RELEASE NO. 70

December 20, 1950

SECURITIES ACT OF 1933
Release No. 3402

SECURITIES EXCHANGE ACT OF 1934
Release No. 4538

INVESTMENT COMPANY ACT OF 1940
Release No. 1550

Amendment of Regulation S–X; Adoption of Comprehensive Admentments to Articles 1, 2, 3, 4, 5 and 11.

The Securities and Exchange Commission today announced a general revision of Articles 1, 2, 3, 4, 5 and 11 of Regulation S–X. While amendments and changes pertaining to specific items in the regulation have been made from time to time, this is the first comprehensive amendment since its promulgation in February 1940.

The amended regulation reflects the adoption by the Commission of a number of suggestions made by practicing accountants, professional accounting groups, financial officers of corporations, educators and others to whom drafts of the revision were sent.[1] The amendment makes it clear also that the several requirements previously expressed in published opinions continue to reflect considered Commission policy. This has been accomplished, to a large extent, by amending Rule 1–01, which now reads, in part, as follows:

"Rule 1–01(a). This regulation (together with the Accounting Series Releases) states the requirements applicable to the form and content of all financial statements required to be filed as part of . . . [applicable statements are listed]."

The principal new requirement pertains to Profit and Loss or Income Statements and is contained in Rule 5–03(a) which states:

"All items of profit and loss given recognition in the accounts during the period covered by the profit and loss or income statements shall be included."

The inclusion of this requirement, which states a long established policy of the Commission,[2] is deemed necessary because of the not always consistent practice followed by some registrants of excluding certain items from the profit and loss or income statements with the result that the amount shown thereon as net income or loss has been susceptible to misinterpretation by investors. Recognizing that there might be exceptional circumstances which would make it appropriate to deviate from this rule, but keeping in mind the Commission's responsibility for prohibiting the dissemination of financial statements which might be misleading to investors, Rule 5–03 Profit and Loss or Income Statements was amended to read:

"*Except as otherwise permitted by the Commission,* the profit and loss or income statements filed for persons to whom this article is applicable shall comply with the provisions of this rule." [*Underscored* phrase added in revision.]

The purpose of this revision is to make clear to registrants that they are not forestalled from giving exceptional treatment to exceptional items when both the representatives of the registrant and the Commission are convinced that such treatment is appropriate.

Notwithstanding this provision, representatives of the Executive Committee of the American Institute of Accountants appeared before the Commission and proposed that either Rule 5–03(a) be eliminated from the regulation or

[1] A preliminary staff draft of the proposed revision was sent to approximately 600 persons on September 21, 1949, and more than 3,000 persons received copies of a second draft dated July 12, 1950, which was published in the Federal Register pursuant to the requirements of the Administrative Procedure Act. Approximately 175 persons commented upon each draft.

[2] Attention is directed to the 14th Annual Report, Securities and Exchange Commission, 1948, at page 111, wherein the Commission's views advocating the "all-inclusive" as opposed to the "current operating performance" profit and loss or income statement are expressed. Available only for reference purposes at S.E.C. Washington, D.C., and Regional offices.

the requirements with respect to the presentation of the final section of profit and loss or income statements be amended to permit, where appropriate, the exclusion of extraordinary items from those making up the caption *Net income or loss.*

To accomplish this, additional items, described in Rule 5–03 (17) and (18), were added to those previously set forth in the regulation, and the last three items of the section pertaining to profit and loss or income statements (Rule 5–03) now appear as follows:

"16. Net income or loss.

"17. Special items.—State separately and describe each item of profit and loss given recognition in the accounts, included herein pursuant to Rule 5–03 (a), and not included in the determination of net income or loss (Item 16).

"18. Net income or loss and special items. Captions 17 and 18 are to be used in those instances where it is believed that the showing of a single unqualified figure of net income or loss might be misconstrued."

RELEASE NO. 71*

December 29, 1950

INVESTMENT COMPANY ACT OF 1940
Release No. 1553

SECURITIES ACT OF 1933
Release No. 3403

SECURITIES EXCHANGE ACT OF 1934
Release No. 4540

Amendment of Rule N–8B–2; Adoption of Form N–8B–4 and Rule N–8C–4; Adoption of Article 6B of Regulation S–X

RELEASE NO. 72*

March 12, 1951

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 10432

SECURITIES EXCHANGE ACT OF 1934
Release No. 4580

Adoption of Revised Form U5S

RELEASE NO. 73

October 30, 1952

Findings and Opinion of the Commission In the Matter of Haskins & Sells and Andrew Stewart, File No. 4–66, (Rules of Practice—Rule II (e)).

PRACTICE AND PROCEDURE

Disqualification of Accountant from Practice Before Commission

Where respondents, a firm of certified public accountants and a partner therein, certified financial statements in a registration statement found by the Commission to be materially inadequate and misleading in that, among other findings, the financial statements grossly overstated intangible assets as a result of the arbitrary use of the par and stated value of shares of stock issued to acquire the assets, including shares expected to be reacquired from promoters as a donation, and attributed to apparently potentially productive items material amounts which should have been shown as promotion services, *held*, respondents have engaged in improper professional conduct making it appropriate to deny temporarily their privi-

* Text of release omitted.

lege of appearing or practicing before the Commission.

APPEARANCES:

Manuel F. Cohen, for the Office of the Chief Accountant of the Commission.

Robert P. Patterson, Boyle, Feller, Stone & McGivern, and Saul Levy, for respondents.

FINDINGS AND OPINION OF THE COMMISSION

These private proceedings were instituted under Rule II(e) of our Rules of Practice to determine whether the privilege of appearing or practicing before us should be denied, temporarily or permanently, to Haskins & Sells, a firm of certified public accountants, and Andrew Stewart, a member of that firm.[1]

Hearings were held, and after a recommended decision by the hearing examiner was dispensed with upon respondents' motion, counsel for the Office of the Chief Accountant of the Commission and counsel for the respondents filed briefs and presented oral argument. On the basis of our examination of the record we make the following findings.

The order instituting these proceedings refers to certain accounting services allegedly improperly performed by respondents in connection with the filing by Thomascolor, Incorporated, a Delaware corporation ("Thomascolor") of a registration statement under the Securities Act of 1933 covering 1 million shares of that corporation's class A stock, $5 par value, to be offered for sale at a price of $10 a share, or a total of $10 million. The proceeds of the sale of this stock were to be devoted to an attempt to develop to a point of commercial use various devices, principally in the field of color photography, invented by Richard Thomas, the chief promoter of Thomascolor. Respondent firm, under the supervision of respondent Stewart, performed the auditing work and certified the financial statements of Thomascolor and its predecessors, Thomascolor Corporation, a Nevada corporation ("the Nevada corporation"), Scientific Development Co., a limited partnership ("Scientific"), and Richard Thomas Enterprises, Inc., a California corporation ("Enterprises").

In connection with the Thomascolor registration statement we instituted stop-order proceedings under Section 8(d) of the Securities Act to determine whether we should issue an order denying effectiveness to that statement. Extensive hearings were held before a hearing examiner, and numerous conferences were held between our Division of Corporation Finance and counsel, accountants, and other representatives of the registrant. After eight amendments had been filed, substantially revising the disclosures made, we dismissed those proceedings and permitted the registration statement as amended to become effective. However, we issued a Findings and Opinion finding that the registration statement as originally filed contained material misrepresentations and omissions with respect, among other things, to the nature and commercial possibilities of the devices and processes proposed to be exploited and the history of Thomascolor and its predecessors, and further finding that the financial statements in the registration statement as originally filed were highly misleading.[2]

The order for hearing in the instant proceeding alleges, generally, that respondents in connection with their work and the issuance of the firm certificate in the Thomascolor registration statement disregarded generally accepted accounting and auditing principles, practices and professional standards and the rules, regulations and long settled decisions of the Commission.

THOMASCOLOR AND ITS PREDECESSORS

THE NEVADA CORPORATION

Thomas, who had been experimenting in the field of color photography, had by 1940 developed a three-color system of photography in-

[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."

[2] *Thomascolor, Incorporated*, Securities Act Release No. 3267 (November 26, 1947). See also 27 S.E.C. p. 151.

volving five inventions, of which three were patented and two were covered by patent applications. At that time Thomas was in difficulty with various creditors who had advanced funds to him. After legal actions against Thomas had been instituted by those creditors, it was agreed between them and Thomas that, for their mutual benefit, a corporation should be formed to hold the patents and patent applications. Accordingly, the Nevada corporation was formed with an authorized capital of 1,000 shares of capital stock, no par value, and Thomas assigned the five patents and patent applications to the corporation in exchange for 980 shares of its capital stock. Thomas retained 725 of the shares, assigned 125 shares to an attorney who had rendered legal services, and assigned the remaining 130 shares to eight persons who had advanced funds to him.

Various efforts of the Nevada corporation to finance the further development of the inventions failed. In March 1941, the Nevada corporation issued to Thomas a license for the manufacture and sale of the inventions. Thomas, who was the owner of a substantial amount of equipment, mortgaged it for the purpose of raising funds for the development of the inventions. By 1942 actions had been started to foreclose some of these mortgages and the earlier creditor actions directed against Thomas were revived. These litigations were settled by an agreement, dated April 22, 1942, between the Nevada corporation, Thomas and the other stockholders of the Nevada corporation pursuant to which Thomas assigned to the Nevada corporation 667½ shares of his stock in the corporation and his interest in the mortgaged equipment. It was also provided that, if Thomas did not repay the creditor stockholders the funds which they had originally advanced to him within 18 months, the assigned shares of stock would be divided among the stockholders other than Thomas. Thomas thereby temporarily lost control of the Nevada corporation.

In January 1944, in order to facilitate the further financing of the Thomas inventions and processes, the Nevada corporation issued a new license agreement, in place of the one originally issued to Thomas. This license designated Edwin C. Street, who had loaned Thomas money and was attempting to work out plans for satisfying the claims of creditors and obtaining funds for the further development of the inventions, as the licensee for the purpose of assigning the license to Enterprises. As noted below, Street subsequently did assign the license to Enterprises. The Nevada corporation also leased and ultimately sold Thomas' equipment in its possession to the latter corporation.

ENTERPRISES

Enterprises was organized in August 1943 with a capitalization of 1 million shares of a par value of $5 each. In February 1944, it filed an application with the California Division of Corporations for permission to sell to the public 50,000 shares of $5 par value stock, to net the corporation $200,000, after deducting a 20 percent selling commission to Street and an associate, and to issue 50,000 shares as "promotion shares" to Thomas and Street and to Fleetwood Southcott and Omer Nigh, who were closely associated with Thomas in the promotion activities. The application referred to these four persons as the "promoters of the plan set forth in the application," and stated that the "promotional shares" were to be issued to them "in exchange for the assignment of the license agreement." In connection with the authorization of the filing of this application the Board of Directors of Enterprises fixed the value of the license agreement at $250,000, reserving the right to "redetermine the value at a higher figure in the event the experience of the corporation with the inventions covered by said license agreement justifies a higher figure."[3]

The California Division of Corporations issued a permit authorizing the proposed issuance and sale of stock. The shares to be received by the four promoters were permitted to be issued "as partial consideration for the

[3] The same reservation had been noted in connection with a prior application in October 1943, when the value of the license was fixed by the Board of Directors at $225,000. This earlier application was withdrawn following the raising of objections by the California Division of Corporations.

transfer first to be made to the applicant of the license agreement herein referred to as recited in said application, subject to the right to receive additional shares as full and final consideration therefor when and as authorized by the Commissioner of Corporations so to do." The permit was issued subject to the assignment of the license agreement to Enterprises and subject to the requirement that the shares to be issued to the four promoters be placed in escrow pending further order of the Division of Corporations and that the holders of such stock agree to waive their right to dividends or to participate in any distribution of assets until the stockholders who had paid cash for their shares should receive as dividends or distributions in liquidation 100 percent of the amount invested. Thereupon the entire stock issue was disposed of as contemplated, 50,000 shares being sold to the public and 50,000 shares being issued in the names of the four promoters and placed in escrow.

In April 1945, Enterprises filed an application for a permit to sell 274,084 additional shares to the public and to issue 274,084 additional shares to Thomas, Street, Southcott and Nigh. This application was granted only in part, a permit being issued for the sale to the public of an additional 137,000 shares and the issuance to the named individuals of 137,000 shares, these latter to be placed in escrow upon the same conditions as the earlier issue. The additional 137,000 shares were all sold to the public.

The license agreement was stated on the books of Enterprises and included in its balance sheet, which was certified by respondents and filed with this Commission, at $935,000, the aggregate par value of the 187,000 shares of $5 par value stocks issued to the four named promoters.

After the second block of stock had been sold, Enterprises purchased the equipment owned by Thomas which it had rented from the Nevada corporation for $149,000, less the amount of rentals theretofore paid. This amount was used by the Nevada corporation to release the equipment from mortgages and other liens, to pay the amounts owing to unsecured creditors of Thomas, and to acquire the stock interests of the creditors in the Nevada corporation. Thomas thereupon reacquired the shares of the Nevada corporation which he had turned over to the Nevada corporation in 1942, and resumed his control of that corporation.

SCIENTIFIC

In June 1945, Thomas organinzed a limited partnership with the name Scientific Development Co. for the purpose of financing further development of three of his inventions pertaining to aerial photography. Thomas was the sole general partner and received a 65 percent interest in the partnership in consideration of the transfer of the inventions. The limited partners were Southcott, Nigh and one other, who subsequently assigned their interests to other persons. The partnership received $50,000 in cash for the 35 percent interest of the limited partners.

THOMASCOLOR

Thomascolor, the Delaware corporation, was organized in February 1946, for the purpose of consolidating the various entities engaged in the development of the Thomas inventions and devices and of obtaining additional funds. Originally its authorized capital consisted of 5 million shares of $5 par value stock, but when it developed that a single class of stock would not insure retention of control by Thomas, the authorized capital was changed to 4 million shares of common stock class A, $5 par value, and 100,000 shares of common stock class B, without par value, each class having 50 percent of the voting power regardless of the number of shares outstanding. The holders of the class A stock were entitled to all dividends paid until they received an aggregate of $1,250,000 after which all dividends were to be paid one-half to the holders of the class A stock and one-half of the holders of the class B stock. Upon liquidation, the holders of class A stock were entitled to receive $5 per share before any distribution was made to the holders of class B stock. Thereafter the class B stockholders were entitled to receive the amount distributed to the holders of class A stock, and any remaining assets were to be divided equally between the two classes.

It was determined that Thomascolor would acquire all the assets of the Nevada corporation, Enterprises, and Scientific and also an invention involving television which was owned by Thomas personally. Thomas assigned to Thomascolor all his interest in the invention relating to color television, his holdings of the common stock of Nevada corporation which amounted at the time to 707½ shares, and his interest in Scientific which then amounted to 60 percent, for a consideration consisting of 56,800 shares of the class A stock having an aggregate par value of $284,000 and 100,000 shares of class B stock having a stated value of 10 cents per share, or an aggregate of $10,000. The Board of Directors of Thomascolor, of which the four persons named above were members, fixed the fair market value of these interests acquired from Thomas as at least $294,000. Thomascolor also issued to Thomas 200 shares of class A stock in consideration of $1,000 paid in cash.

Thomascolor then acquired from Street, Southcott, Nigh and Carl Haverlin, a director of Thomascolor and the Nevada corporation, 90 shares of capital stock of the Nevada corporation, in exchange for 9,000 shares of Thomascolor class A stock. The Nevada corporation transferred all its assets to Thomascolor in exchange for 100,000 shares of Thomascolor class A stock which were thereupon distributed pro rata among the stockholders of the Nevada corporation and that corporation was dissolved. In that distribution Thomascolor reacquired 81,377 27/49 shares of its own stock and 18,622 22/49 shares were distributed to the other stockholders of the Nevada corporation.

Thomascolor also acquired the remaining 40 percent interest in Scientific, which the Thomascolor directors stated had a fair value of $200,000, in exchange for 40,000 shares of Thomascolor class A stock. Scientific then transferred all its assets to Thomascolor and was dissolved.

Enterprises also transferred all of its assets, except $3,000 in cash, to Thomascolor for 374,000 shares of class A stock of Thomascolor. The Board of Directors of Thomascolor found that the fair value of such assets was at least $1,874,000.

THE ALLEGED ACCOUNTING DEFICIENCIES

The accounting treatment to which the order for proceedings refers as the basis for disciplinary action relates primarily to intangible asset items in the balance sheets of Thomascolor and Enterprises.

THE ITEM "PATENTS AND PATENT APPLICATIONS" IN THE BALANCE SHEET OF THOMASCOLOR

The balance sheet of Thomascolor as originally filed contained the following item:

"PATENTS AND PATENT APPLICATIONS (representing the amounts of such assets as carried on the books of predecessor interests plus the excess of the stated value of common stock issued therefor over the net assets acquired as shown by the books of such predecessor interests)—(Note 2) .... $2,014,941.03"

Note 2 read as follows:

"The amount of $2,014,941.03 at which the item 'Patents and Patent Applications' is carried in the above balance sheet represents the valuation of such patents and patent applications by the Directors and is based upon the par value of the 579,800 shares of class A Stock of $5 par value less 81,377 27/49 shares returned to treasury and on 10 cents per share for the 100,000 shares class B issue therefor with adjustments for other assets acquired and liabilities assumed.

"Said valuation does not purport to be the cost to the original owners. The following is a comparison between the amount at which patents and patent applications are carried in the above balance sheet and the amounts at which they were carried in the balance sheets of the predecessor interests:

Thomascolor Incorporated	$2,014,941.03

Predecessor Interests:		
Richard Thomas Enterprises, Inc.:		
License agreement	$935,000.00	
Stock issue expense-commissions	186,991.00	
Undistributed expenses, including depreciation, $70,322.49	215,748.67	
Organization expense	15,653.60	
		1,353,393.27
Scientific Development Co		173,710.66
Thomascolor Corporation, $39,200.00 less reserve for amortization, $11,625.49		27,574.51
Inventions and processes acquired from Richard Thomas		(Not stated)
		1,554,678.44

"For accounting purposes it is the intention of the Company to amortize the valuation of these patents and patent applications over the remaining portion of the 17 year period from the date of the basic patent, May 5, 1942, so that the total valuation will be amortized over approximately the next 12 years. The proportion of the valuation, which, representing cost to the original owners, can be treated as a deduction for tax purposes, will not be known until it is established to the satisfaction of the Treasury Department. Accordingly, it should be assumed for the purposes of this Registration Statement that the annual amortization of patents will not be fully deductible for tax purposes."

The order for hearing alleges that this account, which represented all but $536,642.37 of the total assets of $2,551,583.40 shown on the balance sheet, improperly included material amounts without proper accounting evidence of their nature and character as patent and patent application items.

Respondents in setting up the balance sheet of Thomascolor stated the assets at the par or stated value of the stock issued for the purpose of acquiring them. The net assets of the Nevada corporation, Scientific and Enterprises and the television patents were acquired by Thomascolor for 579,800 shares of its class A stock, $5 par value, and 10,000 shares of its class B stock, 10 cents stated value. Upon the dissolution of the Nevada corporation Thomascolor reacquired 81,377 27/49 of its own class A shares, making the net amount issued for those assets 498,422 22/49 class A shares and 10,000 class B shares having an aggregate par and stated value of $2,502,112.24. Of this, $30,000 par value of class A stock was earmarked as having been given to Thomas for the television patents, leaving a balance of $2,472,112.24. For this Thomascolor acquired assets carried on the predecessors' books at $2,044,849.65, of which $1,554,678.44 were intangible items and $490,171.21 were tangible items and deferred charges. The excess of the aggregate net par or stated value of the stock over the book value of the assets acquired, amounting to $427,262.59, was included under patents and patent applications on the books of Thomascolor.

The entering of the assets acquired by Thomascolor at an amount equal to the par or stated value of the stock issued for the purpose of acquiring them was essentially an arbitrary procedure. The Thomascolor shares had not been traded in and there was no standard by which their actual value could be judged. It was impossible to value the intangibles acquired, particularly in view of the long history of failure despite the expenditure of substantial sums. Obviously the amounts ascribed to patents and patent applications was merely a balancing figure, substantially in excess of the total of the amounts of intangibles in the books of the predecessors, and had no relation to actual values.

In the case of Thomascolor the distortion was intensified by the fact that the stock issued was of two classes having highly unusual characteristics. As has been noted, one-half of the voting power was lodged in the class B stock, and it was provided that after $1,250,000 in dividends were paid to the holders of class A stock, regardless of the number of shares issued, all remaining dividends were to be divided equally between the two classes. Clearly there was no rational basis for placing a value of $5 on each share of class A stock and stating the cost of assets aquired in exchange for shares of that stock on such basis and at the same time using a value of 10 cents per share for the class B stock as a measure for valuing assets acquired in exchange for such stock.

Respondents urge that the recording of the assets in an amount equal to the par and stated value of the stock issued for the purpose of acquiring them is an accepted and proper accounting practice where the amount of stock issued is not arbitrarily fixed, but is arrived at on some rational basis. They argue that there are in this case substantial "elements" or "indicia" of arm's-length bargaining sufficient to permit the acceptance of an amount equal to the par and stated value of the stock issued. Respondents' position is in effect that where stock is issued in a series of transactions, some of which are concededly not the result of arm's-length negotiation, a figure based on the aggregated par and stated value of the stock so issued can be sustained in its entirety if part of the transactions contain elements of arm's-length dealing. We cannot accept respondents' view.

In the light of the unsuccessful history of the patents and patent applications, it was clear that their actual value did not approach $2,014,914.03 and respondents should have recognized that the use of that figure might be misleading to investors.[4] And in our opinion the absence of true arm's-length bargaining in important transactions was so apparent that respondents should have recognized the impropriety of using that figure, which as we have noted was $427,262.59 in excess of the aggregate of the amounts at which the intangibles were carried on the books of the predecessors.

The facts indicate an over-all lack of arm's-length bargaining in the transactions fixing the amounts of stock to be issued for the assets of the predecessors. Thomas caused the organization of, and was the dominating factor in, Thomascolor and the three predecessor organizations. He was the president and a director of both Thomascolor and the Nevada corporation and was the sole general partner of Scientific. He had voting control of Thomascolor and the Nevada corporation and, with his associates, had practical control of Enterprises. All action taken by officers, directors and stockholders of Thomascolor and its predecessors was a mere rubber-stamping of Thomas' plans. All the persons having interest in these ventures were dependent upon Thomas personally to develop a successful invention and accordingly their freedom to dispute any course of action he chose was greatly limited. Even if we could accept respondents' contention that substantial elements of arm's-length dealing were involved in various phases of the transactions, these phases were so minor and subordinate that they could not affect the conclusion that the $2,014,914.03 attributed to patents and patent applications was essentially an arbitrary figure.

But we are unable to find that the various transactions involved arm's-length negotiation or bargaining in any substantial sense. In considering these transactions it should be borne in mind that Thomas as the holder of all the class B stock and only a relatively small amount of class A stock, which as noted above had limited preferences, had no material interest in limiting the amount of class A stock to be issued to acquire assets.[5] Thomas thus

[4] Respondents contend that the figure at which patents and patent applications were carried in the balance sheet of Thomascolor was captioned so as to eliminate any implication that the figure represented the value of the patents. However, as we noted on previous occasions, a dollar and cents figure set opposite an item of property implies it was reached on some rational or precise basis (See *Thomas Bond, Inc.*, 5 S.E.C. 60, 62, 64 (1939)). Moreover, the footnote to this item in the balance sheet expressly describes the figure used as the "valuation" of the patents and patent applications by the directors.

[5] As noted above the class B stock carried with it 50 percent of the voting power and a 50 percent interest in earnings after satisfaction of the limited preferences of the class A stock. Thomas owned 57,000 shares of class A stock, which would constitute 4.2 percent of the stock which it was contemplated would be outstanding in the event that the sale of 1 million shares to the public was consummated.

had little incentive to be other than generous to the other interested persons, and at the same time such persons had no hope of preserving their investment unless there was successful financing.

The first transaction involving the issuance of stock for the purpose of consolidating the predecessors was the acquisition from Thomas in May 1947 of the television patents, 707½ shares of the Nevada corporation and his 60 percent interest in Scientific in exchange for 56,800 shares of Thomascolor class A stock and 100,000 shares of class B stock having an aggregate par and stated value of $294,000. Since Thomas was then the president and sole stockholder of Thomascolor, it is clear that there was no arm's-length dealing in connection with this transaction.

We also cannot find, as contended by respondents, that arm's-length dealings were involved in connection with Thomascolor's acquisition later that month of 90 shares of the Nevada corporation stock from Southcott, Nigh, Haverlin and Street for 9,000 shares of Thomascolor class A stock. These men had been associated with Thomas in his various enterprises for a number of years. They were promoters, officers, directors and stockholders of some or all the corporations. Respondents urge that this is not a sufficient basis for an assumption that they would accept dictation from Thomas where their own interests were concerned. However, we think the record clearly shows a disposition to accede to Thomas's various proposals.

The subsequent acquisition of the assets of the Nevada corporation for 100,000 shares of class A stock of Thomascolor and the dissolution of the Nevada corporation in the course of which Thomascolor received back 81,377 $\frac{27}{49}$ of such shares and the balance of 18,622 $\frac{22}{49}$ shares was distributed to the minority stockholders of the Nevada corporation was also not marked by any real arm's-length negotiations. Although in the preceeding year the directors of the Nevada corporation approved a proposed sale of its assets to Thomascolor on somewhat different terms, the sale which was actually consummated was not submitted to the directors or stockholders of the Nevada corporation, presumably because Thomascolor then owned more than 80 percent of its stock. The acceptance of the distribution by the minority stockholders without protest did not reflect any independence of action on their part under the circumstances. The Nevada corporation had been attempting to develop its inventions since 1941 without success, and new arrangements and further financing were necessary if its stock was to have any value. In these circumstances the minority stockholders had little choice but to accept the results of a transaction adopted by the management as a possible means of salvaging their investment.

The sale of the assets of Enterprises to Thomascolor for 374,000 shares of class A stock of Thomascolor was likewise made under circumstances negativing arm's-length bargaining. The directors of Enterprises who approved the offer were Street, S. I. Volz, a friend of Street and William Nigh, a brother of Omer Nigh, an officer and director of Thomascolor and of the Nevada corporation. Neither Volz nor William Nigh appears to have been active in the company's affairs. The directors of Thomascolor who accepted the offer were Thomas, Southcott and Haverlin. While, as respondents emphasize, there is some evidence of differences between Street and Thomas about some matters, in the main they acted in concert in the promotion of Thomascolor and Enterprises.

Nor does the fact that certain of the public stockholders of Enterprises consented to the sale furnish any material element of arm's-length bargaining. Although Enterprises had in April 1946 obtained the consent of a majority of its public stockholders to an offer to sell its assets to Thomascolor, when the offer was actually made, on somewhat different terms, the consent of only seven public stockholders, owning only 3,250 share, was obtained, with the balance of the necessary majority being obtained from Thomas, Street, Southcott and Nigh. Moreover, at the time the original consents were obtained, the stockholders of Enterprises were advised that the plans were to finance Thomascolor by the sale of stock at $10 a share and to have that corporation acquire the assets of Enterprises through an exchange of Thomascolor stock for Enterprises stock on a share for share basis. Obviously any arm's-length features of this transaction are minimized in view of the suggestion that was made that a consent would facilitate the transformation of the shares then held by the stockholder into new shares having an offering price of twice the original issue price of the Enterprises shares held, as to which the record indicates the high bid had been $7.50 a share.

While the acquisition of the 40 percent interest in Scientific, the limited partnership, for 40,000 shares of Thomascolor class A stock appears to have involved some arm's-length negotiation, there is evidence that some of the assignees of the limited partners were otherwise interested in and connected with other promotions of Richard Thomas. In addition these assignees were, like the minority stockholders of the Nevada corporation and Enterprises, in the position where their funds had been dissipated and they had nothing to lose and no real alternative but to accept Thomas' proposal giving them new interests with the expectation that additional cash could be secured and the possibility of eventual development of the Thomas processes could be kept alive. In any event, this transaction constituted a relatively minor element in the total $2,014,914.03 Patents and Patent Applications figure certified by respondents.

Respondents also seek to justify the carrying of the patents and patent applications at the par value of the stock issued therefor on various other factors. They point to the fact that the purchasers of a 13 percent interest in the patents later transferred to the Nevada corporation paid $115,625 therefor and urge that this indicates a value of nearly $1 million for the patents. But neither these purchasers nor any other persons were in a position to value the patents on any rational basis. The fact that they were willing to invest in the possibilities of successful development of the patents could be no evidence of their actual value. Respondents similarly urge that the fact that the public was willing to invest $935,000 to acquire half the capital stock of Enterprises is evidence that the purchasers of this stock in effect valued the license agreement, for which, respondents assert, the other half of that stock was issued, at $935,000. However, respondents' argument in this connection does not give sufficient weight to the drastic provisions of the escrow agreement under which the shares issued to the promoters were made subordinate to the publicly held shares.[6] Respondents also point to the fact that the prices Thomas received for his interests in the predecessors were less than those paid for the minority interest. But these prices were stated in terms of par and stated value of stock and were distorted by the inclusion of the class B stock at 10 cents per share.

In support of their position on this question, as well as on the other allegations in the order for proceedings, respondents introduced the evidence of three members of other firms of certified public accountants who testified as experts. Respondents lay great emphasis on this testimony and point out that no expert testimony to the contrary was introduced by the Office of the Chief Accountant. However, as we have previously stated, while the opinions of qualified expert accountants may be helpful, this Commission must in the last analysis weigh the value of expert testimony against its own judgment of what is sound accounting practice.[7] We have given careful consideration to the testimony of the experts as well as to all the other evidence in arriving at our conclu-

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[6] Respondents have also argued that in approving the sale of Enterprises stock to the public and the issuance of an equal amount of stock to the promoters, the California Commissioner in effect valued the license agreement at $935,000. However, that there is no basis for this contention is evident from the fact that the stated value of the license agreement was treated as a deduction from capital and not as an asset in the California Commission's correspondence with stockholder's in its second permit, and in its internal reports in connection with the Enterprises financing.

[7] See *Interstate Hosiery Mills, Inc.*, 4 S.E.C. 706, 715 (1939); Cf. *Commonwealth and Southern Corporation*, 9 S.E.C. 609, 616 (1941); *Dayton Power and Light Company*, 8 S.E.C. 950, 974 (1941).

sions herein. We have not deemed it necessary to discuss their testimony since the views they expressed were substantially the same as those of the respondents.

In summary on the basis of the foregoing we find that the account "Patents and Patent Applications" in the balance sheet of Thomascolor prepared and certified by respondents improperly included material amounts without proper accounting evidence to support those amounts or to justify the certification of the figure stated for that account.

THE INCLUSION IN THE ASSETS OF THOMASCOLOR OF $698,000 REPRESENTING STOCK EXPECTED TO BE DONATED BY THE PROMOTERS

The order for hearing alleges that the balance sheet of Thomascolor, as originally filed, improperly included among the assets the amount of $698,000 representing the par value of 139,600 share of class A stock which would be acquired indirectly by donation from Thomas, Southcott and Nigh, subject to the approval of the California Division of Corporations. This amount was included in the $2,014,914.03 figure designated Patents and Patent Applications.

After Thomascolor had acquired the Enterprises assets in exchange for 374,000 shares of its class A stock, Thomas, Southcott and Nigh entered into an agreement with Thomascolor for the transfer to it, for the nominal consideration of $3, of 139,600 shares of the promotion stock of Enterprises held in escrow, subject to the approval of the California Commissioner.[8] The intent of the agreement was that, upon the dissolution of Enterprises, Thomascolor would acquire and cancel the 139,600 shares of its own class A stock which would otherwise have been distributed to the promoters. An application was made to the California Commissioner for his consent to the transfer of the shares in escrow. However, when the Commissioner asked for additional information, including a copy of the registration statement filed with this Commission, counsel for the company decided to wait until the registration statement had been amended, and the application was not pursued further and the proposed transaction was never consummated.

This agreement was part of the over-all plan for the consolidation of the predecessor organizations into Thomascolor. The objective was described by Thomas' counsel as follows: "To obtain satisfactory and propitious financing arrangements it is necessary to effect a consolidated balance sheet for the Delaware Corporation with the lowest possible spread between the value of the patents and the demonstrable costs thereof." Respondent Stewart testified that he "was told that it was all part of the arrangement which was being made whereby Mr. Thomas would not receive more in par value of the stock than he claimed to have contributed in cash."

Respondents seek to justify the inclusion of the $698,000 representing the par value of the 139,600 shares of Thomascolor stock in question, in the amount shown for patents and patent applications by pointing to the facts that that stock had actually been issued and was outstanding, that the stock to be acquired for $3 was stock of Enterprises, not stock of Thomascolor, and that the consent of the California Commissioner had to be obtained before that stock and the Thomascolor stock allocable to it could be acquired by Thomascolor. Respondents urge that the Commissioner might have required the retention of the Thomascolor stock in escrow or the distribution thereof to the stockholders of Enterprises who had contributed cash. They also refer to the fact that the dissolution of Enterprises required the vote of a majority of its stockholders.

Respondents' arguments are without merit. While we recognize that there were conditions precedent to the transactions contemplated by the agreement which might have prevented consummation, and in fact they were not consummated, these contingencies did not justify the accounting treatment adopted with

[8] Street, who held the remaining 47,000 promotion shares in escrow, refused to join in this agreement.

respect to the shares expected to be reacquired pursuant to the donation agreement.[9] Since those shares were issued and outstanding they were properly so shown in the balance sheet. However, it was manifestly improper to measure the cost of assets by the par value of stock subject to an agreement of this nature.

The stock clearly was never intended to be issued in exchange for assets. Its issuance was merely part of the legal mechanics of effecting the consolidation of Enterprises and Thomascolor, and the donation agreement was entered into as a means of reducing the consideration paid by Thomascolor to acquire the assets of Enterprises to an amount net that of the stock expected to be reacquired pursuant to that agreement. Accordingly, the corresponding debit which should have been made in connection with the issuance of that stock should not have been "Patent and Patent Applications" but "Capital Stock Discount."[10]

As we stated in our Findings and Opinion in the stop-order proceedings:

"The controlling accounting principles are not new. They have been frequently enunciated in our earlier decisions. For example, in *Unity Gold Corporation,* 1 S.E.C. 25 (1934), we specifically stated that donated stock should not be reflected in asset accounts, particularly property accounts, tangible or intangible. This is a well recognized and accepted accounting principle. See also *Yumuri Jute Mills Company,* 2 S.E.C. 81, 87 (1937). The fact that in the instant case approval by the California Corporation Commission is yet to be obtained before the registrant actually receives the 'donated stock' affords no basis for departing from these principles because the nature and purpose of the contract relating to the acquisition of the stock by the registrant establishes it as an item which could not properly be considered an asset."[11]

We conclude that respondents in including in the Patents and Patent Applications account the $698,000 representing the par value of the shares expected to be required pursuant to the donation agreement failed to follow proper accounting principles.

THE ITEM "LICENSE AGREEMENT" IN THE BALANCE SHEET OF ENTERPRISES

The balance sheet of Enterprises as of May 20, 1947, immediately before the transfer of its assets to Thomascolor, showed as an asset the item "License agreement . . . $935,000." This item was qualified by a footnote reading as follows:

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[9] Respondents have asserted that at the time their audit was made there was serious doubt by all concerned whether the shares covered by the donation agreement would ever be reacquired. It may be noted, however, that this position is inconsistent with others advanced by respondents in arguing that the figures they used for the patents and patent applications and the license agreement accounts were justified. Respondents' argument noted previously that the public investment of $935,000 in Enterprises imputed a comparable value for the shares issued to the promoters is based on the contention that the restrictions placed on the escrowed stock were only temporary, whereas in connection with the donation agreement they stress the possibility that these restrictions would be retained indefinitely. In addition, respondents contend that, even apart from asserted arm's-length features of the various transactions, there were other indications that the amount at which the patent account was stated was reasonable. If such amount were valid, as contended, there should have been no serious doubts as to obtaining the necessary approval of the California Commissioner in order to effectuate the donation agreement. Such doubts could only be based on concern as to the value of the patents and of the Thomascolor stock to be distributed to the public stockholders of Enterprises. If respondents had considered these matters they should have been aware of the conflict between a determination as to the reasonableness of the adopted values, on the one hand, and the giving of weight to doubts as to the California Commissioner's approval of the donation agreement, on the other hand.

[10] The impropriety of the treatment followed by respondents is evident from the fact that under it upon actual reacquisition and cancellation of its stock it would have been necessary to reduce Thomascolor's property accounts. Had the treatment we suggest been followed no such deflation of the property accounts would be necessary since they would not have been inflated in the first instance and the required entries would simply be to eliminate the capital stock discount (and the corresponding capital in the stock accounts). On the other hand, even were the stock not reacquired, the discount would remain and would properly continue to be shown as such for the reason that the framers of the transactions recognized that no value was received for the stock.

[11] *Thomascolor Incorporated,* Securities Act Release No. 3267 (November 26, 1947), p. 18.

"The outstanding capital stock at May 20, 1947, is 374,000 shares, of which 187,000 shares were issued for cash and 187,000 shares were issued in accordance with the terms of the license agreement whereby the Company acquired the right to use certain specified Thomascolor inventions. No dividends may be paid or other distributions made to the holders of promotion stock until the shareholders who paid cash for their shares have received either as dividends or as other distributions of the Company's assets, in cash or its equivalent, amounts equal to $5 per share. Of the 187,000 shares of stock sold for cash, all but 9 shares were sold by the Company's fiscal agent, who received as commission the amount of $1 per share, or a total of $186,991."

The order for hearing alleges that this item improperly included promotion items. Respondents acknowledged that it is a well established accounting principle that where stock is issued for promotion services, the consideration received therefor should be shown in the balance sheet as promotion services and should not be included in property or similar accounts.[12] However, respondents seek to justify their treatment on the ground that promotional services were not involved and that the evidence which was available to respondents in connection with their audit so indicated.

In our opinion the record shows that the 187,000 shares of the stock of Enterprises issued to Thomas, Street, Southcott and Nigh were issued at least in large part in consideration for promotional services. These four men had been engaged in various efforts looking toward the development of the Thomascolor inventions and a program of financing over a long period of time and the the applications to the California Division of Corporations described them as "promoters." The first license agreement, which was issued to Thomas in 1941, cost Thomas nothing and he was unable to develop any value for it. The second license agreement, which was issued to Street, cost Street nothing. This agreement provided that it was issued to Street solely for the purpose of his assigning it to Enterprises and that the agreement would become void if this were not done. Under these circumstances it should have been apparent to respondents that it was highly improbable that the stock issued to the above persons was issued solely in consideration of the license agreement.

The Office of the Chief Accountant urges that respondents were put on notice that promotional services were included in the consideration for the stock because of the use of the term "promotion stock" by counsel and by the California Division of Corporations in granting its permit to issue the stock. Respondents, on the other hand, argue that "promotion stock" does not necessarily mean stock issued for promotional services but may mean stock issued for property, tangible or intangible, in connection with the formation of a company, and urge that they were justified in regarding that designation as consistent with the issuance of the stock for property because they found other evidence to that effect.

Respondents place considerable reliance on the fact that the permits granted to Enterprises by the California Division of Corporations authorized the issuance to Street, Thomas, Southcott and Nigh of stock "as partial consideration for the transfer first to be made to the applicant of the license agreement herein referred to as recited in said application." Respondents point to the fact that the license agreement is mentioned as a sole consideration for the issuance of such stock and that nowhere

[12] We have on many occasions criticized the inclusion in property and other accounts of the par value of shares issued to promoters for services. See *Haddam Distillers Corporation*, 1 S.E.C. 37 (1934); *Yumuri Jute Mills Company*, 2 S.E.C. 81, 86 (1937); *National Boston Montana Mines Corporation*, 2 S.E.C. 226, 250 (1937); *Rickard Ramore Gold Mines, Ltd.*, 2 S.E.C. 377, 389, 390 (1937); *Paper Sales Company of Detroit, Inc.*, 2 S.E.C. 748, 754 (1937); *Platoro Gold Mines, Inc.*, 3 S.E.C. 872, 881 (1938); *Thomas Bond, Inc.*, 5 S.E.C. 60 (1939); *MacDonald Mines Limited* (N.P.L.), 7 S.E.C. 223 (1940); *Resources Corporation International*, 7 S.E.C. 689, 736 (1940); *Poulin Mining Company Limited*, 8 S.E.C. 116, 621 (1940); *Automatic Telephone Dialer Inc.*, 10 S.E.C. 698, 706 (1941); *F. G. Masquelette & Co.*, Accounting Series Release No. 68 (July 5, 1949). Cf. *Continental Distillers & Importers Corp.*, 1 S.E.C. 54, 77 (1935); *Brandy-Wine Brewing Company*, 1 S.E.C. 123 (1935); *Snow Point Mining Co., Inc.*, 1 S.E.C. 311, 315-6 (1936).

in the permit is there any use of the words "promotion services." Respondents argue that this, as well as two intra-office memoranda of the California Division of Corporations which recited the license agreement as the consideration for the stock, shows that that Division understood the applications for permits to mean that the license agreement was the sole consideration for the stock and did not think that promotion services were in any way involved. Respondents assert that they were entitled to put great weight on the finding of the California Commissioner of Corporations, as a disinterested public official charged with the duty of protecting investors, that the stock was issued for the license agreement. They emphasize that the permit was required to be made a part of the subscription forms submitted to investors.

Respondents also stress that at the time they undertook the engagement they were informed by either Thomas or his counsel that the license agreement was the consideration for the shares, that the corporate minutes and records stated that the license agreement was the consideration, that neither Thomas, Street nor any of the various counsel for Thomascolor with whom respondents had extensive contacts throughout the period of their audit ever indicated that there was any consideration other than such agreement or raised any question with respect to the item under discussion, that drafts of financial statements were submitted to counsel and others and no comment was made, and that the narrative portion of the draft of registration statement which had been prepared by counsel and approved by the Board of Directors of Thomascolor described the assignment of the license agreement as being in consideration of the issuance of the stock in question.

We cannot agree with respondents' position that the evidence that no promotional services were involoved was so clear that they were justified in accepting it as a fact without further inquiry. It was evident that the stock in question had been issued in connection with the promotion of the company, particularly in view of the facts that it had been treated as "promotional shares" by the California Division of Corporations and had been referred to as "promotion stock" by various persons associated with the enterprise. In such circumstances and in the light of the many cases in which problems had arisen with respect to the description of promotional items,[13] there was an affirmative duty on respondents as accountants practicing before this Commission to make certain that the stock was not issued for promotion services. In our opinion respondents unjustifiably placed too much weight on the language of the permit as indicating that the license was the sole consideration for the issuance of the stock. Adequate inquiry into the background of the issuance of the permit was not made. The record shows that representatives of the San Francisco office of the respondent firm visited the office of the California Division of Corporations for the purpose of obtaining information about other subjects and could have easily inquired about the background of the issuance of the permit. Donald A. Pearce, Assistant Commissioner of Corporations of California who testified in these proceedings pointed out that the permits referred to, and were qualified by, the applications, and that the applications referred to the shares issued as promotional shares and to the four individuals named above as promoters. Pearce stated that Street had told him and he had always understood that the shares had been issued for promotional services and would have so advised the respondents if they had asked him.

The failure of counsel and others to mention the subject of promotion services voluntarily was not sufficient excuse for not making a complete inquiry. Respondents' duty went further and required at least that they ask direct questions as to the existence of promotion services instead of relying on the silence of those persons on that matter or on general statements or recitals that the license agreement was the consideration for the stock. From the evidence in the record, it is clear that the four promoters and counsel, as well as Pearce, understood that the stock had been issued for

[13] See cases cited in n. 12, *supra*.

promotional services. The four promoters had entered into a written agreement for the division of the promotional stock among them which recited as the reason for such division "the services and contributions made by them for the benefit of the promotion." If respondents had made proper inquiry into the reasons why shares of promotional stock were issued to four promoters for an ostensible consideration of the assignment of a license agreement by only one of them, such inquiry should have led them to this agreement which on its face disclosed that the consideration for the assignment of the license agreement included promotional services rendered for the benefit of Enterprises.[14]

A memorandum prepared by Thomas' counsel in January 1947, and furnished to respondents summarizing the situation and outlining a proposed course of procedure, which was a document evidently prepared with considerable care, state that the 187,000 shares were issued to Thomas and his associates, "either in consideration of the assignment of the patent license agreement between the Nevada Corporation and Street, or as promotional stock," and "apparently in payment of organization and promotion." The respondents assert that this memorandum was "preliminary" and was prepared when counsel did not have full information, particularly copies of the permits issued by the California Division of Corporations. In any event, however, it afforded a further reason for a full inquiry by respondents to ascertain whether promotional services were in fact involved.

On the basis of our examination of the record we find that respondents failed to follow proper accounting principles and practices in their treatment of the item "License Agreement" in the Enterprises balance sheet certified by them.[15]

FOOTNOTE EXPLANATIONS

The order instituting these proceedings alleges that the footnote explanations to the balance sheets in the registration statement as originally filed were inadequate because of failure to provide and to present properly important factual data.

It is alleged that the footnotes are inadequate in failing to disclose the status in liquidation of the two classes of Thomascolor stock. At the time the registration statement was filed, Thomascolor had outstanding approximately 500,000 shares of class A and 100,000 shares of class B common stock which had been issued to acquire the assets of its predecessors. The charter then provided a preference in liquidation for the class A stock to the extent of $5 per share, after which the class B stock as a class would receive an amount equal to the aggregate paid to the class A shareholders, with any amount remaining being divided equally by the two classes. Under the registration statement, 1 million shares of class A stock were to be sold to the public for $10 per share. As a result of the substantial discrepancy between the sale price and the liquidation preference, as much as $5 million of the $10 million to be paid by the public purchasers of class A stock might be distributed in the event of liquidation to the holders of the previously issued class A stock and to Thomas as the holder of the class B stock. The significance of this situation is highlighted when consideration is also given to the dividend privileges of the two classes of stock. It appears that the excess to be paid by the public purchasers of the class A stock over its par value of $5 per share would be credited to paid-in surplus and such surplus could under

[14] We cannot accept respondents' argument that the services referred to in the agreement were personal services rendered to Thomas and not to Enterprises. This interpretation is inconsistent with both the language of the agreement and the evidence in the record that Street's efforts were directed toward effecting a financing of the Thomas enterprises.

[15] The designation of "License Agreement, $935,000" was also made in the footnote to the item Patents and Patent Applications in the Thomascolor balance sheet, and respondents were similarly deficient with respect to it. Having found a lack of arm's-length dealing in the acquisition of Enterprises' assets by Thomascolor we cannot accept respondents' contention that, whatever its nature in the balance sheet of Enterprises, this item lost its identity upon the acquisition of that corporation's assets by Thomascolor and was properly attributable to the latter's Patents and Patent Applications account.

Delaware law be distributed as dividends. However, under the charter, the class A stockholders had a preference to receive, as a class, only the first $1,250,000 of dividends declared and paid by Thomascolor, after which the class A stockholders would be entitled to only one-half of all future dividends, the other half being payable to the class B stock.

Respondents cite Rule 3-18(d)(3)[16] of our Accounting Regulation S-X, which requires disclosure in the financial statements of the extent to which the liquidating value of preference stock is other than its par or stated value and the effect thereof on surplus, and contend that the rule implies that no disclosure was necessary in this case since the par and liquidating values of the class A stock were the same at the time the financial statements were originally filed. However, the principal reason for this rule is to require a presentation which will reflect fully and adequately the equities of the various classes of stockholders and to indicate the status of surplus particularly from a dividend standpoint. Respondents should have recognized that it is equally important to reflect in the financial statements the extent to which the amount paid or to be paid by preference stockholders exceeds the liquidating value of their shares and the extent to which such excess would be available to others than those preferred stockholders. Such disclosure was necessary in order that the financial statements should not be misleading,[17] and failure to make this disclosure constituted a material omission. Although, as respondents point out, the liquidation preferences are set out in the narrative part of the prospectus, we do not regard this as sufficient reason for failure to describe them in the financial statements.

It is also alleged that the footnotes are inadequate in failing to set forth complete data as to Thomas' ownership and voting power of shares of class A stock and of all the class B stock. Respondents urge that such disclosure was not called for because of the evidence that they relied on as showing that the transactions as between Thomas and public investors were at arm's-length. However, as shown above, respondents were not justified in resting their accounting presentation on the so-called elements of arm's-length bargaining in this case, and the nondisclosure in the financial statements of the identity of Thomas as the controlling person, of both registrant and of the persons or corporations from whom the registrant acquired property, resulted in making those financial statements materially deficient and misleading.[18]

The order for proceedings further alleges that the footnotes were inadequate in failing to present the complete facts as to the possible reacquisition by Thomascolor of 139,600 shares of its class A common stock. As we have stated above this transaction was not properly reflected on the balance sheet. While the impropriety of including the par value of such shares in the item Patents and Patent Applications would not have been cured merely by additional footnote disclosure, the footnote explaining the situation was in any event inadequate. It merely stated that Thomascolor had entered into an agreement for the acquisition for a nominal consideration of 139,600 shares of the promotion stock of Enterprises subject to the approval of the California Commissioner. The footnote should have also stated that if such approval were obtained and the restrictions on these shares were removed, Thomascolor, upon the liquidation of Enterprises, would acquire 139,600 shares of its own class A stock, and that Thomascolor had agreed to cancel such reacquired shares. In addition, the footnote should have stated the effect such transaction would have on the accounts, and should have identified the parties to the agreement as cer-

[16] This rule has since been renumbered Rule 3-19(d)(3). Accounting Series Release No. 70 (1950). (See p. 143.)

[17] See Rule 3-06 of Regulation S-X.

[18] We have repeatedly held that where property of a corporation is stated in its balance sheet at an amount determined in a transaction in which the transferor was a person in control of the corporation, such facts must be disclosed in the balance sheet. *Continental Distillers & Importers Corp.*, 1 S.E.C. 54, 78 (1935); *Rickard Ramore Gold Mines, Ltd.*, 2 S.E.C. 377, 389-90 (1937); *Platoro Gold Mines, Inc.*, 3 S.E.C. 872, 880-1 (1938); *Thomas Bond, Inc.*, 5 S.E.C. 60, 64 (1939); *MacDonald Mines, Ltd.* (N.P.L.), 7 S.E.C. 223, 226-7 (1940); *Automatic Telephone Dialer, Inc.*, 10 S.E.C. 698, 706-7 (1941).

tain of the promoters of Thomascolor.

We cannot agree with respondents' contention that good accounting practice did not require it to supply detailed matter of this nature and that it properly did not do so because such detail would have unduly called attention to the possible benefits from reacquisition of the stock and have created an impression that such reacquisition was assured. Full disclosure of transactions between management and the registrant is required in the financial statements whether the facts disclosed might be interpreted as favorable or unfavorable,[19] and a carefully worded explanatory footnote would preclude misinterpretation. Particularly, if respondents had followed the proper accounting procedure we have outlined above, namely, showing a smaller patent account and a stock discount item in the amount of the par value of the shares involved, presentation of the details of the transaction would not be subject to any misleading inferences.

It is also alleged that the footnote explanations to the various balance sheets certifed by respondents were inadequate in failing to present complete data as to alleged known costs and the extent of alleged unknown costs to affiliated transferors of property to Thomascolor and its predecessors whose balance sheets were certified by the respondents. Respondents attempt to distinguish the precedents relied on by the Office of the Chief Accountant in support of this charge [20] on the ground that they involve cases where there was an absence of arm's-length dealing and where the lack of adequate disclosure was with respect to figures included in the financial statements, whereas in the instant case, respondents assert, the transactions in question were not lacking in arm's-length and not arbitrary and the costs of Thomas and the other allegedly affiliated transferors were not required to be set forth and did not appear in the financial statements or anywhere else in the registration statement as originally filed. They contend that for those reasons it was not incumbent upon them to refer to such costs or to the inability to verify certain of them.

We cannot, however, as our previous discussion demonstrates, accept respondents' contention that there were sufficient elements of arm's-length in the transactions by which Thomascolor or its predecessors acquired interests or property from Thomas and the other promoters or by which Thomascolor acquired the remaining interests in its predecessors that the stated consideration could be viewed as not having been arbitrarily determined. Accordingly, apart from the impropriety of respondents' accounting treatment to which we have already referred, respondents should in any event have disclosed the costs of affiliated transferors in these transactions and their inability to determine or verify them, where such was the case.[21] We find that their failure to do so, particularly in view of the promotional nature of the situation being dealt with, constituted a disregard of the accounting requirements under the circumstances.

For the above reasons we conclude that the

[19] *Cf.* Accounting Release No. 37 (November 7, 1942) (See p. 51); *Red Bank Oil Co.*, Securities Act Release No. 3110 (January 4, 1948), pp. 8, 15, 16.

[20] *Platoro Gold Mines, Inc.*, 3 S.E.C. 872 (1938); *Breeze Corporations, Inc.*, 3 S.E.C. 709 (1938); *Petersen Engine Co., Inc.*, 2 S.E.C. 893 (1937). *Cf.* Accounting Series Release No. 13 (1940) (see p. 12); Accounting Series Release No. 37 (1942).

[21] In the financial statements as subsequently amended, the notes to the Thomascolor and Enterprises balance sheets were amended to indicate that the cost to Thomas of $149,000 of equipment purchased from him by Enterprises was not susceptible of verification. A note was also added to the Thomascolor balance sheet indicating that of the 40 percent minority interest in Scientific acquired by Thomascolor for 40,000 shares of $5 par value class A common stock the cost to those holding 29½ percent was $42,000 and the cost to those holding the remaining 10½ percent, which was shown on the partnership records at $15,000, was unknown to the company. This information and similar information with respect to Thomas' other alleged costs, the costs if any incurred by the promoters in obtaining the license agreement for Enterprises and the alleged costs in connection with the development of patents held by Nevada should have been furnished in the financial statements as originally filed. While we permitted the registration statement to become effective without insisting on so full a presentation, the registrant was advised at that time that the financial statements, as amended, were not entirely satisfactory, and we did not regard the remaining inadequacy as to this item as sufficiently material to keep the statement from becoming effective.

footnote explanations were inadequate in the respects set forth. [22]

RULINGS ON EXCEPTIONS

During the course of the proceedings exceptions were taken to rulings of the hearing examiner overruling objections to certain questions and admitting and excluding various exhibits. In general, the qestion involved in these rulings is whether proffered material was available to respondents at the time of their audit. We have carefully examined the evidence involved and the rulings of the hearing examiner and conclude that the exceptions should be overruled.

CONCLUSION

As has been shown, respondents' accounting treatment and disclosures were materially inadequate and the financial statements certified by them were materially misleading in important respects. Those deficiencies resulted directly from respondents' failure to follow generally accepted accounting and auditing principles and practices and professional standards, and rules, regulations and prior decisions of this Commission. Under the circumstances we find that respondents have engaged in improper professional conduct within the meaning of Rule II(e).

[22] Respondents have contended that in view of the disclosures which they made in the financial statements with respect to the Patents and Patent Applications item their accounting treatment should be accepted under our Accounting Release No. 4 (April 25, 1938) (see p. 3). That release provides, in part: "In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant *and the position of the Commission has not previously been expressed in rules, regulations or other official releases of the Commission,* including the published opinions of its Chief Accountant." (*italics ours*). We have noted in our discussion of the patent item and the extent of the footnote disclosure required in connection with it that Commission precedents have expressed disapproval of the type of accounting treatment and disclosure adopted by the respondents. In view of those precedents, Accounting Release No. 4 cannot aid respondents in this case.

Respondents' disregard of their professional obligations is inexcusable. It was clear from the material examined by them that attempts had been made over a long period of time to develop and exploit the inventions covered by the patents and large sums of money had been expended without any evidence of commercial success. Under the registration statement the public was to be asked to invest $10 million more in this highly speculative venture. It was against this background that respondents prepared and certified balance sheets which grossly overstated intangible assets by the arbitrary use of the par and stated value of shares of stock issued to acquire the assets, including shares expected to be reacquired from promoters as a donation, and attributed to apparently potentially productive items material amounts which should have been shown as promotion services.

Respondents have steadfastly maintained that their presentation and procedures were reasonable and justified. They insist that they acted in good faith, that the situation presented was a unique one and if we find any error on their part it would reflect no more than a difference of judgment as to method of handling such situation, and that no willful or deliberate disregard of our rules or accepted accounting practice was involved. It is also stressed that Stewart enjoys an excellent reputation in his profession and has never had any prior question raised with respect to his accounting activities.

We accept respondents' assertion that they acted in good faith and accordingly do not find any willfulness in the sense referred to by them. However, in a disciplinary action under Rule II(e) we are not required to make such a finding. We are of the opinion that respondents' accounting work in connection with the Thomascolor registration statement was so deficient in the respects set forth above, as a result of their failure to give this professional undertaking the degree of care and inquiry it demanded under the circumstances, that disciplinary action is required.

After careful consideration of all pertinent factors, including those stressed by respondents, we have reached the conclusion that respondents Haskins & Sells and Andrew Stewart should be denied the privilege of practicing before the Commission for a period of 10 days beginning 30 days from the date of the issuance of our order.

An appropriate order will issue.

By the Commission (Chairman Cook and Commissioners McEntire and Rowen), Commissioners Adams and Rossbach not participating.

Orval L. DuBois,
Secretary.

ORDER SUSPENDING PRIVILEGE OF PRACTICE BEEORE THE COMMISSION, IN THE MATTER OF HASKINS & SELLS AND ANDREW STEWART, FILE NO. 4-66 (RULES OF PRACTICE—RULE II (E)).

The Commission having instituted a proceeding pursuant to Rule II(e) of its Rules of Practice to determine whether respondents' Haskins & Sells, a partnership, and Andrew Stewart, a partner therein, certified public accountants, should be denied, temporarily or permanently, the privilege of appearing or practicing before the Commission; and

A hearing having been held at which respondents appeared with counsel, and respondents having waived a recommended decision by the hearing examiner, and briefs having been filed and oral argument heard; and

The Commission having considered the record and having this day issued its Findings and Opinion herein;

It Is Ordered, pursuant to Rule II(e) of the Rules of Practice, that Haskins & Sells and Andrew Stewart be suspended from appearing or practicing before the Commission for a period of 10 days beginning 30 days from the date hereof.

By the Commission.

Orval L. DuBois,
October 30, 1952 *Secretary.*

RELEASE NO. 74

May 29, 1953

INVESTMENT COMPANY ACT OF 1940
Release No. 1868

SECURITIES ACT OF 1933
Release No. 3475

SECURITIES EXCHANGE ACT OF 1934
Release No. 4860

Adoption of Amendments to Certain Rules of Article 6 of Regulation S-X

On March 16, 1953, the Commission announced that it had under consideration proposed amendments to certain rules of Article 6 of Regulation S-X which governs the form and content of financial statements of management investment companies other than those which are issuers of periodic payment plan certificates required to be filed under the Investment Company Act of 1940, the Securities Act of 1933 and the Securities Exchange Act of 1934. It invited all interested persons to submit views and comments on the proposed amendments. The Commission has considered the comments and suggestions received, and has determined that the proposed amendments should be adopted with certain modifications which have been incorporated in the amended rules.

PURPOSE OF AMENDMENTS

The purpose of the amendment of Rule 6-08 of Article 6 of Regulation S-X is to segregate the effect of changes in "Undistributed Net Income" account from other changes in net assets and to permit the showing of certain items included presently in the rule subordinate to a general caption "Capital" or "Principal" in order to distinguish more sharply between capital and income.

Rule 6–09 has been amended in order to provide a simple and self-explanatory title, to clarify the instructions and to distinguish here again more sharply between capital and income.

The use of the optional *Statement of Sources of Net Assets* prescribed by Rule 6–09 is extended to closed-end companies having only one class of outstanding capital securities and reflecting their assets at value.

To avoid misinterpretation of the qualifying parenthetical phrase "(excluding gain or loss on investment)" presently shown in Rule 6–09–6, which was understood by some as calling attention to the existance of additional income or loss and by others as emphasizing the exclusion of such gains or losses from income, the qualifying phrase has been omitted from Rule 6–09–6 and Rules 6–03–21(a)(2), 6–04, 6–04(b)–7 and 6–07–2, which latter four rules also include the qualifying phrase. Further, since the rules require that all three elements [1] of performance during the period be separately stated but assembled on one page, it appears appropriate to discard the qualifying phrase in the above rules.

[1] Net income from interest, dividends and other income; net realized gain or loss on investments; and increase or decrease of unrealized appreciation or depreciation of assets.

RELEASE NO. 75*

May 29, 1953

INVESTMENT COMPANY ACT OF 1940
Release No. 1869

SECURITIES ACT OF 1933
Release No. 3476

SECURITIES EXCHANGE ACT OF 1934
Release No. 4861

Adoption of Amendments to Certain Rules of Article 6 of Regulation S–X

RELEASE NO. 76**

November 3, 1953

SECURITIES ACT OF 1933
Release No. 3491

SECURITIES EXCHANGE ACT OF 1934
Release No. 4958

INVESTMENT COMPANY ACT OF 1940
Release No. 1920

Adoption of Rule 3–20(d) of Article 3 of Regulation S–X

On February 25, 1953, the Commission announced, in Securities Exchange Act of 1934 Release No. 4803–X, that it had under consideration the adoption of a proposed rule concerning treatment of compensation in the form of stock options granted by corporations to their officers and employees. All interested persons were invited to submit views and comments on the proposal.

The rule was proposed because of the apparent lack of unanimity of opinion among corporate and public accountants as to the appropriate manner in which the amounts, if any, to be charged against income representing

* Text of this release omitted.

** The text of the Commission's action and the text of the rule has been omitted.

compensation to recipients of stock options should be determined. The principal point of disagreement was the time at which the determination should be made. Persuasive arguments were advanced for each of three dates, i. e., when the options were (1) granted, (2) exercisable, or (3) exercised.

The Commission considered the comments and suggestions received and concluded that the propriety of using any one of these dates in all cases had not been established, and that determination of, and accounting for, cost to the grantor based upon the excess of fair value of the optional shares over the option price at any one of the three dates advocated might, in some cases, result in the presentation of misleading profit and loss or income statements.

In these circumstances the Commission deemed it inappropriate to prescribe a procedure for determining the amount of cost, if any, of these stock options to be reflected in profit and loss or income statements filed with the Commission. However, in order that investors may be apprised of the monetary significance of the concessions made by registrants to officers and employees through the granting of stock options, the Commission announced, on August 25, 1953, in Securities Exchange Act Release No. 4926–X, a proposal to adopt a rule to be added to Regulation S–X, and to be designated Rule 3–20(d), which will require full and complete disclosure of all stock option arrangements in financial statements filed with the Commission.

Only a small number of comments were received with respect to this latter proposal, and the Commission has determined that the rule should be adopted with certain minor modifications in wording. The principal change in the rule as adopted is the addition to paragraph (2) of the sentence "The required information may be summarized as appropriate with respect to each of these categories."

RELEASE NO. 77

February 19, 1954

Disposition of Rule II(e) proceedings against certifying accountant alleged to have failed to observe appropriate audit requirements as to financial statements of broker-dealer under Rule X–17A–5 under the Securities Exchange Act of 1934.

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

The broker-dealer in question, a partnership engaged principally in the commodities brokerage business, had one branch office which was managed by a junior partner. The accountant, after consulting with the senior partners in the broker-dealer firm, decided that it would not be necessary to visit and audit the branch office in order properly to audit the firm's financial statements because of their belief that all of the assets and liabilities of the branch office were reflected in the books of the principal office and were susceptible to verification at the latter office. The accountant qualified the opinion expressed in the certificate, that the financial statements fairly presented the financial position of the broker-dealer, with the statement that its examination of the branch office was "limited to a verification of reported assets and liabilities." The senior partners in the broker-dealer firm ultimately discovered that the partner operating the branch office had reported fictitious purchases and sales of commodities and fictitious profits thereon to the principal office, thereby resulting in an overstatement of the broker-dealer's assets on its books and the consequent falsity of its financial statements filed with the Commission.

The qualification in the accountant's certificate as to the scope of the examination appeared in the financial reports filed with both the New York Stock Exchange and the Commission for the years 1947 through 1951, and neither the Exchange nor the Commission's staff made any comment thereon. The accountants sent confirmation forms to customers having open balances according to the broker-dealer's books and although a high percentage of such confirmation forms were returned, none was received challenging the accuracy of the stated balances. The local bank used by the branch office confirmed certain liabilities and an account of the broker-dealer firm but such confirmation did not include information as to an account of the junior partner in that bank which was carried in his own name but was used in connection with the firm's transactions.

Although it was not established that examination of the branch office would necessarily have resulted in discovery of the fictitious purchases and sales, it appeared that an investigation of the junior partner's bank account would have led to such discovery. While the local bank denied that it was under a duty to report information in its posession concerning the junior partner's account to the accountant, the Commission recognized that the fact that the accountant did not receive such information contributed in considerable measure to the failure to discover the existence of the fictitious transactions.

The Commission was of the opinion that while more thorough auditing procedures might have resulted in the discovery of the fictitious commodity transactions, the record in this case did not disclose a lack of the requisite qualifications to represent others or a lack of integrity or improper professional conduct within the meaning of Rule II(e), and accordingly, the proceedings against the accountant were dismissed. The Commission, in taking this action, noted that no member of the public suffered any loss as a result of the transactions involved.

RELEASE NO. 78

March 25, 1957

Findings and Opinion of the Commission In the Matter of Touche, Niven, Bailey & Smart, et al., proceeding pursuant to Rule II(e), Rules of Practice.

ACCOUNTING—PRACTICE AND PROCEDURE

Suspension of privilege to Practice before the Commission

Lack of Independence by Accountant

Failure to Comply with Accepted Accounting Practice

In a proceeding under Rule II(e) of the Commissions Rules of Practice, where a firm of certified public accountants certified financial statements filed with the Commission which were materially misleading in that, among other things, the balance sheet understated reserves for uncollectible accounts, overstated current assets, and listed as due from customers material amounts which represented advances to subsidaries, and the income statement made insufficient provision for losses on uncollectible accounts, and the firm and two partners who participated in the preparation and filing of the statements improperly relied upon unsupported representations of management with respect to these matters, *held*, the firm and the partners engaged in improper professional conduct and their privilege to practice before the Commission should be suspensed for 15 days.

APPEARANCES:

Edmund H. Worthy, for the Office of the Chief Accountant of the Commission.

Eustace Seligman, Howard T. Milman, Jerome Gotkin, Bruce A. Hecker, and *Sullivan & Cromwell,* for respondents.