

RELEASE NO. 66

October 19, 1948

SECURITIES ACT OF 1933
Release No. 3313

SECURITIES EXCHANGE ACT OF 1934
Release No. 4180

Amendment of Regulation S-X by Adoption of Article 5A; Amendment to Article 1, Rule 1-01; Article 4, Rule 4-14; Article 5, Rule 5-01; Article 12, Rule 12-06, Rule 12-06A and Rule 12-07; Amendments to Form 10 and Form 10-K.

The Securities and Exchange Commission today announced the adoption of a new article to Regulation S-X, the amendment of related existing articles in such regulation and the concurrent amendment of Form 10 and Form 10-K.

Since 1936 the Commission has prescribed, for securities of corporations organized within 2 years to engage in the exploitation of mineral deposits other than oil or gas, one or more forms containing provisions for special presentation of financial statements to be used instead of the conventional balance sheets and profit and loss statements. The currently effective forms, making such provision, designated as Forms S-2, S-3 and S-11, provide for separate statements of assets and capitalized expenses, liabilities, capital shares, other securities and cash receipts and disbursements. Except for immaterial differences in captions the general form and content of the financial statements required by Article 5A are the same as those required by the above mentioned forms. The purpose of these amendments is to include these alternative forms of financial statements in Regulation S-X and to extend their use to applications for registration on Form 10 and annual reports on Forms 10-K and 1-MD when filed by commercial and industrial companies in the promotional or development stage and to applications for registration on Form 10 and annual reports on Forms 10-K and 1-MD when filed by mining companies not in the production stage but engaged primarily in the exploration for or the development of mineral deposits other than oil, gas or coal if such mining companies have not been in production during the period of the report or for the 2 years immediately prior thereto and if receipts from the sale of mineral products by the company and its subsidiaries combined have not exceeded \$500,000 in any of the most recent 6 fiscal years and have not

aggregated more than \$1,500,000 in the most recent 6 fiscal years.

Rule 5A-07 which specifies what schedules are to be filed does not apply to Forms S-2, S-3 or S-11 under the Securities Act of 1933. It does, however, apply to companies of the type described in paragraphs (b) and (c) of Rule 5A-01 when filing an application for registration on Form 10 or an annual report on Form 10-K or Form 1-MD under the Securities Exchange Act of 1934. In this respect such rule is consistent with the requirements for other companies filing under that act.

The amendments to Form 10-K indirectly amend Form 1-MD; consequently persons of the type described in Rule 5A-01 using the latter form will be affected by the amendments to Form 10-K.

Notice of the proposed adoption of the amendments to Regulation S-X and of the amendments to Form 10, Form 10-K and Form 1-MD described herein has heretofore been published in the Federal Register. After due consideration of all relevant matters presented in regard to the proposals, the Commission has determined that the proposals should be modified in certain respects and adopted as so modified. The Commission finds that the adoption of these rules and regulations is necessary and appropriate in the public interest and for the protection of investors and necessary to carry out the provisions of the Acts. Accordingly, the Commission hereby takes the following action:

Acting pursuant to the authority conferred upon it by the Securities Act of 1933, particularly Sections 6, 7, 8, 10 and 19(a) thereof, and the Securities Exchange Act of 1934, particularly Sections 12, 13, 15(d) and 23(a) thereof, the Securities and Exchange Commission hereby amends Regulation S-X as follows:

I. Paragraph (a) of Rule 1-01 of Article 1 is amended by deleting the reference to Forms A-2 and C-1 which have been rescinded by the Commission and by including therein a reference to Form S-11.

As amended paragraph (a) of the rule reads as follows:

(a) Registration statements under the Securities Act of 1933, filed on Form S-1, S-2, S-3, S-4,

S-5, S-6, or S-11 except as otherwise specifically provided in such forms;

II. Article 4 is amended by adding a new rule designated as Rule 4-14. The purpose of this rule is to require commercial, industrial, and mining companies in the promotional, exploratory or development stage, having subsidiaries to show the financial information for the registrant and each of its subsidiaries in parallel columns.

RELEASE NO. 67

April 18, 1949

Findings and Opinion of the Commission In the Matter of Proceedings under Rule II(e) of the Rules of Practice, to determine whether the privilege of Barrow, Wade, Guthrie & Co., Henry H. Dalton and Everett L. Mangam to practice as accountants before the Securities and Exchange Commission should be denied, temporarily or permanently.

ORDER ADOPTING RECOMMENDED DECISION OF THE HEARING EXAMINER AND DISMISSING PROCEEDINGS

The Commission having instituted proceedings pursuant to Rule II(e) of its Rules of Practice on the question whether the privilege of practicing as accountants before the Commission should be denied to Barrow, Wade, Guthrie & Co., Henry H. Dalton, and Everett L. Mangam;

Private hearings having been held before a hearing examiner and the hearing examiner having filed a recommended decision recommending that the proceedings be dismissed, that the record in the case be made public and that the Commission publish a statement indicating in appropriate detail the facts in the case and the reasons for the Commission's determination;

Motions having been filed by counsel for the respondents and counsel for the Office of the Chief Accountant of the Commission requesting that the

Commission adopt the hearing examiner's recommended decision as the Commission's Findings and Opinion in the matter and that it be released and published as an Accounting Series Release; and

The Commission having duly considered the matter,

IT IS ORDERED that the aforesaid motions be, and they hereby are, granted, and that the hearing examiner's recommended decision, attached hereto, be, and it hereby is adopted as the Findings and Opinion of the Commission; and

IT IS FURTHER ORDERED that the proceedings be, and they hereby are, dismissed.

By the Commission.

ORVAL L. DuBois,

April 15, 1949.

Secretary.

RECOMMENDED DECISION OF THE HEARING OFFICER

APPEARANCES:

Edmund H. Worthy for the Office of the Chief Accountant of the Securities and Exchange Commission.

Robert T. McCracken and Robert C. Walker for Barrow, Wade, Guthrie & Co., Henry H. Dalton and Everett L. Mangam.

Pursuant to Rule IX(d) of the Rules of Practice of the Securities and Exchange Commission,

THIS RECOMMENDED DECISION IS ADVISORY ONLY AND THE FINDINGS, CONCLUSIONS AND OTHER MATTERS HEREIN CONTAINED SHALL NOT BE BINDING UPON THE COMMISSION; AND THIS RECOMMENDED DECISION IS CONFIDENTIAL, SHALL NOT BE MADE PUBLIC, AND IS FOR THE USE OF THE COMMISSION, THE PARTIES AND COUNSEL.

This proceeding was initiated under Rule II(e) of the Commission's Rules of Practice to determine whether Barrow, Wade, Guthrie & Co., a

partnership engaged in a general auditing and accounting business, and practicing before this Commission, Henry H. Dalton, a certified public accountant and former manager of the Los Angeles, California office of Barrow, Wade, Guthrie & Co., and Everett L. Mangam, also a certified public accountant employed by Barrow, Wade, Guthrie & Co. in its Los Angeles, California office, or any of them, are lacking either in the requisite qualifications to represent others or in character or integrity, or have engaged in unethical or improper professional conduct; and whether they, or any of them, should be disqualified and denied temporarily or permanently the privilege of appearing and practicing before the Commission.¹

Basis for Charges

Drayer-Hanson, Incorporated, was organized under the laws of the State of California on April 29, 1946, to acquire the business and assets of a partnership composed of four individuals.² Prior to the organization of the corporation, Barrow, Wade, Guthrie & Co. was employed to make an audit of the records of the partnership.

On April 29, 1946, the corporation filed a registration statement with the Commission, pursuant to the requirements of the Securities Act of 1933, covering a proposed public offering of 80,529 shares of its class A stock, and up to April 16, 1947, at which time the public offering was discontinued, 59,030 shares of this stock were sold to the public at \$10 per share. This registration

statement and certain amendments thereto contained financial statements of Drayer-Hanson Corporation and certain of its predecessors, which statements were certified by Barrow, Wade, Guthrie & Co. These financial statements represented the partnership net worth at April 30, 1946, to be approximately \$260,000 and the net earnings of the partnership for the 10 months ended April 30, 1946, to be approximately \$181,000 for the partnership and approximately \$91,000 when computed as though the partnership had been a corporation.

The auditor's certificate accompanying the financial statements filed as a part of the registration statement, omitting certain details not necessary to be stated here, read as follows:

"We have made an examination of [the financial statements]. In connection therewith, we have reviewed the systems of internal control and the accounting procedures of the partnership and of the corporation and, without making detailed audits of the transactions, have examined or tested accounting records of the partnership and of the corporation and other supporting evidence by methods and to the extent we deemed appropriate. Our examinations were made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary, except as stated in the following paragraph.

"We were present only during the taking of a physical inventory, which did not include work-in-process, as at March 31, 1946, and satisfied ourselves as to the procedures followed in the determination of inventory quantities as of that date. We were not in attendance at the physical count of the inventories taken at the close of each of the years 1942, 1943 and 1944 and we were informed that such procedures were not performed by any other independent public accountants. In the absence of a physical inventory of work-in-process at March 31, 1946, we subsequently made test inspections of selected items to assure ourselves as to the existence of the inventory and the adequacy of the related accounting data. The inventories at the close of each of the years 1942 and 1944 were reviewed by us as to the basis of pricing and clerical accuracy and we inquired into the methods used by the corporation employees in determining physical quantities to ascertain that methods were employed which would assure reasonable accuracy. We were informed that an inventory was taken as at December 31, 1943, but we were advised that such inventory was lost and therefore not available for our inspection. We were informed that no physical inventory was taken as at June 30, 1945. On the basis of the examinations and tests made by us, we have no reason to believe that the inventories as set forth in the accompanying statements are unfairly stated.

"In our opinion, subject to the exception stated in the foregoing paragraph, relating to the limitation of the scope of our examination, the accompanying [financial state-

¹ Rule II(e) reads as follows:

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

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

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

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."

² In the Matter of Drayer-Hanson, Incorporated, 27 S.E.C. 838, Securities Act Release No. 3277, Accounting Series Release No. 64.

ments] fairly present the position of the partnership as at April 30, 1946, and the results of the operations of the partnership and the predecessor corporation for the 3 years and 4 months then ended in conformity with generally accepted accounting principles applied consistently during the period under review. * * *

Some time in June 1947, the Commission was advised by Drayer-Hanson, Incorporated and by Barrow, Wade, Guthrie & Co. that an error had been discovered in the balance sheet as of April 30, 1946, and the partnership income statement for 10 months ending that date, which statements had been certified by Barrow, Wade, Guthrie & Co. and included in the registration statement and prospectus.³

Thereafter, the Commission made an investigation pursuant to Section 8(e) of the Securities Act of 1933 to determine whether the registration statement filed by Drayer-Hanson, Incorporated violated any of the provisions of that Act. On March 18, 1948, the Commission issued its report of the investigation.⁴

On October 22, 1948, the Commission ordered the present private proceeding to determine whether certain information obtained from its official records concerning the filing of the registration statement by Drayer-Hanson, Incorporated and certain related matters, and certain information reported by the staff as to the misleading character of the financial statements included in the said registration statement and the appended certificate by Barrow, Wade, Guthrie & Co. and the negligent and improper professional conduct of the auditors in making this audit, particularly in the execution of the auditing procedures adopted, were true.

At the hearing which was opened on November 16, 1948, the respondents stipulated that the statements of fact and conclusions based thereon as set forth in the report of the Commission on the investigation in the matter of Drayer-Hanson, Incorporated, Accounting Series Release No. 64

³ This error consisted of an overstatement of approximately \$87,000 in an inventory item designated "work-in-process and prefabricated parts," and resulted in an overstatement of the partnership net worth at April 30, 1946, and the partnership net income for the 10 months ended April 30, 1946, in the same amount.

⁴ In the *Matter of Drayer-Hanson Incorporated*, 27 S.E.C. 838, Securities Act Release No. 3277; Accounting Series Release No. 64. (See p. 110 of this publication.)

may be considered as evidence in these proceedings, thus in effect admitting all of the facts pleaded in the order directing these proceedings. The respondents then offered evidence of their methods of operations in the past and of changes made in the organization and operation of Barrow, Wade, Guthrie & Co. to prevent a recurrence of a situation similar to the Drayer-Hanson, Incorporated audit. This leaves for consideration in the present proceeding the remaining question as to the qualification of the respondents to appear and practice before the Commission and whether they, or any of them, should be temporarily or permanently disqualified from or denied the privilege of practicing before the Commission.

Barrow, Wade, Guthrie & Co., Organization, Operation and Policy in 1947 and prior thereto

Barrow, Wade, Guthrie & Co., a partnership, was organized in 1883 and has been in continuous operation ever since as an accounting firm. In 1946 and at the present time it maintains 15 branch offices and 2 sub-offices in the principal cities of the United States, with 1 in Canada. Its main or head office is in New York, N. Y. In 1946, at the time of the Drayer-Hanson, Incorporated matter, 8 of the offices of Barrow, Wade, Guthrie & Co. were under the management or control of a partner and 7 offices, including the office in Los Angeles, California, were managed and controlled by a local manager who was not a partner. At the present time, 10 of its offices are managed by partners and only 5 are under the control of a local manager who is not a partner. In 1946 and at the present time, Barrow, Wade, Guthrie & Co. have 31 partners assigned to the various offices. In offices where there are several partners, one of them acts as managing partner.

In 1946, at the time of the Drayer-Hanson audit, Barrow, Wade, Guthrie & Co. had an Executive Committee composed of four partners. The sole function of this committee was to handle general policy problems, financial matters, the opening or closing of offices and the hiring of key personnel. Each of the branch offices of Barrow, Wade, Guthrie & Co. was set up as an autonomous unit either under the management of a partner or partners or a local manager not a partner. No supervision or control was exercised by the Executive Committee over the management of its

various offices. The partner or manager in charge of each office had authority to sign the firm's name on reports or certificates, lease offices, hire and discharge personnel, undertake new engagements, make arrangements regarding fees and other plans necessary for the proper conduct of the practice in their territory. Such local partners or managers were responsible for the assignment of work in the offices, the supervision of all employees or partners assigned to the office, the maintenance of relations with the clients, and were further charged with the responsibility of outlining the procedures to be followed on each particular job and to see that they were followed, to review the working papers and prepare the reports with the assistance of the employee in charge of that particular job. There was no requirement that any of these matters be referred to the Executive Committee, the head office, or any other partner.

The managers of branch offices were selected with the same care as partners and were qualified only after a long record of employment with the partnership or similar experience with other accounting firms. During 1946 and thereafter, all partners and managers of branch offices were certified public accountants, and, with the exception of one partner whose duties did not relate to the accounting and auditing work of the partnership, they were also members of the American Institute of Accountants.

In 1946 and 1947, and for some time prior thereto, it was the policy of the partnership to issue circular letters at intervals calling attention of partners and managers to important developments in the accounting circles, the responsibility assumed by the partners in certifying accounts for the purpose of registering securities under the Acts administered by this Commission. The partnership also directed the attention of all partners, managers and employees to the considered opinions of the Committee on Accounting Procedure and the Committee on Auditing Procedure of the American Institute of Accountants as reflected in the Institute bulletins and statements and emphasized the necessity of reading and referring to the accounting releases of the Securities and Exchange Commission and the need for following carefully the rules, regulations and instructions relating to the preparation of financial statements and

schedules for registration statements.⁵ It was the established policy of Barrow, Wade, Guthrie & Co. and all of its employees were specifically instructed to follow the procedures as to inventories prescribed by the American Institute of Accountants in 1939.⁶

⁵ Regulation S-X (applicable in this case), contains the following pertinent requirements:

"Rule 2-02. Accountants' Certificates.

"(b) Representations as to the audit. The accountant's certificate (1) 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; (2) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (3) 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 person or 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."

⁶ Extensions of Auditing Procedure is No. 1 in a series of formal statements prepared and issued by the Committee on Auditing Procedure of the American Institute of Accountants in October 1939. This statement was also approved by the membership of the Institute. It states on p. 6: "That hereafter, where the independent certified public accountant intends to report over his signature on the financial statements of a concern in which inventories are a material factor, it should be generally accepted auditing procedure, that, in addition to making auditing tests and checks of the inventory accounts and records, he shall, wherever practicable and reasonable, be present, either in person or by his representatives, at the inventory-taking and by suitable observation and inquiry satisfy himself as to the effectiveness of the methods of inventory-taking and as to the measure of reliance which may be placed upon the client's representations as to inventories and upon the records thereof. In this connection the independent certified public accountant may require physical tests of inventories to be made under his observation."

On p. 11, in discussing the accountant's report or certificate, the statement continues: "If on the other hand, such

Henry H. Dalton

From December 1, 1937 to October 31, 1947, Dalton was manager in charge of the Los Angeles, California office of Barrow, Wade, Guthrie & Co. After a high school and business college education, he passed the intermediate examination of the Association of Chartered Accountants of the Province of Quebec, Canada in 1921. In 1932 he was licensed to practice as a certified public accountant in the State of California. He became a member of the American Institute of Accountants in 1936. For 9 years he was employed by a firm of chartered accountants in Canada and on December 3, 1925, he entered the services of Barrow, Wade, Guthrie & Co. as a junior accountant in the New York office where he remained 4 years. He was then made assistant manager of their San Francisco office, which position he occupied for 7 years. In 1936 he was made co-manager of the Los Angeles office and on December 1, 1937, was promoted to manager of that office. On October 31, 1947, he was removed as manager of the Los Angeles office and remained in a somewhat inactive status until May 1948, at which time he resigned his position with Barrow, Wade, Guthrie & Co. and entered a partnership with other accountants in Los Angeles. His auditing experience covers many types and kinds of business, but in his letter of July 23,

*** (explanation of procedures followed) are made by reason of any reservation or desire to qualify the opinion, they become exceptions and should be expressly stated as such in the opinion paragraph of the auditor's report. As previously stated, if such exceptions are sufficiently material to negative the expression of an opinion, the auditor should refrain from giving any opinion at all, although he may render an informative report in which he states that the limitations or exceptions relating to the examination are such as to make it impossible for him to express an opinion as to the fairness of the financial statements as a whole."

In December 1942, the Committee on Auditing Procedure in statement No. 17, Physical Inventories in Wartime, in discussing the temporary concessions made necessary by the overriding requirements for war production observed: "No amount of supplementary work by the independent accountant can thus completely remedy the basic weakness resulting from the client's failure to provide some form of physical inventory." See also the Commission's Accounting Series Release No. 30, January, 1942.

1946, to one of the partners, he stated "We have been faced with many problems not encountered by either of us prior to this time."

Everett L. Mangam

From 1931 to 1936, Mangam had a varied business experience. He entered the accounting profession in 1936, at first engaging in a small practice. In January 1937, he was employed by Barrow, Wade, Guthrie & Co. in their Utica, New York office as a junior accountant and remained in that office in various capacities until 1940 when he was made assistant manager and in 1942, acting manager. During his entire experience in the Utica office he at no time acted independently but all of his work was under the supervision and direction of the manager of that office.

The Utica office of Barrow, Wade, Guthrie & Co. was comparatively small and nearly all of its clients had employed the partnership for a number of years and procedures had been developed over this time in handling the work. Prior to Mangam's undertaking an audit, the manager of the Utica office always reviewed the preceding year's papers with him and outlined the procedures to be followed in the current audit, and supervised the audit as it progressed. Mangam had never previously been confronted with a situation comparable to the Drayer-Hanson matter. This was particularly true with respect to making an audit without a prior complete physical inventory.

In December 1942, Mangam was commissioned in the U.S. Navy where he remained until January 1946. During this period he was employed in the Cost Inspection Service, Navy Cost Inspection, Termination Specialist and as a member of the Army-Navy Lecture Team on Accounting. After his discharge from the Navy he returned to Barrow, Wade, Guthrie & Co. as a senior accountant in February 1946, attached to the New York office. On April 1, 1946, he commenced services at the Los Angeles office in charge of the Drayer-Hanson audit under the direction and supervision of Dalton.

Mangam was licensed as a certified public accountant in Ohio in July 1940, and in Cali-

ifornia in January 1947. He has been a member of the American Institute of Accountants since 1941, the Ohio Society of Certified Public Accountants since 1940, the National Association of Cost Accountants since 1938 and of the California Society of Certified Public Accountants since 1947.

Drayer-Hanson, Incorporated Audit

In February 1946, Dalton, the manager of the Los Angeles office of Barrow, Wade, Guthrie & Co., was first approached with respect to the audit of the books and accounts of a partnership known as Drayer-Hanson which was engaged in the business of designing, manufacturing and selling heat transmission equipment. Dalton was informed that the partnership was to be reorganized as a corporation and proposed to make a public offering of its securities in the State of California. Shortly after the audit was commenced and some time prior to the completion thereof, he was advised that the offering would be registered with the Securities and Exchange Commission. At his first conference with the Drayer-Hanson management, Dalton, among other things, stressed the necessity of taking complete physical inventories including raw materials, fabricated parts, work-in-process and finished goods and it was agreed by the Drayer-Hanson partnership that this would be done. Acting within the scope of his authority as manager of the Los Angeles office, and without notifying the head office of Barrow, Wade, Guthrie & Co., Dalton accepted this engagement.

On March 27, 1946, Dalton was first informed that the management of Drayer-Hanson had decided not to take a physical inventory of the work-in-process. He advised the management of the probable necessity of a qualification in the accountant's certificate in the absence of this inventory. At this conference, Dalton, after a rather casual examination of some of the accounting records and relying in part on information given him by the management, agreed to proceed with the audit without requiring a complete physical inventory of work-in-

process.⁷ Dalton did not communicate this decision to the main office of Barrow, Wade, Guthrie & Co. or to any of its partners until July 23, 1946, at which time he forwarded to the main office drafts of financial statements and a copy of the proposed certificate to be issued and referred to some of the difficulties encountered in this audit.

Mangam did not report for duty at the Los Angeles office until April 1, 1946, and took no part in any of the preliminary conferences or in the decision that the work-in-process would not be inventoried. He was placed in charge of the audit and continued until its completion in the latter part of July 1946. Among other things, he prepared an audit program for the engagement which included a study of the system of internal check and control and the cost accounting system maintained by Drayer-Hanson and its predecessors. He knew that the inventory of work-in-process had not been taken but stated that he understood "that our opinion would be qualified." He assigned the work to be done on the audit to his assistants and supervised such work by reviewing the working papers prepared by them. He personally performed certain of the auditing procedures which he believed to be necessary to perform the engagement in accordance with what he regarded as generally accepted auditing standards, and at the conclusion of the audit prepared a draft of the required financial statements and in collaboration with Dalton prepared a draft of the firm's report or certificate.

The alternate auditing procedures adopted in lieu of a physical inventory of the work-in-process, as outlined by the Commission in its report of investigation⁸ were determined by

⁷ At this time Dalton knew that previous inventories by Drayer-Hanson had not been taken in the presence of any independent accountants and that no physical inventory of work-in-process had been taken since December 31, 1944. He also knew that no examination of the accounts of Drayer-Hanson or its predecessor had been made by any independent accountant prior to this time. Moreover, he testified that in his opinion the taking of a physical inventory of work-in-process was practicable and reasonable.

⁸ In the Matter of *Drayer-Hanson, Incorporated*, Securities Act Release No. 3277, Accounting Series Release No. 64.

Mangam after spending several days making a survey of Drayer-Hanson's system of internal check and control. This survey disclosed a number of material weaknesses in the system, especially with respect to the recording of transactions having an effect, directly or indirectly, upon the amount of work in process inventory shown in Drayer-Hanson's accounting records. Mangam discussed these matters with Dalton from time to time.⁹ In spite of the weakness disclosed by his survey, Mangam employed such alternate auditing procedures as he himself considered necessary in the absence of a physical inventory, in an inadequate manner.

Supervision by Dalton

Dalton made a general review of the working papers to ascertain the methods used and the proof obtained with respect to the results and what had been done in the various tests and checks in order to ascertain the authenticity of the financial statements. He reviewed all of the working papers in detail with Mangam and questioned him specifically on the survey he had made of the system of internal check and control, the work done and the results obtained from the audit of the work-in-process inventory, the examination made of the general journal entries, especially those related to finished goods, work-in-process, and cost of sales, and on any other points that did not appear to be clear. As manager of the office it was his responsibility to supervise and check all of the work of his subordinates and to satisfy himself that the audit had been made in accordance with accepted auditing standards.

After Dalton's review of the working papers and financial statements, he and Mangam prepared a draft of a certificate to cover the finan-

cial statements. This draft certificate with the related financial statements and a covering letter dated July 23, 1946, were sent to the Philadelphia office of Barrow, Wade, Guthrie & Co. for criticism and suggestions and for the further purpose of discussing with the staff of the Securities and Exchange Commission the manner in which certain facts should be reflected in the financial statements. This letter of July 23, 1946, was the first notice to any partner or to the head office of Barrow, Wade, Guthrie & Co. that the audit of Drayer-Hanson was made without a physical inventory of the work-in-process.¹⁰

After the receipt of the letter of July 23, 1946, one of the partners of Barrow, Wade, Guthrie & Co. discussed certain matters with members of the Commission's staff, and on July 31, 1946, the partner wrote a letter to Dalton informing him of certain comments by members of the Commission's staff and making certain suggestions including several dealing with the inventory situation. Following the partner's letter of July 31, the certificate was changed so as to include an exception phrase at the end of the last sentence of the first paragraph of the certificate and to include an exception in the opinion paragraph as to the fairness of the presentation of the statement as a result of the limitation on the scope of the audit as to inventories. On August 12, 1946, Dalton forwarded a copy of the Drayer-Hanson registration statement, as filed, to the Philadelphia office of Barrow, Wade, Guthrie & Co.

Means Taken to Strengthen and Centralize the Control of Functional Operations of Barrow, Wade, Guthrie & Co.

As a result of the Drayer-Hanson case, and the consequent revelation of the failure of the

⁹ Mangam testified, "I expressed my dissatisfaction with the situation from the very first day, because I could see that it wasn't going to be an easy matter to do very much with the work-in-process unless a physical inventory was available. I held to that opinion day after day." But Mangam also indicated (see p. 121 of Accounting Series Release No. 64) that he believed he would be able to use alternative procedures to assure himself, with respect to work-in-process, that the inventory was there.

¹⁰ Some time in May 1964, while the field work on the audit was in progress, one of the partners of Barrow, Wade, Guthrie & Co. was in the Los Angeles office on other business for the firm. While there, he accompanied Dalton to the Drayer-Hanson plant. Dalton informed this partner generally of the problems with respect to the engagement but did not inform the partner of the specific problems which had arisen and of the fact that the audit was being made without a complete physical inventory.

partnership policy to provide the public with the resources of experience and skill of the partnership as such, certain changes have been made in the personnel, the policy and procedures of Barrow, Wade, Guthrie & Co. as follows:

(1) A new manager has been placed in charge of the Los Angeles office and the staff implemented by the addition of a second certified public accountant.

(2) All partners and managers were notified of Accounting Series Release No. 64 (see page 110) with the suggestion that it receive careful study and staff members and assistants be impressed with the responsibilities assumed by the firm in certifying financial statements for registration purposes and the degree of care which must be exercised in reviewing the system of internal control and in the physical verification of all inventories.

(3) A "Manual of Auditing Procedure," prepared over a period of several months by a committee of partners, has been distributed and discussed throughout the firm. The manual is to be supplemented and revised periodically.

(4) Partners and managers in field offices have been instructed that the policy on the examination of financial statements for inclusion in registration statements will be to have the partner or a nonpartner branch manager in charge of an assignment consult with other partners or branch managers on matters relative thereto. The New York executive office is to be notified of all registration work undertaken. The acceptance of new clients must be approved by at least two partners or two nonpartner branch managers, and financial statements to be included in a registration statement must likewise be so approved prior to their release. Where such statements are prepared in an office having only one partner or a nonpartner branch manager, the executive office must be notified and another partner will be assigned to cooperate and review the work.

(5) The partnership agreement is being amended to separate the administrative and operational functions and responsibilities of the firm. An operating committee of nine members will deal with auditing and accounting proce-

dures, personnel matters, review procedures, Securities and Exchange Commission work control and review, and income tax work. The committee will be divided into subcommittees, each responsible for one or more of the functions referred to. An administrative committee will be charged with seeing that functions of the operating committee will be carried forward.

(6) Partners are now located at all except five field offices. It is planned eventually to have a partner or partners in each office, according to the needs of the business.

CONCLUSIONS

I find that Drayer-Hanson, Incorporated, filed its registration statement with the Commission as alleged.

That the Commission initiated the proceedings under Section 8(e) of the Securities Act of 1933 on the registration statement filed by Drayer-Hanson, Incorporated and released its report on March 18, 1948.¹¹

That the registration statements and amendments thereto contained financial statements of Drayer-Hanson and certain of its predecessors, certified to by Barrow, Wade, Guthrie & Co.; and that the respondent, Everett L. Mangam, in collaboration with Henry H. Dalton prepared the financial statements; and, that the respondent, Henry H. Dalton signed on behalf of the respondent Barrow, Wade, Guthrie & Co. the certification appended to the financial statements.

That the financial statements included in the registration statement referred to above and the appended certificate of Barrow, Wade, Guthrie & Co. were inaccurate and misleading.

That the balance sheets included in the registration statement were materially misleading for the reason that the work-in-process inventory as of April 30, 1946, was overstated approximately \$87,000; and that the profit and loss statement for the 10 months ended April 30, 1946, included in the registration statement was misleading for the same reason.

¹¹ See p. 110.

That Dalton by his acquiescence in the decision of representatives of the registrant not to take a physical inventory of work in process at March 31, 1946, and Barrow, Wade, Guthrie & Co. by their failure to object ultimately to Dalton's decision, failed to acquire sufficient information to warrant an expression of an opinion with respect to work-in-process inventories at March 31, and April 30, 1946.

That Barrow, Wade, Guthrie & Co. and Dalton without justification implied in their certificate that the system of internal check and control and the cost accounting system in operation at Drayer-Hanson and certain of its predecessors furnished reliable costs with respect to cost of sales and raw materials, work-in-process, and finished goods inventories.

That the statement in the certificate of Barrow, Wade, Guthrie & Co. that "* * * [the auditors] have no reason to believe that the inventories as set forth in the accompanying statements are unfairly stated" is without justification and misleading.

That respondents Mangam and Dalton were negligent in the conduct of the audit; Mangam, because of the inadequate manner in which he employed alternate procedures, considered by him to be necessary under the circumstances, in the absence of a physical inventory; Dalton, for the reason that the auditing procedures adopted and followed under his supervision were not employed with due professional care.

That Barrow, Wade, Guthrie & Co. failed to supervise the audit in the manner required by existing circumstances.

That each of the respondents acted in an improper professional manner in ignoring and disregarding generally accepted auditing standards and procedures applicable in this case and applicable rules and regulations and long settled decisions of the Commission with respect to the matters referred to above.

Recommendations

The partnership of Barrow, Wade, Guthrie & Co. has been engaged in the accounting business since 1883. They have reported upon financial statements of issues publicly offered

and covered by effective registration statements filed with the Commission pursuant to the Securities Act of 1933 in the aggregate amount of nearly \$1 billion and have also certified financial statements for many brokers and dealers registered with this Commission. There is no evidence that any material error has ever been made by Barrow, Wade, Guthrie & Co. in any of said financial statements, with the exception of those prepared for Drayer-Hanson. All of the partners are certified public accountants, with long years of experience.

Henry H. Dalton had been an accountant for over 30 years and had been employed by Barrow, Wade, Guthrie & Co. for the past 22 years. He had participated in very difficult and complicated accounting work, some of which had been supervised and reviewed by partners of Barrow, Wade, Guthrie & Co. and his work had always been highly satisfactory. During all of this time there was no evidence that he lacked any of the qualifications of an able and efficient accountant or that he lacked character or integrity.

Everett L. Mangam was employed by Barrow, Wade, Guthrie & Co. as an accountant for 5 years when he entered the U.S. Navy. He remained in the Navy on accounting work until shortly before the Drayer-Hanson audit. He had been a certified public accountant for about 6 years. During the time he was in the employ of Barrow, Wade, Guthrie & Co. his work had been highly satisfactory and no question had ever been raised as to his qualifications, character or integrity.

I conclude that all of the respondents possess the requisite qualifications to represent others and that they, and each of them, are not lacking in character or integrity.

This leaves the remaining question under Rule II(e) as to whether the respondents, or any of them, engaged in unethical or improper professional conduct in the handling of the Drayer-Hanson audit.

Barrow, Wade, Guthrie & Co.

The failure to require a physical inventory of work-in-process and many of the serious problems which developed in the course of the audit

of the Drayer-Hanson records were not brought to the attention of any partners of Barrow, Wade, Guthrie & Co. until Dalton's letter of July 23, 1946, to one of the partners. Prior to the Drayer-Hanson audit it had been the policy of the partnership to clothe the manager of each office with final authority to exercise his own judgment in all matters coming up in his territory without reference to any of the partners or to the head office. Consequently, in this case no formal, predetermined supervision of this audit was exercised by any partner. All of the working papers were retained by Dalton in the Los Angeles office. In his letter of July 23, 1946, to an eastern partner, Dalton did not call attention to the manner in which the audit work was done, or, of course, that he had ignored and disregarded generally accepted auditing standards and procedures pertinent in this audit. In reply to Dalton's letter of July 23, 1946, the partner, in his letter dated July 31, 1946, however inadequate the comments may have been, did suggest certain procedures considered necessary by him in the absence of a physical inventory of the work-in-process. At this time the partners of Barrow, Wade, Guthrie & Co. had full confidence in Dalton. No charge has been made that the partnership deliberately and willfully engaged in unethical or improper professional conduct. It is clear from the evidence that the general policy of the partnership of not requiring supervision by partners of the work of the various offices ignored and disregarded applicable and long settled opinions of the Commission in that it functioned without centralized supervision of the field offices and in this case exercised not even a local control.¹² Moreover, the evidence indicates that the firm received information of such sufficiency that it should have impelled a more positive stand toward compliance with professional standards and the Commission's rules. In any event, and wholly apart from these considerations, the partnership having clothed its manager with

full authority to bind it must accept full responsibility for his conduct.

The changes made by the partnership since the Drayer-Hanson audit to strengthen and centralize the control of functional operations of the firm as hereinabove mentioned indicate that the partnership recognizes the deficiencies in its former policy. When the error in the inventory of work-in-process was later discovered by Barrow, Wade, Guthrie & Co. they called the matter to the attention of the Commission and contributed to Drayer-Hanson, Incorporated \$87,500 which was the approximate amount of the inventory error.

The evidence conclusively establishes that Barrow, Wade, Guthrie & Co. has been sufficiently impressed with the inadequacy of their former policies and has materially revised them. Their conduct in promptly reporting this matter to the Commission and their cooperation in developing all of the facts and in promptly offering to contribute the full amount of the inventory shortage is commendatory. Considering all of these facts, and in view of the adverse publicity which the firm has received in Accounting Series Releases No. 64, (see p. 110) I find no reason to recommend that the privilege of Barrow, Wade, Guthrie & Co. to practice before the Commission be suspended temporarily or permanently, and I therefore recommend that the proceeding as to Barrow, Wade, Guthrie & Co. be dismissed.

Henry H. Dalton

The Los Angeles office of Barrow, Wade, Guthrie & Co. had for some time prior to the Drayer-Hanson audit been understaffed. During the war years and subsequent thereto, Dalton was the only certified public accountant in the office and the entire responsibility for all of the work of that office had rested on him. He had had no regular vacations for 8 years and in 1946 at the time of this audit, he was mentally and physically exhausted. In the record in this case there is no evidence that he was ever charged with any professional misconduct. In addition, the absence of more appropriate suggestions from his superiors, the opportunity

¹² In the Matter of *Interstate Hosiery Mills, Inc.*, 4 SEC 706. See also In the Matter of *McKesson & Robbins, Inc.*, Accounting Series Release No. 19 (see p. 17).

for which clearly existed, must be viewed as highly important.

From my observation of Dalton at the hearing and his frankness in fully admitting his faults in this case, I am satisfied that he has been sufficiently impressed as to the seriousness of this matter and that further disciplinary action is not necessary. Considering his past record, the evidence of his mental and physical exhaustion at the time of the Drayer-Hanson audit and the penalties to which he has already been subjected, I believe the Commission might well dismiss the present proceeding as to him, and I so recommend.

Everett L. Mangam

The evidence established that Mangam was negligent in his application of the alternate auditing procedures which he had outlined. However he was not responsible for proceedings with the audit without requiring a physical inventory because such procedure was established at the time he entered upon this engagement. He testified that this was the first time he had ever conducted an audit without requiring complete physical inventories. While he was recognized by Barrow, Wade, Guthrie & Co. as being a capable and efficient accountant, this high regard must of course be viewed in the light of the recommendation for his assignment to the Los Angeles office in a subordinate capacity. Where the circumstances were such as has been disclosed in this case, and apart from whatever normal practice might be, it seems clear that Mangam had the right to expect that such procedures as he outlined

and the execution of them as he revealed them would be carefully supervised and checked by his superior. There is no indication that Mangam withheld any information from his superior. He directed the attention of his superior from time to time to the conditions which confronted him and to the difficult problems with which he was confronted. Having in mind that this was his first experience on a complicated and difficult auditing engagement, and that he had good reason to feel that such steps as he took were being supervised and checked by, presumably, a capable and able superior, he might well have believed that he had proceeded as far as was proper and necessary. Under all of the circumstances, I do not believe Mangam's conduct warrants any disciplinary action by the Commission.

While recommending that the proceedings against all of the respondents be dismissed, it seems highly desirable that the public, and particularly the accounting profession, be informed that where a firm of public accountants permits a report or certificate to be executed in its name the Commission will hold such firm fully accountable. If the proceedings are dismissed, it is my further recommendation that the Commission make public the entire record in this case and publish a statement indicating in appropriate detail the facts in the case and the reasons for the Commission's determination.

Respectfully submitted,

ALLEN MACCULLEN,
Hearing Examiner.

February 8, 1949.

RELEASE NO. 68

July 5, 1949

Findings and Opinion of the Commission In the Matter of Proceedings under Rule II (e) of the Rules of Practice to determine whether the privilege of F. G. Masquelette & Co. and J. E. Cassell to practice as accountants before the Securities and Exchange Commission should be denied, temporarily or permanently.

ACCOUNTING—PRACTICE AND PROCEDURE

Temporary Disqualification of Accountants from Practice before Commission

Where firm of certified public accountants and partner thereof, respondents in a proceeding under

Rule II(e) of Commission's Rules of Practice, certified that financial statements forming part of a registration statement filed under the Securities Act of 1933 conformed with generally accepted accounting principles when in fact they did not,

and represented themselves as independent certified public accountants when in fact they were not independent, *held*, that respondents engaged in improper professional conduct and should be temporarily denied the privilege of practicing before the Commission.

APPEARANCES:

William W. Stickney, for the Office of the Chief Accountant of the Commission.

Edgar J. Goodrich, James M. Carlisle, Jerome J. Dick and Simms, Modrall, Seymour & Simms, for Respondents.

Joseph G. Bennis, for Respondent F. G. Masquelette & Co.

Martin A. Threet, for Respondent J. E. Cassel.

FINDINGS AND OPINION OF THE COMMISSION

This proceeding was instituted under Rule II(e) of our Rules of Practice to determine whether F. G. Masquelette & Co., a firm of certified public accountants, and J. E. Cassel, a member of that firm, possess the requisite qualifications to represent others, or are lacking in character or integrity, or have engaged in unethical or improper professional conduct. If we find either of them to be deficient in any of these respects or to have engaged in improper conduct, we must then determine whether the privilege of appearing or practicing before us should be denied, temporarily or permanently.¹

Hearings were held before a hearing examiner, who has filed a recommended decision. Counsel for the Office of the Chief Accountant of the Commission and counsel for the respondents have filed briefs and we have heard oral argument. On the

¹ Rule II(e) reads as follows:

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

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

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

Practicing before the Commission is defined by Rule II(e) as including "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."

basis of an independent examination of the record, we make the following findings.

When the events with which we are here concerned occurred, the firm of F. G. Masquelette & Co. had offices in Houston and El Paso, Texas, and Albuquerque, New Mexico. Cassel was the resident partner in charge of the Albuquerque office.²

This proceeding relates to the activities of respondents in connection with the filing of a registration statement under the Securities Act of 1933 ("the Act") by Health Institute, Inc., covering 50,000 shares of preferred stock and 40,000 shares of common stock to be sold to the public for a total of \$907,500. This corporation was organized for the purpose of erecting a seven story resort hotel at Hot Springs, New Mexico, a town with an estimated population of 4,700 in the southern part of the State. The registration statement, which was filed on December 16, 1946, contained a balance sheet certified by F. G. Masquelette & Co. An amendment was filed January 13, 1947, containing an amended balance sheet, dated January 1, 1947, also certified by F. G. Masquelette & Co. The firm name was affixed to the certificates on these balance sheets by Cassel.

An investigation was conducted under Section 8(e) of the Act, following which the registration statement was withdrawn.

The allegations contained in the order for hearing are, generally, that respondents represented themselves as independent certified public accountants when they were not in fact independent, and that they certified that the balance sheets fairly presented the position of the company in conformity with generally accepted accounting principles when in fact generally accepted accounting principles were not applied.

² At the opening of the hearings respondents moved to dismiss the proceedings or, in the alternative, that the order for proceedings be made more definite, alleging that there were in fact three firms named F. G. Masquelette & Co., one at Houston, one at El Paso and one at Albuquerque. Some persons are said to be members of all three firms, some of two and some of only one. The record is clear that F. G. Masquelette & Co. has in many ways represented itself to the public as a single firm. The hearing examiner has recommended denial of the motion and, as pointed out in respondents' briefs, no exception has been taken to this recommendation. The motion is denied.

The record in this proceeding includes the registration statement as originally filed together with the amendment, including exhibits, exhibits introduced in the Section 8(e) proceedings, and several affidavits submitted on behalf of respondents. Only a small amount of testimony was taken in this proceeding, and the rather extensive testimony which was taken in the Section 8(e) proceeding was not introduced.

Cassel admitted the allegations contained in the order for hearing subject only to their explanation.

The registration statement as originally filed contained the following balance sheet and certificate:

HEALTH INSTITUTE, INC., (N.S.L.)
(Incorporated in New Mexico)
BALANCE SHEET—NOVEMBER 20, 1946

| <i>ASSETS</i> | |
|--|--------------|
| Leasehold..... | \$100,000.00 |
| Construction work in progress..... | 7,417.24 |
| Organization expense..... | 5,178.15 |
| | 112,595.39 |
| Total..... | 112,595.39 |
| <i>LIABILITIES</i> | |
| Current Liabilities: | |
| Due on Architect's Contract, Burwinkle & Springman..... | \$2,000.00 |
| Account payable to Charles J. Van Ruska.... | 10,595.39 |
| | 12,595.39 |
| Capital stock: | |
| Prior Preferred 5½% Cumulative (authorized, 50,000 shares—Par value \$10 per share—none issued). | |
| Common (authorized, 50,000 shares—Par value \$10 per share—issued and outstanding, 10,000 shares)..... | 100,000.00 |
| | 112,595.39 |
| Total..... | 112,595.39 |

NOTE TO BALANCE SHEET:

Additional liabilities for organization expenses and construction work in progress (not yet capitalized) have been incurred in undetermined amounts, believed not to exceed \$5,000 at November 20, 1946, for services of accountants, architects, attorneys, and engineers.

HEALTH INSTITUTE, INC.
Hot Springs, New Mexico

GENTLEMEN:

We have examined the balance sheet of Health Institute, Inc. (N.S.L.) as at November 20, 1946, have reviewed the accounting system, and procedures of the company, and have made a detailed

audit of the transactions. We examined or tested accounting records and other supporting evidence to the extent and in the manner we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary. All transactions to date have been of a capital nature; no income has accrued, and no expenses have been incurred of other than a capital nature. The corporation has had no receipts, and no disbursements have been made.

In our opinion, the accompanying Balance Sheet presents fairly the position of HEALTH INSTITUTE, INC. (N.S.L.) at November 20, 1946, in conformity with application of generally accepted accounting principles.

F. G. MASQUELETTE & Co.

CERTIFIED PUBLIC ACCOUNTANTS

ALBUQUERQUE, NEW MEXICO
November 25, 1946.

(1) It was alleged in the order for hearing and Cassel admitted that the amount, \$100,000, shown in the balance sheet for the item Leasehold was improper, and that the amount shown, \$100,000, in respect of the item Capital Stock, Common, was likewise improper without deducting the discount resulting from its issuance for a nominal consideration.

The leasehold in question was a 99-year lease, dated July 15, 1946, covering approximately 96/100ths of an acre in Hot Springs. It ran to Charles J. Van Ruska, president and principal promoter of Health Institute, Inc., as lessee, and was assigned by him to the company on November 16, 1946, in exchange for 9,998 shares of common stock. The lease provided for a monthly rental of \$150 a month for the first 3 months, \$300 a month thereafter until June 15, 1971, and \$150 a month from that date until the end of the term. Among other things, the lease required the lessee to pay all taxes and to move the existing houses on the property to other property owned by the lessors.

The circumstances under which Van Ruska entered into this lease are not shown by the record in this proceeding. It is clear, however, that there is no justification for its appearing in the balance sheet at a figure of \$100,000. The deed conveying the property to the lessors is dated April 30, 1945,

and recites a consideration of \$15,000. The property was assessed for the year 1946 at \$5,250, of which \$3,000 was allocated to improvements. The expenses of Van Ruska in connection with the lease were nominal. Notwithstanding his full knowledge of these facts, Cassel, on behalf of F.G. Masquelette & Co., certified falsely that the balance sheet, on which the leasehold was shown at \$100,000, conformed to generally accepted accounting principles.

In the second balance sheet,³ contained in the amendment to the registration statement, the following note was appended to the item "Leasehold . . . \$100,000,":

"(1) Valuation of leasehold is purely arbitrary, and is placed at a figure to equal the par value of the COMMON stock issued in exchange for the leasehold. The direct cost of the above lease to Charles Joseph Van Ruska, personally, and the assignment of the same to Health Institute, Inc. (N.S.L.) exceeded \$2,000. In addition, Mr. Van Ruska has spent an excess of \$10,000 of his personal funds in the promotion of this enterprise. Neither of these costs (out-of-pocket expenses) are being borne by the Corporation. In addition to these out-of-pocket expenses, Mr. Van Ruska has spent his time and effort and experience over a period of approximately 6 months in the promotion of this enterprise with no cost to the Corporation.

The addition of this footnote did not cure the deficiency. Dealing with a similar situation, we said in *Queensboro Gold Mines, Ltd.*, 2 S.E.C. 860 (1937), at page 862:

"Nor is the mischief fully cured by an explanatory note revealing that the figure is 'purely arbitrary' and that the vendor, who purchased the property 'at a nominal cost' to himself, 'controlled the board who valued' the property . . . Such disclosure, while helpful, is not sufficient."

And in *Mining and Development Corporation*, 1 S.E.C. 786 (1936), at page 799 we said:

³ The accountants' certificate appended to this balance sheet is identical with the one filed with the earlier balance sheet, which is quoted above, except that the date January 1, 1947, is substituted for November 20, 1946.

"Moreover, even were the footnote to state with complete frankness the true fact that the assets were over-valued, this would not mitigate the effect of the valuation figure itself. A balance sheet item which is flatly untrue will not be rendered true merely by admission of untruth."

As stated above, it was charged that the amount, \$100,000, shown in the balance sheet with respect to the item Capital Stock, Common, was improper in that the discount resulting from the issuance of the stock for a nominal consideration was not deducted. As the stock was issued for the leasehold, which, it is admitted, was improperly shown on the balance sheet at \$100,000, it follows that it was improper to indicate that the stock had been issued at its full par value, whereas, in fact, it had been issued at a discount.⁴

(2) It was alleged in the order for hearing and admitted by Cassel that the balance sheet as at November 20, 1946, improperly included the items "Construction Work in Progress—\$7,417.24," "Organization Expense—\$5,178.15" and "Account Payable to Charles J. Van Ruska—\$10,595.39."

The amount of \$7,417.24 shown for "Construction Work in Progress" included \$2,000, liability for which was shown in the balance sheet under the caption "Due on Architect's Contract, Burwinkle & Springman." The remainder, \$5,417.24, of the item "Construction Work in Progress" and the amount of \$5,178.15 shown as "Organization Expense" constituted the alleged liability of \$10,595.39 to Van Ruska.

Admittedly, Cassel did not take adequate steps to verify the accuracy of these items. As stated above, Van Ruska was president and principal promoter of Health Institute, Inc. Cassel's workpapers indicated supporting vouchers for only \$2,363.89 (\$1,301.49 classified as Construction Work in Progress and \$1,062.40 as Organization Expense) of the expenditures claimed to have been made by Van Ruska, and Cassel made no inde-

⁴ The impropriety here results from the use of the once very common, but now thoroughly discredited, device of employing par value as a representation of value for financial statement purposes. This practice developed from a widespread misconception of the meaning and significance of par value. See Hatfield, *Accounting*, 1927, pp. 72, 196-209; also Newlove, Smith and White, *Intermediate Accounting*, 1939, pp. 239-240; and May, *Financial Accounting*, 1943, p. 109.

pendent investigation as to whether Van Ruska had paid, or was obligated to pay, or whether Health Institute, Inc. was properly chargeable with, the \$8,231.50 balance allegedly due Van Ruska. He relied entirely on a written statement by Van Ruska that the company owed him that amount. Cassel's work sheets show that he participated with Van Ruska in drafting this statement, which was later typed and signed by Van Ruska.

Such procedure does not constitute an adequate verification of accounts by an independent accountant and the statement in the certificate of F. G. Masquelette & Co., affixed to the balance sheet of Health Institute, Inc., as at November 20, 1946, that their "examination was made in accordance with generally accepted auditing standards applicable in the circumstances" was manifestly false.⁵

Van Ruska later disclaimed the purported indebtedness and admitted that he had not made expenditures in the amounts shown. These items were omitted from the second balance sheet.

(3) It was alleged in the order for hearing and Cassel admitted that the certificates affixed to the balance sheets as at November 20, 1946, and January 1, 1947, falsely stated that such balance sheets fairly presented the financial position of Health Institute, Inc., at the respective dates.

It is clear that the inclusion in both balance sheets of the amount of \$100,000 in respect of the leasehold, and of a similar amount for Capital Stock, Common, and the inclusion in the balance sheet as of November 20, 1946, of the amounts of \$7,417.24, \$5,178.15 and \$10,595.39 for Construction Work in Progress, Organization Expense, and Account Payable to Charles J. Van Ruska, respectively, contravened generally accepted accounting principles. The balance sheets, therefore, did not fairly present the financial position of the company.

(4) It was alleged in the order for hearing and Cassel admitted that the certificates affixed to the two balance sheets contained false statements that the accountants had (a) reviewed the accounting

system and procedures of the company, (b) made a detailed audit of the transactions, (c) examined or tested accounting records and other supporting evidence, and (d) made an examination in accordance with generally accepted auditing standards applicable in the circumstances.

The record indicates, and it was admitted, that the company had no books of account and no accounting system, and had no accounting records other than a few vouchers and rough notes in Cassel's own files. In these circumstances the statements in the certificates concerning the scope of the accountant's examination and the statement that such examination was made in accordance with generally accepted auditing standards applicable in the circumstances were patently false and misleading.⁶

(5) It was alleged in the order for hearing and Cassel admitted that while respondents were purporting to certify the financial statements as independent certified public accountants, Cassel actively participated in the promotion of Health Institute, Inc.

Cassel was introduced to Van Ruska on or about July 18, 1946. From that time until the hotel enterprise was abandoned he worked closely with Van Ruska and his associates in an effort to further the project. In particular, he corresponded with three underwriting firms and an insurance company in an effort to obtain financing for the enterprise. He participated in discussions with the local office of the Civilian Production Administration, and assisted in preparing an application for a permit to proceed with the construction of the hotel. He arranged for the publication of newspaper articles publicizing the proposed hotel. He drafted the agenda for at least one directors' meeting, and was present at a number of meetings. He negotiated with the architects and arranged an architects' agreement. He solicited the purchase of shares of stock of the company. In short, Cassel participated actively in many things that were done in the promotion of the hotel.

Respondents argue that Cassel was not in reality a promoter and that his activities amounted to nothing more than "running errands" for Van Ruska. It is pointed out that Cassel's office was in

⁵ See *National Boston Montana Mines Corporation*, 2 S.E.C. 226, 249 (1937); *Associated Gas and Electric Company*, 11 S.E.C. 975, 1054 (1942); In the Matter of *Drayer-Hanson, Incorporated*, 27 S.E.C. 838, Securities Act Release No. 3277, Accounting Series Release No. 64 (1948).

⁶ See Accounting Series Release No. 13 (1940). (see p. 12 of this publication.)

Albuquerque, while Van Ruska's headquarters were in Hot Springs. It is urged that if Van Ruska had something to be done in Albuquerque it was only natural for him to ask Cassel to do it and for Cassel to help him out. Van Ruska had no office facilities, and Cassel permitted Van Ruska to use his office, and on occasion wrote letters on Van Ruska's behalf. While, possibly, some of Cassel's activities might properly be characterized as "errands," we find it extremely difficult to conclude that a certified public accountant so intimately identified with the accounting profession as Cassel⁷ would permit himself to be used as a mere runner of errands. Certainly such activities are incompatible with the practice of public accounting by an independent accountant. Moreover, Cassel rendered active assistance in attempting to organize the enterprise, suggesting procedures to be followed and persons to be consulted about various aspects of the matter, and in attending to a large part of the work himself.

We find that Cassel was a promoter of Health Institute, Inc.⁸ A finding of his lack of independence follows from Rule 2-01 (b) of Regulation S-X, which reads as follows:

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

Respondents point out that at the time Cassel engaged in these various activities there was no thought of registering under the Securities Act and that it was hoped that the enterprise could be

⁷ At the date of these proceedings Cassel was a director and a past president of the New Mexico Society of Certified Public Accountants; he was also a member of the committee on membership and a former Council member of the American Institute of Accountants.

⁸ "The term 'promoter' includes—

"(a) Any person who, acting alone or in conjunction with one or more other persons, directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer." Rule 405, General Rules and Regulations under the Securities Act of 1933 (formerly Rule 455).

financed in large part by private loans. For instance, at the time Cassel carried on negotiations with various underwriting firms and an insurance company it was thought that no public offering of securities would be necessary. This argument is, of course, quite beside the point. Cassel is not criticized for acting as a promoter. The impropriety charged, and here sustained, is that he purported to certify to the financial statements as an independent accountant after he had become so enmeshed in the promotion of the enterprise that he could no longer have properly considered himself independent.

We have found, among other things, that Cassel certified the balance sheets of Health Institute, Inc., as an independent accountant, when he was not in fact independent; that the certificates included the statement that his examination was made in accordance with generally accepted auditing standards applicable in the circumstances, when it was not; and that the certificates contained the statements that the balance sheets conformed to generally accepted accounting principles and fairly presented the financial position of the company, when such was not the case. In short, we have found that the balance sheets, and Cassel's representations with respect thereto were completely false and misleading. Under these circumstances we find that Cassel engaged in improper professional conduct within the meaning of Rule II(e).

We turn to the firm of F. G. Masquelette & Co. As stated above, Cassel was the resident partner of the firm in Albuquerque. He made such examination as was made of the accounting transactions of Health Institute, Inc., and signed the certificates applicable to the balance sheets of the company as at November 20, 1946 and January 1, 1947, in the name of F. G. Masquelette & Co. There is no indication in the record, nor does the record show any contention on the part of F. G. Masquelette & Co., that Cassel was not authorized to sign, or that he exceeded his authority in signing, the certificates in the firm's name.

In a recent case we held that "where a firm of public accountants permits a report or certificate to be executed in its name the Commission will hold such firm fully accountable."⁹ We find that,

⁹ See Accounting Series Release No. 67 (April 18, 1949).

by reason of Cassel's activities, the firm of F. G. Masquelette & Co. engaged in improper professional conduct within the meaning of Rule II(e).

Having found that Cassel and F. G. Masquelette & Co. engaged in improper professional conduct within the meaning of Rule II(e), we must determine whether the privilege of practicing before us should be denied them, temporarily or permanently.

Under all the circumstances, considering the nature of the improprieties practiced by Cassel and the extent of the firm's responsibility therefor we think the public interest is appropriately

served by denying F. G. Masquelette & Co. the privilege of practicing before this Commission for a period of 30 days from the date of the issuance of our order, and denying J. E. Cassel the privilege of practicing before this Commission for a period of 1 year from the date of the issuance of our order.

An appropriate order will issue.

By the Commission (Chairman HANRAHAN and Commissioners McENTIRE, McDONALD, and ROWEN).

ORVAL L. DuBOIS,
Secretary.

ORDER TEMPORARILY DENYING ACCOUNTANTS' PRIVILEGE OF PRACTICING BEFORE THE COMMISSION

A proceeding having been instituted by the Commission pursuant to Rule II(e) of its Rules of Practice to determine whether respondents, F. G. Masquelette & Co., of Houston, Texas, a firm of certified public accountants, and J. E. Cassel, of Albuquerque, New Mexico, a partner in said firm, should be disqualified or denied, temporarily or permanently, the privilege of appearing or practicing before the Commission;

A hearing having been held after appropriate notice, and the Commission being fully advised and having this day issued its findings and opinion herein:

IT IS ORDERED that F. G. Masquelette & Co. be and it hereby is denied, for a period of 30 days from the date hereof, the privilege of appearing and practicing before the Commission;

IT IS FURTHER ORDERED that J. E. Cassel be and he hereby is denied, for a period of 1 year from the date hereof, the privilege of appearing and practicing before the Commission.

By the Commission.

ORVAL L. DuBOIS,
Secretary.

June 30, 1949.

RELEASE NO. 69*

July 12, 1950

SECURITIES ACT OF 1933
Release No. 3381

SECURITIES EXCHANGE ACT OF 1934
Release No. 4465

INVESTMENT COMPANY ACT OF 1940
Release No. 1485

Notice of Proposal to amend Regulation S-X; A general revision of Articles 1, 2, 3, 4, 5 and 11 of that regulation. As revised this release became Accounting Series Release No. 70 and for this reason it is not reproduced here.

* Text of release omitted.