from that on which the dividend is paid, the dividend may, with prior approval of the Commission, be treated as income.

Account 240, Taxes, Other than Income Taxes, and Account 270, Income Taxes, in the revised system supersede Account 240, Taxes, in the original system and result in separating income taxes from other taxes. The order of presentation of the accounts also indicates that income taxes should be shown as the last item of deductions in computing net income rather than as an operating expense.

While the revision of the Classification was in process, a suggestion was received that holding company investments be carried at amounts which reflect their equity in the subsidiaries on the basis of the underlying original cost of the subsidiaries' property, less appropriate depreciation and depletion reserves, and that any present excess over that amount be segregated and eventually eliminated. While this proposal was rejected, it was recognized that in balance sheets of public utility companies, it is important to set forth tangible and intangible utility plant so as to show separately the original cost, plant acquisition adjustments, and plant adjustments, and, in consolidated balance sheets of a public utility holding company and its subsidiaries, to show in addition the difference between the parent's investment in and the underlying book equity of subsidiaries as at the respective dates of acquisition. It is therefore proposed to adopt rules to require such segregation in financial statements filed with the Commission where original cost studies have been completed and to require appropriate footnote disclosures where such original cost studies are not completed or required.