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 suspended 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.

FINDINGS AND OPINION OF THE COMMISSION

These are proceedings instituted under Rule II(e) of our Rules of Practice[1] to determine whether the privilege of appearing or practicing before us should be denied, temporarily or permanently, to Touche, Niven, Bailey and Smart ("TN"), a partnership of certified public accountants, to Henry Eugene Mendes and William W. Werntz, partners in said partnership, and to Oscar Blomquist, an individual formerly employed by said partnership.[2]

After appropriate notice, private hearings were held. Respondents and the Office of the Chief Accountant of the Commission ("Staff") submitted proposed findings and briefs in support thereof, and reply briefs. The hearing examiner submitted a recommended decision, recommending that the proceedings be dismissed as to respondent Blomquist, but that the other respondents be denied the privilege of practicing before us for a period of 15 days. Thereafter, respondents filed exceptions and brief in support thereof, and we heard oral argument. On the basis of an independent review of the record, we make the following findings and conclusions.

The issues in these proceedings relate to TN's certification on March 19, 1948, of the financial statements of Seaboard Commercial Corporation ("Seaboard") which were included in Seaboard's annual report for its fiscal year ended December 31, 1947, filed with this Commission on Form 10-K pursuant to Section 13 of the Securities Exchange Act of 1934. The order initiating these proceedings alleges (1) that those financial statements were materially misleading, particularly in that the balance sheet showed an inadequate reserve for losses and contingencies, overstated current assets, and included amounts due from subsidiaries as amounts due from customers, and the income statement made insufficient provisions for losses on uncollectible accounts, and (2) that the respondents failed to comply with generally accepted auditing standards and disregarded generally accepted accounting principles, and rules and regulations of this Commission.

HISTORY AND BUSINESS OF SEABOARD AND ITS MAJOR ACCOUNTS

Seaboard

Seaboard began business under that name in 1934 at which time it was engaged principally in the wholesale and retail automobile financing business. In 1937 a Factoring and Accounts Receivable Division ("Receivable Division") was established, for the purpose of purchasing accounts receivable of manufacturers and wholesalers and this became an increasingly important part of Seaboard's business. It was Seaboard's policy to keep its advances below the face amount of the security, the difference being termed a margin, to keep its accounts receivable portfolio in a high state of liquidity, with average maturities of 30 to 60 days, and to maintain diversifications as to amounts, industries, and geographical location.

In 1939, Seaboard began engaging in inventory financing. After the entry of the United States into war in 1941, Seaboard retired entirely from the automobile financing field and began to finance war contracts, making collateralized loans, primarily against receivables, for working capital purposes. In 1942, Seaboard acquired ownership of a manufacturing company, and thereafter during the war years, Seaboard's activities were concentrated principally in its accounts receivable operation, business advisory service in connection with financing war production, and wholly-owned manufacturing companies.

During the war years Seaboard's advances to manufacturers, principally engaged in war work, were so reduced that Seaboard was able

[1] Rule II(e) provides:

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

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

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

[2] Another named respondent, Carl F. Hall, who was a TN partner, died in December 1956.

to retire all its debt for borrowed money and at December 31, 1945, its bank indebtedness was only $750,000. However, thereafter its borrowings increased substantially, and by December 31, 1947, its current liabilities on notes payable to banks had reached $4,600,000.

By the time TN began their audit at the end of 1947 there had been a drastic change in Seaboard's condition as a result of a heavy concentration of Seaboard's funds in six companies which had experienced increasingly serious financial difficulties in 1946 and 1947. As of December 31, 1947, Seaboard had stated assets of $7,987,317 of which $5,238,855 represented advances to and investments in these six companies. Of the latter amount $4,107,820 consisted of advances by Seaboard to five manufacturing companies (and related companies), Amity Manufacturing Corporation ("Amity"), Bridgeport Safety Emery Wheel Company, Inc. ("Bridgeport"), Ripley Company, Inc. ("Ripley"), Technical Devices Corporation ("Technical"), and Varet Knitting Mills, Inc. ("Varet"). Only $335,866 of the $4,107,820 represented advances against receivables, whereas $2,934,813 was against inventories, which are less desirable as security. Moreover, contrary to Seaboard's practice in previous years of having average margins of from 16 percent to 35 percent on advances against receivables and inventories, all these loans had very small margins, and some of the inventory loans had none. In addition to the advances to these five companies, as of December 31, 1947, Seaboard also carried an investment of $512,500 and in advances of $618,535 to Coastal Machine Works, Inc. ("Coastal"), a wholly-owned manufacturing subsidiary, and about $318,000 of those advances were unsecured.

These six companies received business advisory assistance from Seaboard and changes of management were effected in an effort to improve the adverse situations encountered. Nevertheless these companies required increased advances, their margins of security decreased or disappeared, and they incurred losses during 1947. Seaboard's financial position as of December 31, 1947, was so closely bound up with that of these six companies that for a proper understanding of the major questions presented in connection with TN's audit it is necessary to look first at the history and financial condition of these companies.

Amity

Amity's borrowing from Seaboard began in 1944 with a loan of $13,000 to finance its wartime production of flame throwers. After the successful completion of financing of Amity's wartime production, Seaboard undertook to finance Amity's peacetime activities with an initial loan of $23,000. Amity's efforts to produce peacetime products were never successful despite almost unlimited financial assistance from Seaboard, the assistance of the Seaboard business advisory service, and changes in Amity's management instigated by Seaboard. Amity suffered increasing losses throughout 1946 and 1947, and Seaboard made increasing advances. Seaboard's advances increased to $142,000 at May 15, 1946, to $323,000 at October 31, 1946, to $946,000 at October 31, 1947, and to over $1 million at December 31, 1947. For the year ended October 31, 1947, Amity had losses of $508,106 on sales of $128,369, and, despite an earlier write-up of assets on the basis of a reappraisal, as of October 31, 1947, it had a deficit of $435,477.

Although Seaboard officials had made optimistic statements in 1946 about Amity's new plans and prospects for profits and reduction of debt, losses by Amity and advances by Seaboard continued to increase. By February 4, 1948, Amity's debt to Seaboard had increased to $1,097,225.[3]

Bridgeport

Seaboard's initial advance to Bridgeport, a company engaged in the manufacture of grinding wheels and machinery, was made in May 1945, in the amount of $156,802. Up to

[3] For the 3 months ended January 31, 1948, Amity had sales of $21,641 and a loss of $131,439, and for the 6 months ended April 30, 1948, a loss of $249,683 was sustained on sales of $30,162. Amity was declared bankrupt in October 1948 and Seaboard realized about $40,000 on its then advances of about $1,300,000

this time Bridgeport had apparently been operating profitably and had a substantial net worth.[4] Thereafter Bridgeport incurred continous losses, its inventories increased to a point where they substantially exceeded annual sales, and Seaboard's advances to it increased.

Although as early as January 1946, when Seaboard's advances to Bridgeport totaled only about $340,000, Robert P. Babcock, president of Seaboard, stated that Seaboard had advanced Bridgeport more than had been contemplated and Seaboard officials issued optimistic statements as to Bridgeport's prospects, its condition worsened and large additional sums were advanced. In 1946 fixed assets were written up about $197,000 following a reappraisal request by Seaboard, and it was only after this write-up that Bridgeport was able to show a net worth of about $66,000 at the end of 1946.

Despite substantial increases in the indebtedness to Seaboard, Bridgeport operated continuously on a hand-to-mouth basis; in July 1947 its treasurer requested that Seaboard advance $1,776 so Bridgeport's cash balance of $224 could be increased to $2,000. Unaudited figures for the 11 months ended November 30, 1947, at which time Seaboard's advances were $1,347,000 showed Bridgeport with a net worth $645, losses for the 11 months of $74,723 on sales of $788,171, and an inventory of $1,068,096. Bridgeport did not have a cost system, efforts to install such a system having been unsuccessful, and its accounting records were inadequate and unreliable. In October 1947 a Seaboard staff auditor had reported a difference of $102,000 between inventories pledged as collateral as shown by Bridgeport's records and as shown by Seaboard's records. Such inventory was subsequently shown by Bridgeport's audited statements for the year ended December 31, 1947, to have been overstated by $635,000.[5]

Ripley

From May 1946 when Seaboard made an initial advance of $90,000 to Ripley, which manufactured toy calliopes and electronic products, to the time of the 1947 audit, Ripley did not make a profit on any of its products and required continuous advances. For the 1946 fiscal year ended February 28, 1947, Ripely's losses were $427,070 on sales of $396,964. Ripely's debt to Seaboard at that time was $350,632. Its net worth of $207,568 included an amount of $121,839 of surplus resulting from a reappraisal of assets.

As with the other companies, new management was resorted to, which in this instance was brought in early in 1947 and again there were optimistic statements that the new officials had constructive plans and were making progress. These plans included programs to substantially reduce Seaboard's advances by liquidating nonusable assets and selling Ripley's plant, but neither effort had been successful and for the 10 months ended December 31, 1947, Ripley had losses of $104,837 on sales of $220,715. Ripley's debt to Seaboard at December 31, 1947, was $308,402 [6] and at February 4, 1948, the indebtedness had increased to $330,592.[7]

Technical

Seaboard made its first loan to Technical, a company engaged in the manufacture of electronic and photographic products, in May 1946 in the amount of $160,000. Due to insufficient capital, inadequate production volume

[4] The term "net worth" as used herein means the excess of assets over liabilities and the term "deficit" refers to the excess of liabilities over assets.

[5] Bridgeport's audited statements for 1947, which were furnished Seaboard in May 1948, also showed that on sales of $846,511 for 1947 Bridgeport had a loss of $772,820; and that at December 31, 1947, it had a deficit of $728,764. Bridgeport's losses and debt continued to advance after December 31, 1947, and on June 30, 1948, it owed Seaboard $1,897,423 and had a deficit of $1,028,764. Bridgeport was placed in bankruptcy late in 1948 and Seaboard realized about $203,000 out of its then advances of approximately $1,800,000.

[6] The reductions from the amount due in February 1947 resulted from Ripley's assignment to Seaboard of a tax refund of $191,000 due Ripley on a carryback of Ripley's loss of $424,000 in 1946.

[7] On June 30, 1948, Ripley owed Seaboard $388,470 and had a deficit of $124,766. In September 1948, Seaboard forgave $150,000 of Ripley's indebtedness and reduced the interest rate on the remaining $231,000. In September 1952, Ripley still owed Seaboard about $40,000.

and other factors, Technical incurred losses through 1946 and 1947.

In December 1946, Seaboard officials were so concerned that Technical was advised that no delay in effectuating improvements in the situation could be tolerated. In February 1947, a survey of the Technical situation prepared by Seaboard officials listed numerous unfavorable factors and none of a favorable character. Notwithstanding continuous attention from Seaboard, Technical's losses continued and Seaboard made additional advances. As of December 31, 1947, Seaboard's advances had increased to $460,000 and Technical had a deficit of $57,900.

In the latter part of 1947 Seaboard officials again reported that the situation looked hopeless. Seaboard was instrumental in obtaining new management, which was accompanied by optimistic statements that now progress was being made and earnings could be anticipated and the Seaboard debt reduced. However losses by Technical and advances by Seaboard continued in 1948.[7a]

Varet

Varet was organized by Seaboard in November 1947 to acquire Fairhue Sportwear Co. ("Fairhue") and a predecessor, Varet Knitting Mills. Fairhue had been in the business of selling sweaters made by Varet Knitting Mills, and Seaboard made an initial advance to Fairhue in March 1946. Late in 1946 the market for sweaters collapsed and left Fairhue with an overstocked inventory of wartime yarn and sweaters. In August 1946, Seaboard's advances totaled $250,079, of which $175,000 was against inventory.

Efforts by Fairhue and Seaboard to dispose of the inventory were on the whole unsuccessful during the entire period from late in 1946 to the end of 1947, and Seaboard's advances increased to $257,942 at December 31,1946, at which time $225,250 was against inventory, and to $644,534 at December 31, 1947, at which time $434,148 was against inventory. The extent of the inventory problem is indicated by the fact that at September 30, 1947, Fairhue's sales for the previous 8 months totaled $39,351 while its inventory was $473,666.

Following unsuccessful efforts to sell a new line of knitted wear and the incurring of operating losses by Fairhue, Seaboard in November and December 1947 took over, through the medium of Varet and another new corporation, Knitted Specialties, Inc., the assets of Fairhue, consisting mainly of the frozen inventory. As of December 31, 1947, Varet owed Seaboard $644,534 and Knitted Specialties owed $38,027. Varet's debt to Seaboard increased to $651,069 at February 4, 1948.[8]

Coastal

Seaboard's relation to Coastal had its origin in an initial loan of $20,000 in March 1941 to Automatic Machinery Manufacturing Corporation ("Automatic Machinery"), a company in the machine tool business. Seaboard's advances to Automatic Machinery increased substantially and amounted to $1,918,357 in December 1942, at which time Automatic Machinery had a deficit of $107,579. Seaboard thereupon caused the stock of Automatic Machinery to be transferred to Bolton Manufacturing Company, a company engaged in making aircraft parts, whose outstanding stock Seaboard at the same time purchased for $412,500. Seaboard then organized a new company, Bolton Manufacturing Corporation ("Bolton") which took over the assets and liabilities of Bolton Manufacturing Company and merged with Automatic Machinery. The result of these transactions was that at the end of 1942 Seaboard owned all the stock of Bolton, representing an investment of

[7a] At the end of March Seaboard's advances totaled $573,000 and Technical had a deficit of $91,000; at the end of May the advances were $696,000 and the deficit was $122,000. Technical also was put in bankruptcy in late 1948, and Seaboard realized approximately $163,000 on its then claim of about $761,000.

[8] Although a new Varet management was installed in March 1948, Seaboard instructed Varet to cease operations and to liquidate. By June 30, 1948, Seaboard's claim totaled $700,139 and Varet had a net worth deficit of $450,000. As of July 31, 1948, Seaboard estimated that its proceeds from liquidation would amount to approximately $115,000 against then outstanding claims of $660,244, and set up a reserve for its anticipated loss of $545, 244.

$412,500, and that Bolton owed Seaboard $1,918,357, representing Automatic Machinery's obligation to Seaboard assumed by Bolton.

In July 1943 Seaboard organized Coastal, purchased its stock for $300,000 and advanced it $350,000. With these funds Coastal paid Bolton approximately $550,000 for certain of the latter's assets, and Coastal began the manufacture of machine tools and various machinery operations. Bolton used the $550,000 together with proceeds of certain contract cancellation claims to reduce its indebtedness to Seaboard to $841,000 at the end of 1943.

In the 6 months to December 31, 1943, Coastal had a loss of $49,889, and Seaboard in its report filed with us for 1943 carried its $300,000 investment in Coastal at $100,000, its cost less a reserve of $200,000. As a result of profitable wartime operations, by the end of 1945 the entire indebtedness to Seaboard of both Coastal and Bolton had been paid, and Seaboard eliminated the reserve and stated its investment in Coastal at $300,000. At the same time Seaboard set up a reserve of $200,000 for its investment in Bolton which with the end of the war had discontinued its production of aircraft parts, and stated its investment in that company at $212,500 instead of the previous $412,500.

Although by the end of 1946 Bolton had become inactive, Seaboard continued to carry its investment at $212,500, and its equity in Bolton was stated at $239,739. Bolton's assets, however included an amount of $179,747 due it on advances it had made to Coastal. Coastal, which had theretofore ceased its production of war goods, also owed Seaboard $607,286 and had suffered a loss in 1946 of $155,163 before a tax refund of $146,384, and a net loss of $8,779 after such refund. Coastal's losses increased in 1947 to $1,135,353 before tax refunds and $661,473 after such refunds. Its liabilities exceeded its assets by almost $134,006.

At this point Seaboard reshuffled its investments in Coastal and Bolton. In November 1947 it donated its investments in Coastal, carried at $300,000, to Bolton, and increased its stated investment in Bolton from $212,500 to $512,500. On December 31, 1947, Bolton wrote off as worthless its $300,000 investment in Coastal and its advances to Coastal of $191,419 by charges to its profit and loss account, as a result of which Bolton reported a net loss of $326,244 for 1947. Bolton took over Coastal's assets and liabilities, including indebtedness to Seaboard, which totaled $618,535 as of December 31, 1947, and assumed the name of Coastal.

At December 31, 1947, Seaboard carried its investment in Coastal at $512,500 and its advances to that company at $618,535. As of the same date, Coastal wrote up its assets by $439,378 to reflect their reproduction cost as determined by a reappraisal made a year earlier. By this write-up, Coastal's net worth was increased from $80,000 to $512,321. Thereafter Coastal's losses and Seaboard's advances continued to increase.[9]

The above is a brief summary of the mass of evidence and exhibits in the record showing the troubles faced by Seaboard at the time of TN's audit. The condition of the six companies described above had deteriorated drastically during 1947, and the sharp increase in Seaboard's advances to these companies was contrary to Seaboard's desires and expectations.[10] Notwithstanding numerous statements to or by Seaboard's management that the advances soon would be reduced or liquidated, the record is replete with instances of expressions by Seaboard of great concern over the size and condition of the accounts, not only throughout 1947, but even in late 1946, when the amounts advanced were substantially less than they were at the end of 1947. Not only did the advances increase in the face of generally increasing and continuing losses by

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[9] Coastal's indebtedness to Seaboard increased to $750,000 at June 1948, and its losses for the preceding 6 months were $195,000 before possible inventory adjustments which would have increased the loss. It appears that on the subsequent liquidation of Coastal, Seaboard realized on its total investment and advances of in excess of $1,100,000 only about $145,000 in cash and a mortage for about $120,000.

[10] There were other less important accounts, some of which will be referred to subsequently, which also presented problems as of December 31, 1947.

the six companies, but more and more such advances were against inventories, as well as other less desirable forms of collateral such as mortgages, or even totally unsecured, and less and less against Seaboard's traditional and preferred type of collateral, accounts receivable of the debtors. And this concentration on inventory financing was in the face of Seaboard's adoption at the end of 1946 of plans and programs to liquidate its inventory advances, and of an announcement by it in its annual report to stockholders for 1946 that its program for 1947 was to increase the business of its accounts receivable division and to reduce its inventory financing.[11]

With this background, we turn to a consideration of the circumstances of the audit made by TN as of December 31, 1947, the questions that developed therein, and the treatment of such questions by TN.

The Audit

Touche, Niven & Co., one of the three firms which consolidated on September 1, 1947, to form TN, had been the auditors of Seaboard for over 15 years. Thomas W. Brown, who, as a partner of Touche, Niven & Co., had supervised prior Seaboard audits, was the partner in charge of the 1947 audits.[12] Also initially assigned to the Seaboard audit, which was commenced in late December 1947, were respondents Werntz and Blomquist. Werntz, after serving for a number of years as Chief Accountant of this Commission, had joined one of the firms which formed TN, shortly before the formation of TN. At the time of the Seaboard audit, he occupied the status of principal accountant with responsibility for making many of the decisions with respect to the audit.[13] Blomquist was the senior in charge of the field work.

As a result of the information gathered by Blomquist in the course of the regular audit procedures, Brown and Werntz became aware of the drastic deterioration in Seaboard's condition during 1947, and instructed Blomquist to undertake certain supplementary audit procedures, consisting primarily of an examination of the credit files maintained by Seaboard on its major accounts. The data obtained showed that TN was faced with a situation quite out of the ordinary and differing greatly from prior audits. It showed that Seaboard was seriously involved in the six financially troubled companies described above, and that despite optimistic reports by Seaboard officers in 1946 and 1947 limits placed on advances to those companies had in many instances been exceeded, and there was a real possibility of substantial losses on these advances.

Brown and Werntz concluded that Seaboard's book reserve of about $119,000 for possible losses was clearly inadequate and that substantial amounts of receivables were improperly classified as current assets. After Blomquist completed his field work on February 16, 1948, he was asked to prepare an estimate of a reserved for probable losses, and he arrived at a figure of $1,453,551, not including any provision for Coastal, whose accounts TN audited directly. At about the same time, Werntz prepared a memorandum summarizing the information obtained regarding Seaboard's major accounts including Coastal.

Werntz's memorandum noted the shrinkage or disappearance during 1947 of the excess of advances to the six companies over the receivables and inventories securing such advances and that of the total advances to these companies of over $4,600,000 only about $336,000 was against accounts receivables whereas almost $2,600,000 was against inventories and the balance was unsecured. The memorandum stated that Amity owed Seaboard over $1 million, that Amity had lost $508,000 in the year ended October 31, 1947, and had a deficit, as of that date, of $435,600. As to Bridgeport, the memorandum showed that there was only approximately $1,000 of net worth as a cushion for Seaboard loans of around $1,467,000; that Bridgeport's unaudited financial statements at November 30, 1947, in-

[11] As of December 31, 1947, Seaboard carried total receivables of $5,700,000, of which $2,600,000 represented stated advances against inventory.

[12] Brown died in 1950 before the institution of these proceedings.

[13] Werntz became a partner of TN in 1950.

dicated an 11-month loss of $75,000 on sales of $788,000 and that Bridgeport's total stated assets of $1,592,000 included an inventory of $1,068,000; and that a Seaboard auditor had reported Bridgeport's inventory to be overstated by $102,694. With respect to Ripley, the memorandum recited that the last balance sheet made available to TN was that of July 31, 1946, that the primary problem was to secure at least twice the volume of sales that had thus far been obtained, and that operating losses continued into January 1948. Technical's latest available statements as of July 31, 1947, were described as showing an excess of liabilities over assets of $30,000 and May–July 1947 losses of $11,000 on sales of $115,000. Varet's substantially over-stocked inventory and the absence in Seaboard's credit file of any financial statements or other definite information as to Varet's financial status were also referred to. As to Coastal, the memorandum stated that TN's audit of that company for 1947 showed tentative figures for net assets of $502,758 after a write-up of fixed assets at reappraisal figures some $350,000 in excess of book values and that Coastal during 1947 had an $800,000 loss from operations, and it raised the questions of whether any part of the Coastal debt could be considered a current asset by Seaboard and whether Seaboard needed a reserve against its investment in Coastal. The memorandum concluded that the validity of the accounts and the propriety of their classification as current assets were extremely important questions.

These matters were discussed with Seaboard's management at a meeting held on March 1, 1948, at which Seaboard took the position that its book reserve of about $119,000 was adequate. Following the meeting and on the basis of the then available information, Brown arrived at an estimated reserve of $1,345,600, not including any reserve for Coastal, and in addition listed as noncurrent assets $1,374,000 of advances to the five companies plus $318,535 of advances to Coastal, or a total of $1,692,535. Werntz made similar notations, apparently on the basis of Brown's figures.

A series of further conferences with Seaboard's management culminated in the certification on March 19, 1948, of financial statements which reflected a reserve for losses and contingencies of $857,729, created by a charge to surplus of $750,000, and classified advances of $318,535 to Coastal and $641,713 to the other five companies as noncurrent assets.

The record shows that Blomquist's function in the Seaboard audit was to get the information required by the regular audit procedures and the supplemental instructions given him by Brown and Werntz and to prepare appropriate working papers and an estimated reserve figure. He had no part in the final decisions as to the amount of the reserves or the other matters in issue in these proceedings, did not participate in any of the meetings with the Seaboard management, did not participate in the preparation of the TN certificate, and did not know what conclusions had been reached by the other representatives of TN until after the completion of the financial statements and their delivery to Seaboard. Under the circumstances we conclude, as recommended by the Staff and the hearing examiner, that the proceedings as to Blomquist should be dismissed. For convenience, hereinafter references to respondents shall mean the firm of TN and its individual representatives other than Blomquist.

The Reserve for Losses

The major issues in these proceedings are whether the reserve of $857,729 for losses and contingencies included in the financial statements certified by TN was materially inadequate, and whether the respondents, in certifying to the statements including this reserve, failed to follow generally accepted auditing standards and procedures and failed to exercise an independent and informed judgment thereon.

Respondents do not deny that Seaboard's condition had deteriorated drastically in 1947, that its loans and advances were concentrated unduly in six companies which had very serious difficulties, that there were grave doubts the advances to these companies could be collected

in full, and that the information available to them in the course of their audit clearly indicated that a large reserve was needed. On the contrary, respondents contend that their audit procedures disclosed the seriousness of the situation and the need for a large reserve and that a large reserve—$857,000— was in fact provided. They contend further that the reserve was adequate on the basis of the facts available to them at the time of the audit, and that any attempt to attack the reasonableness of the reserve on the basis of the fact that Seaboard subsequently become insolvent and ultimately suffered losses greatly in excess of the reserve provided, is an improper attempt to judge respondents on the basis of hindsight.

Inadequacy of Reserve for Accounts other than Coasta

We turn first to a consideration of the question of the adequacy of the reserve for the advances to the five principal debtors, exclusive of Coastal, in the light of the information available to respondents in the January–March 1948 period during which the audit was conducted. As noted above, as a result of Blomquist's reports indicating the existence of serious difficulties in Seaboard and its principal accounts, he was instructed to undertake supplementary audit procedures and to prepare an estimate of the reserve required by Seaboard. Respondents, while commending the thoroughness of Blomquist's audit procedures, contend that his $1,453,551 estimate was only a tentative figure and that he might well have agreed to its reduction if he had obtained the additional information presented at the subsequent extended discussions with Seaboard.

Blomquist testified that his reserve estimate was based on all the information obtained by him from Seaboard's records and credit files and that he took into account, among other factors, that the advances to the principal accounts had steadily increased throughout 1947 and those companies had operating losses in 1947; that the service charges on the advances were generally being accumulated and in some cases the Seaboard directors had discontinued such charges because the companies could not pay them; and that the principal acoounts had no funds and the only payments they might make would be out of funds advanced by Seaboard. Blomquist further testified that he himself made no allowance for a reserve as to Coastal because he knew that TN also audited Coastal and he assumed his associates would take the factors presented into account. Blomquist gave Werntz his work papers containing his reserve calculations and discussed his figures with him several times. He testified that Werntz stated his estimated reserve was the starting point for the conference with Seaboard and that Seaboard would have to prove to TN that such reserve was wrong.

The first conference with the Seaboard management on March 1, 1948, was attended by Brown and Werntz for TN, and by Babcock, Andrew B. Rose, vice president, and Frederick L. Burns, secretary-treasurer, for Seaboard. The Seaboard representatives took the position that no reserve was required for any of the major accounts, with the exception of Varet, as to which they stated a reserve of $75,000 to $100,000 might be necessary. Brown and Werntz were further told that the loans to these companies were close to, or had already reached their peak, that the companies had turned the corner, and that very substantial reductions in the advances would be made prior to the end of 1948 and in some instances more immediately. However, no concrete facts to support these conclusions were presented, the representations of the Seaboard management consisting largely of expressions of confidence that the new managements of the debtors could work out the existing difficulties.

For example, with respect to Amity, it was stated that the head of Seaboard's advisory service had assumed the active management of Amity and Seaboard had every confidence that he would be able to cure the production and marketing problems which Amity had experienced in connection with its peacetime products and put Amity in a position in which it could reduce advances from Seaboard, that steps were being taken to achieve those objectives and it was felt that substantial orders for such products would be obtained, that investigations were in progress looking toward obtaining new products which it was

thought would enable Amity to attain a profitable volume, and that parts of the inventory would be liquidated to obtain as much cash as possible and Amity would concentrate on its remaining business.

The statements made regarding Bridgeport, Ripley, Technical and Varet were in a similar vein. Babcock's exposition of the future prospects of these companies was replete with such statements as that the new managements were experienced people and that he "believed" that under their direction the "troubles would be worked out," that "a program for the reduction of expenses" had been worked out, that Seaboard management "felt" that new products "would have an excellent market and would result in substantial and profitable business," that Seaboard "felt" that new management "would be able to place the company on a profitable basis" and was "interested in developing" what "looked to be a very promising product."

These representations of Seaboard's management were not substantially different from the information obtained by Blomquist. He testified that the minutes of the monthly meetings of Seaboard's board of directors repeatedly recited that the losses in the six companies were expected to end in the next month or shortly thereafter and that he also saw numerous references to future possibilities and expectations. He gave consideration to these stated expectations as well as to the fact that none of them had materialized.

Nor does it appear that Brown and Werntz were overly impressed with the information presented to them at the March 1 conference. As noted above, following the meeting Brown calculated a reserve of $1,345,600 exclusive of Coastal,[14] and Werntz copied Brown's reserve figures. Brown's calculation was entitled "Theoretical loss based on information presently available" and was composed of the following items: $485,000 for Amity, $60,000 for Bridgeport, $50,000 for Technical, $100,000 for Varet, $150,000 for "Tax claims," and $500,000 for "General (based on inadequacy last year)." At about the same time he made a similar calculation, arriving at a figure of $1,350,000 which he labled "Estimated loss based on available financial statements."

The record shows that for some time after the March 1 meeting respondents were still using an estimated or tentative reserve figure of $1,350,000. An audit memorandum prepared by Brown and Werntz in April 1948 states that following the March 1 conference and after discussions among TN partners a preliminary report of examination was prepared as a means of presenting TN's view to Seaboard, which "took exception to the classification of certain items as current assets and indicated a need for a substantial reserve for possible losses. Tentatively, the drafts of the certificate indicated outside limits of about $1,300,000 on the reserve and $1,500,000 for exclusions from current assets." A draft certificate prepared after March 1 stated that on the basis of the financial condition of the debtors a "substantial reserve, probably in excess of $1,350,000 is required," and that approximately $1,500,000 "should be excluded from current assets as not realizable within 1 year."

Respondents deny that the $1,350,000 figure was made known to the Seaboard representatives. However, Babcock, Rose and Burns all testified that the TN representatives first mentioned a figure in excess of $1 million as the amount of the required reserve. The Brown-

[14] The respondents contend that Brown's estimate should be reduced by $73,700 to reflect possible refunds of Federal income taxes resulting from carry-backs of losses. They also contend that Brown's computation included $150,000 as a reserve against the tax claims purchased by Seaboard from Bolton and Coastal and that this reserve against the tax claims was later determined to be unnecessary. They contend, therefore, that for comparison purposes Brown's estimated reserve was not $1,345,600, but $1,121,900. However, the possibility of a tax refund of $73,700 presupposed charging the additional reserve against the income account in order for Seaboard to show a loss. There is no evidence that Seaboard intended to do this, and in fact the increase in the reserve of $750,000 ultimately adopted was not charged to income but directly to surplus. Furthermore, it is not clear that no reserve for the tax claims was necessary; on the contrary, TN's certificate itself, in its final form, showed that the reserve provided was intended to cover possible claims arising from Seaboard's agreement to reimburse Coastal for any refunds required in connection with the tax claims assigned to Seaboard.

Werntz audit memorandum states that at the second meeting held on March 6th, Babcock and Rose again reviewed the financial status of the principal accounts "after examining the draft report." [15] But whether or not TN informed Seaboard of the $1,350,000 reserve figure, it is clear that it was TN's opinion that the required reserve was in the neighborhood of $1,350,000 up to March 12, when admittedly a draft certificate expressing this opinion was taken by TN to the conference with the Seaboard management.

Respondents have repeatedly characterized their initial figures as tentative, implying that they were therefore not signficant. In a sense all figures are tentative until financial statements are ultimately set up in final forms and certified. But this does not detract from the weight to be given respondents' figures as representing their best judgement at the time as experienced public accountants dealing with questions of the utmost importance in their audit.

Although no additional significant information was presented by Seaboard after March 1,[16] respondents subsequently receded from their opinion as to the size of the necessary reserve and gave Seaboard an unqualified certificate on the basis of a reserve of $857,729. Respondents urge that they properly gave consideration to the judgment of the Seaboard management as to the prospective earning power of the debtors. However, estimates of reasonably prospective earnings should be based on "past earning, adjusted to reflect the influence of changes which have already taken place and those that are reasonably foreseeable." [17] Respondents did not follow this course in adopting the $857,729 reserve figure.

Although the known earnings history of the six debtor companies was admittedly very bad, as to some of those companies respondents did not see current earnings figures and did not seek financial statements as of the end of 1947 or for January or February 1948. The latest financial statements seen by the respondents were those of October 31, 1947, for Amity, November 30, 1947, for Bridgeport (unaudited), July 31, 1946, for Ripley (unaudited),[18] and July 31, 1947, for Technical (unaudited). They saw no financial statements on Varet or its predecessors. Under the circumstances existing at the time of the audit, proper auditing procedure required that respondents obtain the latest financial information which was available prior to completion of the audit,[19] in order to give them a basis on which to assess the reasonableness of Seaboard's representations. Had such information been obtained, it would have shown that in general the six companies continued to lose money and to require and receive further advances from Seaboard during the last of 1947 and the first months of 1948.

Respondents have attempted to justify their failure to obtain more recent financial state-

[15] Respondents contend that the words "draft report" refer to the financial statements, and that the "certificate" which contained the statement regarding the amount of the reserve was a separate document and was not shown to Seaboard. This does not appear to be a reasonable construction of the words used in the Brown-Werntz memorandum, particularly in the light of the statement therein that the "report" took exception to the classification of assets and indicated a need for a substantial reserve, and the fact that an auditor's statement about the accounts he has examined is called both a report and a certificate and the terms are commonly regarded as interchangeable. See American Institute of Accountants, Accounting Research Bulletin No. 9, May 1941. We also note that in a draft of the Brown-Werntz memorandum the word "certificate" was used where "report" appears in the final form and was crossed out in ink and replaced by "report."

[16] Some of the conferences after March 1, were attended by respondents Hall and Mendes, for whom the management reiterated the information about these companies previously given Brown and Werntz. Werntz was absent on another project following March 14, and did not attend the subsequent conferences; he testified, however that TN had determined on $857,729 as the appropriate figure and so informed Seaboard on March 12, before he left.

[17] See *Minnesota and Ontario Paper Company*, 7 S.E.C. 456, 476 (1940).

[18] Respondents contend that additional financial information regarding Ripley was furnished by Seaboard during the conferences, but there is no indication as to what such information consisted of and it does not appear that respondents saw any up-to-date earnings statement.

[19] Among financial statements which were available prior to completion of the audit were Ripley statements as of February 28, and December 31, 1947, Technical statements for the year ended December 31, 1947, and Fairhue and Varet Knitting Mills statements as of September 30, 1947.

ments on the grounds, among others, that Seaboard's close contact with the debtor companies made its judgment and intentions more significant than more current or audited statements of the companies since the latter were not in good financial condition and "in the course of rehabilitation financing of this type it was not unusual for there to be deficits from operations, low current ratios and other unfavorable financial conditions." This explanation is not persuasive. Aside from the unwarranted premise that Seaboard was of its own accord engaged in rehabilitation financing,[20] the respondents' attempt to minimize the significance of more current financial statements seems particularly inappropriate in view of the fact that in the computation of the final reserve of $857,729, the only specific reserve figures listed were approximately the amounts of the deficits shown by the financial statements of Amity as of October 31, 1947, and of Technical as of July 31, 1947.[21]

Respondents' failure to request more current financial statements or to communicate with or inspect any of the underlying companies indicates that they deferred to the judgment of Seaboard's management in reducing their estimate of the needed reserve. While respondents did not follow the view of Seaboard's management that no increase at all over the book reserve of $119,000 was required, that view was so obviously and radically wrong that not only was its rejection required but it so destroyed the reliability of the management's judgment that respondents were not justified, in the absence of concrete supporting facts, in accepting such judgment as a basis for reducing to $857,729 their original reserve estimate of about $1,350,000.

Respondents assert that two significant and persuasive "facts" were presented by Seaboard management in support of a lower reserve figure: (1) Seaboard's future expectations for the six companies; and (2) Seaboard's past experience in successfully rehabilitating other companies. As to (1), there was nothing really new presented since Seaboard's future expectations had been well known to Blomquist through his examination of the minute books and credit files of Seaboard; as to (2), Seaboard's past experience with other companies was not comparable to the situation confronting it at the end of 1947, and in any event was more than offset by its actual experience with the very companies whose future was in issue.[22]

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[20] Seaboard was not voluntarily in the business of financing companies in need of rehabilitation. Seaboard's normal business, as described to its bankers and in its financial statements and reports to its stockholders and this Commission, was that of a regular commercial finance company, which was primarily interested in making short-term collateralized loans, principally against accounts receivable, to provide needed working capital for manufacturing and industrial concerns which, because of inadequate working capital, an insufficient record of past operating profits, or similar reasons, were unable to command bank credit. The record is clear that Seaboard's loans to its major accounts started as ordinary finance loans, without any intention or expectation on Seaboard's part of financing companies needing rehabilitation, and that the deterioration in the condition of these companies, far from being anticipated as a normal situation, was completely contrary to the expectations of Seaboard and developed in spite of all that Seaboard could do by way of funds and management assistance.

[21] The Brown-Werntz memorandum of April 1948 explaining the $857,729 reserve stated that that figure represented the conclusion that at December 31, 1947, there existed unrealized losses of $435,600 with respect to Amity and $30,000 with respect to Technical and that a general reserve of not less than $350,000 would be necessary as a provision against possible further losses and tax contingencies. The $30,000 provided for Technical was the amount of Technical's deficit at July 31, 1947, as reflected in Blomquist's work papers. By December 31, 1947, however, the Technical deficit was almost doubled, increasing to $57,908. Respondents claim that the Technical December 31, 1947, financial statements, which were not mailed to Seaboard until March 8, 1948, "were not available" to them. However, it does not appear that if respondents had asked for them they could not have obtained those statements prior to the conclusion of their audit.

[22] A schedule was furnished by Seaboard at a meeting held on March 9, which summarized the financial history of a number of companies who had previously been indebted to Seaboard. Those companies differed in material respects from Seaboard's major accounts at December 31, 1947. For example, several of the companies were enabled to repay their indebtedness through war contracts. In at least some cases, the indebtedness was adequately collateralized, largely by accounts receivable. Only one of the companies had a net worth deficit at the time of the maximum debt to Seaboard, while one other company apparently would have had a deficit but for an appraisal. All the others had substantial net worths.

It may also be noted that one of the companies listed on the schedule was Automatic Machinery. As previously noted, Seaboard's initial loan to that company of $20,000 in 1941

No cost or other specific data was presented to show any real prospects of improvement in the abnormal situation which was found. Blomquist testified that he was not impressed with Seaboard's general assurances and expectations based on new managements and possible new products. That respondents also did not find persuasive the information supplied is also shown by the fact, previously noted, that as late as March 12, and after the information of past performance was furnished them, respondents were still using a draft of a certificate indicating a need for a reserve of at least $1,350,000. While the fact that a company has been losing money does not mean that it will necessarily continue to do so, an independent certifying accountant cannot, consistent with proper professional standards, rely on management's unverified representations that the company is about to turn the corner, particularly where, as in this case, the auditors knew that a serious deterioration had taken place and management's representations that progress was being made had failed to materialize in the past and were contradicted by every known fact.[23]

A significant and important respect in which respondents failed to ascertain the facts essential to the determination of an appropriate reserve figure was their failure to determine whether the Bridgeport and Varet inventories pledged as collateral with Seaboard were properly stated.

increased to $1,918,357 in December 1942, at which time Automatic Machinery had a deficit of $107,579 and was merged with Seaboard's wholly-owned subsidiary, Bolton Manufacturing Company, and the operations it had pursued were discontinued. Bolton's wartime operations enabled it to pay off the indebtedness inherited from Automatic Machinery, but thereafter it and its offshoot Coastal were in constant difficulties and Seaboard's investments and advances exceed $1 million.

[23] In denying that TN relied entirely on the judgment of Seaboard management in reducing their original estimate of the needed reserve, respondents point out that the Seaboard judgment given them was based in part on the judgment of some of the officials of the underlying companies. But there was no more basis for relying on the unsubstantiated expectations of the managements of the underlying companies than there was for relying on Seaboard's hopes for these companies.

There were a number of indications that the Bridgeport inventory was substantially overstated. The latest statements seen by TN, the unaudited statements of November 30, 1947, carried the inventory at $1,068,096, an increase of almost $500,000 over December 31, 1946, and substantially in excess of Bridgeport's sales of $788,171 for the first 11 months of 1947. In addition Seaboard's minutes and credit files disclosed that the inventory accumulation was not due to any anticipated demand for Bridgeport's products and that Bridgeport lacked a reliable cost system.

Since Bridgeport's balance sheet as of November 30, 1947, showed a net worth of only $645 compared with Seaboard's advances of $1,347,987, and its inventory account of over $1 million represented 67 percent of its total assets and 89 percent of its current assets, it was of the utmost importance in considering whether and to what extent a reserve was required by Seaboard against its advances to Bridgeport to determine whether the inventory was overstated. We cannot accept respondents' asserted reliance on management's unsupported representations concerning the future of Bridgeport as warranting their ignoring the danger signals with respect to the size of Bridgeport's inventory. And there is no evidence to indicate that the respondents, as they claim, ascertained any business facts satisfactorily explaining the increase in the inventory.

Bridgeport's certified year-end financial statements, which were received in May 1948, showed that the inventory had in fact been grossly overstated by approximately $635,000 as of December 31, 1947, that as contrasted with Bridgeport's reported net worth of $645 as of November 30, 1947, it had a deficit of $728,764 as of December 31, 1947, and it had incurred a loss of $772,820 in 1947. Although those statements were not available to respondents in March 1948 when they certified Seaboard's statements, Charles Schneck, manager of the accounting firm of S. D. Leidesdorf & Company, which was retained by the creditor banks of Seaboard subsequent to the TN audit to prepare a balance sheet of Seaboard as of December 31, 1947, testified that under the circumstances he would have obtained an

evaluation of the Bridgeport inventory by either making a survey of his own or communicating with or awaiting the report of the independent accountant. Respondents assert that it is unlikely any helpful information could have been obtained by contacting the accountant prior to the completion of his audit of Bridgeport and they contend their choice was to wait until completion of that audit, which would have delayed the Seaboard audit by over 2 months, or to undertake to satisfy themselves by other means. However, respondents made no attempt to ascertain whether the inventory was stated at its proper value other than to talk to Seaboard's management, although by their own admission the situation confronting them in the Seaboard audit was out of the ordinary, and therefore called for extraordinary measures.

With respect to the Varet inventory, which respondents knew constituted the primary security for Seaboard's advances to Varet and was the subject of continuing attempted disposition, respondents did nothing to substantiate Seaboard's representations that with the liquidation of the inventory a loss of at most only $100,000 would be sustained on these advances. Respondents take the position that an on-the-spot survey of Varet's affairs, which Schneck suggested as a means of establishing the value of the inventory in the absence of certified statements, would have been unavailing to accomplish that objective. However, when in July 1948 TN, at the request of Seaboard's bank creditors, actually made surveys of Seaboard's principal accounts they reported that as of June 30, 1948, it appeared that the Varet inventory then stated at $584,555 had an estimated realizable value of only $83,600.[24] Respondents' failure to go beyond management's statements regarding the expected loss is particularly indefensible in the face of the fact that the respondents at no time during the audit saw a financial statement on Varet or its predecessors.

We find that in certifying the reserve figure of $857,729 respondents failed to follow generally accepted auditing standards and procedures and accounting principles and practices.

[24] By June 30, 1948, Seaboard's advances totaled $700,139 and Varet had a deficit of $450,000.

Failure to Provide Reserve for Investment in and Advances to Coastal

We have seen that Seaboard at December 31, 1947, stated its investment in Coastal at $512,500 and its advances to Coastal at $618,535, a total of $1,131,035. At December 31, 1946, Seaboard had carried its investment in Coastal at $300,000, and an investment of $212,500 in Bolton. As previously noted, in 1947 Seaboard donated its investment of $300,000 in Coastal to Bolton, which had become inactive by the end of 1946, and correspondingly increased its stated investment in Bolton from $212,500 to $512,500. Bolton, which then acquired Coastal's assets and liabilities and assumed its name, wrote off as of December 31, 1947, the donated $300,000 investment, $191,419 owed Bolton by Coastal, and $133,551 representing the excess of Coastal's liabilities over its assets when taken over by Bolton. Notwithstanding these write-offs and the fact that in 1947 Coastal had sustained a loss of $1,135,353 before and $661,473 after income tax refunds, the stated value of the Coastal assets was then written up by a net amount of $439,378 on the basis of a year-old reproduction cost appraisal, thereby increasing net worth from about $80,000 to $519,321. Coastal's 1947 financial statements including the latter figure were certified by TN, and were attached as part of the Seaboard annual report filed with us.

While recognizing that ordinarily an investment in a subsidiary may properly be carried at cost despite occasional losses, this Commission has stated that—

> "evidence of probable loss must be given due attention and, where such evidence points to an apparently permanent decline in the value and earning power of the underlying properties, the company holding such investments should recognize and make provision for the loss either by writing down the investment or by setting up a reserve therefor.
>
> "The issue is, then, whether the available evidence indicated so great a probability of

loss as to require that, in accordance with generally accepted accounting principles, appropriate provision therefor be made.[25]

The inactivity of Bolton, the substantial continued losses of Coastal, and the Bolton write-off of its investment in the advances to Coastal as worthless as of December 31, 1947, were ample evidence of a "permanent decline in the value and earning power." That Werntz was not unaware of this is shown by his notation dated March 3, 1948, in the audit work papers: "Coastal Investment—if Bolton writes off Coastal stock doesn't Seaboard have to do the same?" and as noted above, Werntz in his February 1948 memorandum summarizing the information obtained in the course of the audit, stated that one of the problems presented was whether Seaboard needed a reserve against its investment in Coastal.

Respondents contend that no reserve as to Coastal was necessary because Coastal's audited balance sheet as of December 31, 1947, showed a net worth of $519,321 and Seaboard's stated investment in Coastal was below that figure, and that any attempt to go behind these figures is barred because it would constitute an attack on Coastal's audited figures and would be outside the issue in these preceedings, which relate to the Seaboard audit.

In our opinion respondents cannot so insulate themselves from consideration of the need of a reserve against the Coastal investment. While the sufficiency of the Seaboard audit is in issue here, the question of the necessity of a reserve against the Coastal investment is relevant and material to that issue. Coastal was a wholly-owned subsidiary and in accordance with our requirements Coastal's certified statements were filed with the Seaboard statements, and respondents could not shut their eyes to information bearing on that question merely because it may have been acquired in the course of their audit of Coastal's statements. Moreover, as we have noted above, respondents' own Seaboard audit papers contain notations as to the need for a reserve against the Coastal investment.

Even if we were to accept respondents' contention that they were entitled to rely on Coastal's audited statements as though such statements had been certified by other independent public accountants, we could not agree that the failure to provide a reserve for the Coastal investment was reasonable and in accordance with accepted accounting procedure. The Coastal certificate specifically noted that the assets had been restated to reflect reproduction cost on the basis of a year-old appraisal with the result that net worth was increased by $439,378, and expressed a qualified opinion only and did not take responsibility for the value at which the assets were carried. To accept without question the net worth figure would be to ignore the plain warning on the face of the certificate that such net worth was certainly questionable under generally accepted accounting principles. And when the fact is considered that respondents were themselves the certifying accountants for Coastal who had questioned and refused to take any responsibility for the asset figure, any possible justification for a mechanical acceptance of that figure and the resultant net worth figure disappears.

It seems clear that under the circumstances the write-up of Coastal's assets was a departure from good accounting practice and that it was so recognized by the respondents. In the Brown-Werntz memorandum of April 1948, it was stated that TN questioned the propriety of the restatement of the Coastal assets, pointing out that on the transfer of these assets to Bolton, the latter had written off its investment in Coastal as worthless, and also that Coastal during the preceding year had operated at a very substantial loss.[26] Werntz

[25] *Associated Gas and Electric Company*, 11 S.E.C. 975, 1019–20 (1942). See also *Montgomery's Auditing*, 7th Ed. (1949), pp. 288–89.

[26] TN's prior questioning of this item highlights the unsoundness of respondents' position in these proceedings that any question regarding Seaboard's failure to write off the $300,000 Coastal investment after Bolton had written it off as worthless should be ignored as an improper attempt to attack the correctness of the Coastal audit.

It is also significant that not withstanding respondents' position that both they and we are precluded from going behind the audited statement showing Coastal's net worth, they themselves point out that the Coastal statements were

testified that at the March 6, 1948 meeting, with Seaboard management, Babcock was told in connection with the several reappraisals of assets of the six companies, that such reappraisals were not in accordance with generally accepted accounting practice and would require an exception or qualification in an auditor's certificate. Werntz further testified that at that meeting the Coastal situation was discussed with that problem in mind, and it was pointed out that TN was going to have to state its qualification on that point in the Coastal certificate.

If the write-up of Coastal's assets were disregarded, as it should have been, the net assets behind Seaboard's stated investment of $512,500 would have amounted to only about $80,000 and a reserve of at least $432,500 should have been provided against the Coastal investment or the investment should have been written down by a correspondent amount.[27]

Language of Certificate

Respondents also deferred to the desires of Seaboard's management with respect to the language of the certificate itself. The draft of the certificate contained a paragraph reading as follows:

"A major portion of the corporation's present operations consists of the extension of credit and the furnishing of advisory services to businesses which are unable to secure adequate bank credit. Rehabilitation of the financial and operating conditions of such enterprises necessarily requires a program of increasing advances and results at times in operating losses on the part of such enterprises until operating and management problems are solved. As the record of the performance of this Corporation shows . . . the ultimate collectibility of such accounts depends upon various factors such as (but not limited to) future development of products, improvement in management or change of personnel, and sufficient interim financing, until the business becomes self-sustaining. Thereupon reductions in debt commence and accounts ultimately pay out, in some cases with marked rapidity, where favorable trends enable customers to make substantial earnings, to procure supplemental financing or to obtain fixed long-term capital, or by other means. Accordingly, the Corporation has regularly provided out of its earnings a reserve for losses and contingencies which at December 31, 1947, amounted to $107,729.64. In view of the current uncertainties in general business conditions, both domestic and international, the Corporation has added to this a special appropriation of $750,000 from earned surplus to provide for future contingencies. This reserve, in our opinion, is adequate to provide for the tax contingencies referred to in Note B and for losses which may be incurred in respect of outstanding receivables."

At a meeting with TN representatives on March 17 or 18, Babcock insisted that since Seaboard had agreed to set up the minimum reserve TN considered necessary, the certificate should read the same as in prior years. Thereupon the quoted language, with the exception of the last sentence, was eliminated, but with the understanding that similar language would be inserted in the notes to the financial statements. However, only the next to the last sentence was so added.

attached to the Seaboard statements and disclosed the existence of an appraisal write-up and of Coastal's substantial operating loss in 1947, and that the Seaboard statement disclosed the amounts at which the investments were carried. They thereby apparently suggest that the two statements read together might have enabled a reader to ascertain that there was some probability of loss in the Coastal investment. We cannot accept such suggestion as a justification for the failure to carry on the Seaboard statement any reserve for the apparent impairment of its investment in Coastal.

[27] It may also be noted that the Coastal balance sheet included a reserve of $142,968, which, as shown by the notes to the financial statements, was set up to provide for Coastal's liability under the Renegotiation Act governing profits on war contracts. However, the Price Adjustment Board in a unilateral order had prior thereto ordered a $390,000 refund, so that Coastal's net assets of $80,000 were subject to even further reduction to the extent the final settlement of the $390,000 claim exceeded the $142,068 reserve. In fact, Coastal subsequently agreed to the entry of a default judgment for the full amount of $390,000.

The quoted language had been included in TN's drafts of qualified and unqualified certificates, and evidently had been considered necessary for an adequate disclosure of the situation which had developed at Seaboard, although as we have previously indicated it was not an accurate portrayal of Seaboard's regular business. Respondents' compliance with the wishes of Babcock in this instance constitutes additional evidence of their lack of independence.[28]

William C. Keefe, house counsel for Seaboard, advised Babcock that the reference in the quoted paragraph to the rehabilitation of companies should be deleted because of the effect it might have on Seaboard's creditors,[29] and that disclosure in the certificate or in the financial statements relating to the nature or condition of the companies Seaboard was financing at the time would seriously affect Seaboard's credit with the banks. Respondents assert that they were not advised of these reasons, but it seems clear that with their experience and background they should have understood that this was why Babcock objected to the proposed disclosure.

Notes to Financial Statements

Note F to the Seaboard financial statements consisted primarily of language used in previous years, plus a paragraph relating to the $750,000 addition to the reserve, and read in part as follows:

". . . Losses resulting from receivables are charged to reserve for credit losses as soon as a receivable or an unrealized portion thereof becomes either bad or doubtful, in the opinion of the management . . .

"The balance in reserve for losses and contingencies remaining after the write-downs and write-offs, of all receivables believed to be bad or doubtful, as described in the preceding paragraph, does not include amounts in respect of receivables then known to be bad but is solely against future losses on receivables, or future losses not in respect of receivables. Therefore, no amount of the balance in reserve for losses and contingencies is specifically allocated to assets. The reserve could not be reflected as a deduction from assets without understanding such assets. In addition, it is believed that such a deduction might suggest that the charge-off policy of the enterprise is not as complete as above indicated.

"In view of the current uncertanties and general business conditions, both domestic and international, the Corporation has made a special appropriation of $750,000 from earned surplus to provide for future contingencies which has been added to the reserve regularly provided out of earnings making at December 31, 1947, a total reserve for losses and contingencies of $857,729.64. Should any losses ultimately be sustained in excess of the portion of the reserve provided by charges against income, provision therefor will be made by additional charges to income."

Under the circumstances existing at the time of the audit, this note was materially false and misleading, particularly in indicating that no losses existed in any of the accounts, that Seaboard's advances were stated at their estimated relizable value and that any deduction from the reserve was intended solely to provide against losses that might result from the occurrence of future events. The fact that losses did exist at December 31, 1947, is apparent from the facts previously recited and is expressly recognized in the Brown-Werntz April 1948 memorandum. Moreover, the reference in the last paragraph quoted to "current uncertainties and general business conditions, both domestic and international," fails to give any indication that the additional reserve was required because of the specific deterioration of the major accounts.

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[28] Respondents, while denying that the change indicated any lack of independence, state in their brief that, viewed with hindsight in light of the fact that Seaboard later became insolvent, it might have been better to have left the certificate unchanged or perhaps to have retained the substance in a footnote.

[29] Keefe testified that he advised Babcock that "if he was telling the banks that he was in this type of [rehabilitation] business that was one thing, and if he wasn't, he certainly didn't want to be telling it in the financial statements."

Respondents' certification to the Seaboard 1947 financial statement containing this note is additional evidence of their lack of independence.

Conclusions with Respect to the Reserve

We find that on the basis of the information known and available to respondents at the time of their audit, the $857,729 reserve reflected in Seaboard's balance sheet as of December 31, 1947, was materially inadequate, thus resulting in an overstatement of earned surplus and net worth, and making the balance sheet materially misleading. The inadequacy of the reserve was indicated not only by the mass of information available to respondents, some of which has been summarized herein, but also by Blomquist's reserve estimate of $1,453,551 arrived at on the basis of all the information he developed during the audit, by respondents' own subsequent initial judgment that a substantial reserve "probably in excess of $1,350,000" was needed, and by the failure to provide any reserve for the Coastal investment. In certifying the financial statements with the lower reserve figure, respondents, contrary to generally accepted auditing standards and procedures, improperly placed substantial reliance on unsupported representations of management as to the future which were at direct variance with all the known existing facts, without obtaining current financial data on the underlying accounts or making any independent inquiry into the value of underlying company inventories where the value of such inventories was the principal factor in determining the reasonableness of any reserve. In these respects, and in failing to disclose in their certificate the true nature or condition of Seaboard's accounts, and in not taking exception to Note F to the financial statements, respondents did not exercise an independent and informed judgment in auditing and certifying Seaboard's financial statements.

Failure to Charge Reserve for Losses Against Income

In addition to the above conclusions relating to the insufficiency of the reserve against uncollectible advances in the Seaboard balance sheet as of December 31, 1947, we find that Seaboard's income statement for the year 1947 was misleading in that insufficient provision was made therein for losses on uncollectible accounts. Under accepted accounting principles and standards of fair disclosure, Seaboard's 1947 income should have been charged with the additional provision necessary to bring the reserve up to where its application against the receivables outstanding at December 31, 1947, would have reduced them to their estimated realizable value.[80] The increase of $750,000 in the reserve insisted upon by respondents was charged directly to earned surplus and as a result the Seaboard statement showed a net income for 1947 of $249,800 before taxes, whereas if the charge had been made against income, even the inadequate reserve increase of $750,000 would have produced a loss of approximately $500,000, and respondents' reserve figure of $1,350,000 from which they receded would have produced a loss of about $1 million.

Respondents, while agreeing that, as stated in Accounting Research Bulletin No. 32 of the American Institute of Accountants, the general presumption is that "all items of profit and loss recognized during the period are to be used in determining the figure reported as net income," seek to escape its effect in this case by urging that the loss provided for in the reserve was not realized and was not "recognized" by management. But obviously the propriety of certifying an income statement which fails to charge against income a reserve for losses on bad debts cannot be made to turn on the fact that management has refused to "recognize" losses which all the evidence indicates exist. The deterioration in Seaboard's accounts which made the increase in the reserve necessary was recognized by respondents as a situation which developed during 1947. The testimony of respondents, their audit papers and memoranda, and their refusal to certify Seaboard's statements unless an increase in the reserve was provided, all serve to confirm this conclusion.

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[80] Montgomery's Auditing, 7th Ed. (1949), p. 145.

The estimated losses therefore should have been charged to 1947 operations through the income statement.

Respondents also contend that the reserve is within the exception to the quoted presumption which Accounting Bulletin No. 32 recognizes for "items which in the aggregate are materially significant in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period." But Seaboard's estimated losses were directly attributable to its usual business operations during 1947. That the reserve for losses was unusual in relation to the size of reserves for prior years did not make it the kind of extraordinary item excludable from the determination of net income.[31]

We find that under the circumstances respondents' certification that the income statement presented fairly the results of Seaboard's operations for 1947 in accordance with generally accepted accounting principles, was misleading, and evidenced a failure to exercise an independent judgment.[32]

Overstatement of Current Assets

Another major issue in these proceedings is whether Seaboard's balance sheet for the year ended December 31, 1947, materially overstated current assets and understated noncurrent assets. As stated above, the balance sheet as finally certified by respondents listed as noncurrent $318,535 of advances to Coastal and $641,713 of advances to the other companies.[33]

We have noted that Brown and Werntz recognized early during the audit that a major problem facing them was the classification of the receivables as current assets, and that following the March 1, 1948 conference with Seaboard they prepared schedules which classified $318,535 due from Coastal and $1,374,000 due from the other companies as noncurrent assets.[34] We have also noted that a draft certificate prepared after discussions among the TN partners and which was shown to the Seaboard management, took exception to the classification of current assets and tentatively indicated that approximately $1,500,000 should be excluded from current assets "as not realizable within 1 year." Also, Blomquist, in accordance with Werntz's instructions, prepared a tentative balance sheet in which $318,561 due from Coastal and $1,346,586 of advances due from the other companies were classified as noncurrent assets.

Advances to Companies other than Coastal

Respondents seek to justify the use of the

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[31] Examples of extraordinary items which may be excluded from the determination of net income under Bulletin No. 32 are material losses of a type not usually insured against, such as those resulting from wars, riots or earthquakes.

It is significant that although the increase in the reserve for losses was not charged to income, there was included in Seaboard's 1947 income statement $542,660 realized on the disposition of Seaboard's investment in Southington Hardware Manufacturing Company, one of Seaboard's subsidiaries, notwithstanding that Accounting Research Bulletin No. 32, which as seen respondents rely upon as support for their failure to include the reserve in the income statement, lists among the items excludable from income "credits resulting from unusual sales of assets not acquired for resale and not of the type in which the company generally deals." And respondents' own memorandum of April 1948 recognized that inclusion of the Southington item in income "in a year in which it is necessary to set up a substantial provision for losses by means of a charge to earned surplus may invite a question." We do not accept respondents' attempt to distinguish the Southington item from the reserve for uncollectible advances on the ground that the former represented realized income, whereas the latter was only for possible losses which had not been recognized by management.

[32] The misleading nature of the income statement becomes even more apparent when it is realized that a very substantial part of Seaboard's income was stated to be earned service charges on its advances. As we have noted, most of the advances outstanding at December 31, 1947, were to companies which had been losing money and which could not meet their interest and service charges except from amounts advanced by Seaboard.

[33] Respondents' audit memorandum of April 1948 listed the items, other than that relating to advances to Coastal, transferred to noncurrent as:

Amity—Advances against inventories	$416,713.41
Advances against chattel mortgages	75,000.00
Varet—Advances against inventories	100,000.00
Marvin O. Shepherd—Advance on note	10,000.00
Stratford Corporation—Advance on note	40,000.00
	641,713.41

[34] In addition, Brown's schedule showed a noncurrent figure of $100,000 for Varet which was not reflected either in his total or in Werntz's schedule.

$641,713 figure as the measure of noncurrent advances to companies other than Coastal, and assert that their original higher figures were tentative and based on erroneous criteria. We are unable to accept this position.

As in the case of the original computations of the reserve for uncollectible accounts, the initial and larger classification for noncurrent assets apparently represented respondents' best judgment on the basis of the information available to them. And it is significant that these larger figures were calculated after conferences at which the Seaboard management expressed its views and after consultations among several of TN's partners. The draft balance sheet prepared after the March 6, 1948, conference by Blomquist in accordance with instructions from Werntz, appears to be a considered attempt to segregate amounts which could not be expected to be collected within a reasonable time in the future.[85]

Respondents assert that in the course of conferences with management they concluded that advances to customers could be considered current where the advances did not exceed the net assets of the customer, and that amounts of advances equal to the deficits of the underlying companies would be transferred to noncurrent. Apart from the question of the propriety of using the deficits in the underlying companies as the measure of Seaboard's long-term or noncurrent assets, it is clear that the $641,713 figure certified by respondents did not actually reflect all such deficits. The respondents had failed, as pointed out above, to obtain recent financial statements on some of the companies, did not see any financial statements on Varet or its predecessors, and were not in a position to base the allocation of current and noncurrent assets on the existing net asset position of these companies. Moreover, the $641,713 figure did not include any amount for Technical, although respondents knew that company had a deficit of approximately $30,000 as of July 31, 1947, and this deficit had increased to approximately $58,000 by December 31, 1947.

Respondents asserts however that their failure to ascertain or eliminate all the advances represented by deficits is not material because the deficit test represented merely a secondary test in the interest of conservatism, the real justification for the $641,713 figure being the "business cycle" test expressed in Accounting Research Bulletin No. 30 of the American Institute of Accountants. That bulletin states that current assets may include items "which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business." Respondents urge that Seaboard's business cycle was the relatively long period of time required to rehabilitate companies in dire financial straits. However, under such view all of Seaboard's advances could be considered current, even though collection could not be expected for periods of up to 3½ years.[86]

Neither Bulletin 30 nor Seaboard's history justified the attempt to treat as current assets Seaboard's accounts with the companies whose serious financial problems precipitated the difficulties facing the accountants in the 1947 audit. As stated, Seaboard's normal business was that

[85] The work papers show that the $1,346,586 noncurrent total included $468,000 of advances to Amity, Bridgeport, Technical and Varet reportedly secured by chattel and real estate mortgages. Since these companies were operating at losses and substantially all their accounts receivable and inventories were already pledged with Seaboard, it was reasonable to assume that they would not have funds in the near future to liquidate the advances against the real estate and chattel mortgages. There was also excluded from current assets $802,667 representing advances in excess of 90 percent of the reported inventory collateral (the contracts with Amity, Bridgeport and Varet indicated that advances should not exceed 70–75 percent of inventory pledged as collateral). In addition, $75,918 of service charges due from Bridgeport which had been accumulating since March 1947 were also listed as noncurrent. Such amounts were unsecured and prospects of collecting them would seem to have been more remote even than prospects of collecting the advances against mortgages and excess inventories.

[86] It was testified that Seaboard's "business cycle" would be up to 3½ years on the ground that it would take this long to rehabilitate some of the underlying companies. Blomquist testified that from the condition of Seaboard's accounts at December 31, 1947, it looked like it would take a minimum of another 2 to 3½ years to work them out; at least that "was the best hope you could have." And since some of these accounts were already at least 2 years old, on respondents' theory Seaboard's "business cycle" would be as long as 5½ years.

of a regular commercial finance company primarily interested in making short-term collateralized loans,[37] and Werntz himself testified that the reason why the propriety of the classification of these accounts as current became so extremely important was because he felt that Seaboard would not be able to collect the debts "or get them back into a situation where they resembled ordinary accounts receivable, possible inventory financing, within a reasonable time in the future."[38] Under the circumstances the classification as "current" assets of a commercial credit company of advances to companies which had deteriorated to the point where on optimistic estimates 2 to 3½ years was required to work them out, would obviously be misleading.[39]

[37] The contention that Seaboard's business cycle was 2 to 3½ years (actually over 5 years on the basis of the history of its accounts as of December 31, 1947) is in conflict with the statement in Seaboard's 1938 stockholders' report, after the establishment of its Receivables Division in 1937, that it was in a position to liquidate its entire borrowed debt within 3 months from cash on hand and ordinary collection of receivables; the notes to its certified balance sheets for the years 1939, 1940 and 1941, that the accounts in its Receivables Division had a high degree of liquidity and that the average days to maturity was within 60 days; the statement in its 1943 report that the company had demonstrated the liquidity of its receivable portifolio over a period of years; the statements in its 1944 and 1945 reports that its balance sheets continued to reflect a satisfactory liquid position; and the statements in the 1946 report that the company's program for 1947 was to increase its accounts receivable business, reduce its inventory financing, and increase the liquidity of its assets so that in a short time it would be in the same liquid condition it enjoyed prior to the war.

[38] This reference to getting the accounts "back" to ordinary accounts receivable is a recognition that Seaboard was not by choice and typically in the business of rehabilitating companies in dire financial condition, as are the above noted statements in prior years in Seaboard's reports and financial statements which were audited by TN's predecessor firm.

[39] Accounting Research Bulletin No. 30 recognizes that the working capital of a borrower has always been of prime interest to grantors of credit, and states that the tendency is for creditors to rely upon the ability of debtors to pay their obligations out of the proceeds of current operations. It describes an operating cycle as the average time intervening between the acquisition of materials or services, their sale and conversion into receivables, and the final cash realization. This operating cycle concept in the case of Seaboard obviously makes sense only in relation to the businesses of the underlying companies, and those businesses under normal operations had a cycle of not more than 1 year. The fact they were unable to operate successfully and profitably cannot be used to extend the cycle and make current assets out of frozen or hopeless accounts.

Advances to Coastal

The Staff has contended, and the hearing examiner has found, that all of Coastal's indebtedness to Seaboard of $618,535 should have been transferred to noncurrent assets and that the transfer of only $318,535 of that amount did not conform to good accounting practice. Respondents take the position that the latter figure was determined in accordance with the provision of Rule 5-02-7 of our Regulation S-X[40] that indebtedness of a subsidiary shall not be considered as current unless its net current asset position justifies such treatment. They contend that since Coastal's balance sheet as of December 31, 1947, listed current assets which exceeded current liabilities to others than Seaboard by about $334,000, they were justified in treating the lower amount of $300,000 of advances to Coastal as current.

Good accounting practice does not permit classification as current assets of advances to a subsidiary, even if it has sufficient net current assets to cover the advances, unless it is the intention or practice of the subsidiary to currently liquidate the indebtedness.[41] TN's own Guide to Report Writing, dated December 1, 1947, states that indebtedness of a subsidiary may be included in current assets to the extent that its margin of net current assets justifies such treatment, "though preferably only if it is the practice of the subsidiary to liquidate the account periodically or if we have reasonable assurance that the account can be liquidated at an early date."[42] By this test the entire $618,535 of advances to Coastal should have been transferred to noncurrent assets since the facts available with respect to Coastal's history of losses and increasing indebtedness made it un-

[40] Regulation S-X, promulgated by us under the various Acts administered by us, specifies generally the form and content of financial statements required to be filed under such acts.

[41] *Cf.* Montgomery's Auditing (7th Ed., 1949), p. 169.

[42] Accounting Research Bulletin No. 30, cited by respondents in support of their application of the business cycle concept to Seaboard, also states that there should be excluded from the current classification receivables arising from unusual transactions, such as advances to affiliates which are not expected to be collected within 12 months.

reasonable to expect that Coastal's operations would provide any significant funds out of earnings to make current payments on Seaboard's advances.

Moreover, if the narrow view were accepted that Rule 5-02-7 justifies classifying as current assets advances to a subsidiary merely on a showing that the subsidiary's net current asset position covers such advances, Seaboard's balance sheet still overstated the amount of current advances to Coastal. Coastal's balance sheet did not classify as a current liability a reserve of $142,968 with respect to a government claim against it under the Renegotiation Act.[43] Generally accepted accounting principles require that such a reserve be classified as a current liability.[44] If this reserve had been included, as it should have been, in Coastal's current liabilities, Coastal's net current asset position would have been reduced by that amount, thus necessitating a transfer to noncurrent assets on Seaboard's balance sheet of at least an additional $109,000.

Note to Financial Statement

Note C to the current notes and accounts receivable shown in Seaboard's balance sheet as of December 31, 1947, which respondents stated was inserted at their request, recited that—

> "In accordance with generally recognized trade practices in the business in which the Corporation is engaged, notes and accounts receivable include items, a substantial but indeterminable amount of which may not be fully realizable within 1 year. Of the aggregate current and noncurrent receivables, approximately $3,158,894.93 represents items due from three customers."

We find this Note to be inaccurate and misleading. There is evidence of a trade practice of finance companies under certain circumstances to include in current assets installment receivables which mature or become due more than 1 year after the balance sheet date. This practice is recognized in Regulation S-X[45] and was referred to in notes to Seaboard's financial statements for the years 1934 through 1946 as the basis for classifying as "*current*" in those years the entire amount of installment receivables and notes receivable retail due after 1 year.[46] However, there is no evidence of a trade practice to include in current assets receivables originally due within 1 year which had become stagnant due to deterioration in the financial condition of the debtors. Seaboard's major accounts at December 31, 1947, were of the latter character and did not qualify for the treatment referred to in Note C.

The Note was further misleading in implying that the items referred to might be realized within 1 year, when in fact this possibility was all but precluded by the continuing losses and precarious financial condition of the debtors. The last sentence of Note C indicates the great concentration of advances to three customers of over $3 million. Werntz in a draft of the Note had suggested there be added at its end the words "in which there appears to be no material equity capital." Certainly that would have been of the greatest interest to bank creditors, and the only suggested criticism of the proposed addition is that it would have been an understatement.[47] Werntz' suggestion was not adopted and the statement about the lack of equity was omitted.

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[43] See n. 27—*supra*.

[44] See American Institute of Accountants, Accounting Research Bulletin No. 21 (December 1943).

[45] Rule 3-13 of Regulation S-X provides:

"Items classed as current assets shall be generally realizable within 1 year. However, generally recognized trade practices may be followed with respect to the inclusion of items such as installment receivables or inventories long in process, provided an appropriate explanation of the circumstances is made and, if practicable, an estimate is given of the amount not realizable within 1 year."

[46] The notes to Seaboard's prior statements were similar to notes appearing in the financial statements of a number of other commercial credit companies for 1947, all of which refer to inclusion in current assets of certain receivables *due* or which *mature* more than 1 year after the balance sheet date.

[47] The three customers referred to in Note C were Amity, Bridgeport and Varet. The financial statements seen by respondents showed Amity to have a deficit of about $435,000 and Bridgeport a net worth of $645. Respondents saw no financial statements on Varet but Seaboard conceded that it might suffer a loss of $100,000 on the liquidation of the Varet inventory.

Conclusions with Respect to Current Assets

In conclusion, we find that the respondents, after thorough consideration of the problem, tentatively determined that Seaboard would have to transfer from current to noncurrent assets about $1,350,000 of its advances to companies other than Coastal; that they receded from this position without sound reason, and certified a balance sheet listing only $641,718 of such advances as noncurrent, an amount which was materially understated; that the $318,535 of advances to Coastal transferred to noncurrent was materially understated; and that Note C to the financial statements was inaccurate and misleading.

Relationship of Underlying Companies to Seaboard

The Staff has contended, and the hearing examiner has found, that Seaboard's balance sheet was also materially misleading because amounts shown as due from "customers" erroneously included amounts due from subsidiaries.

Under the applicable provisions of Regulation S-X, current amounts due from subsidiaries were required to be stated separately, and amounts due from a subsidiary were not to be considered as current unless the net current asset position of the subsidiary justified such treatment.[48] The instructions for preparation of the Form 10-K in effect at the time of the Seaboard audit defined a "subsidiary" of a person as "an affiliate controlled by such person directly or indirectly through one or more intermediaries." "Affiliate" was defined as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with such person." And "control" was defined as "the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise."

Respondents state that they reasonably believed that the companies classified as customers were not subsidiaries because Seaboard did not treat these companies as subsidiaries in its records and respondents through past association had complete confidence in the Seaboard management. They assert that although Seaboard had instigated numerous changes in the managements of the "customers" and advanced the funds whereby new managements acquired interests in such companies, such actions were taken by Seaboard to protect its interests as the dominant creditor and do not raise any inferences of a subsidiary relationship.

Respondents urge that an essential characteristic of a subsidiary relationship is the ownership of stock. But in at least two cases it appears that Seaboard did own the stock of companies classified as customers. One of these was Tampa—New Orleans—Tampico Air Lines, Inc. ("Tampa") which respondents admit was a wholly-owned subsidiary of Seaboard. Werntz testified that although he knew the Tampa stock was owned by Seaboard the amount Tampa owed Seaboard, about $15,000 at December 31, 1947, was so small that the subsidiary question did not come to mind when setting up the balance sheet. But the significance of the Tampa relationship went beyond that indebtedness. Seaboard had begun financing Tampa in January 1946 and shortly thereafter, following Tampa's default on the loan, acquired first a controlling interest in Tampa and then all of Tampa's stock. In December 1946 the Tampa balances owing Seaboard were considered greater than could be collected and so were written down by $100,000.[49] In 1947 an additional $389,250 was written off, making a total of $489,250 written off in the 2 years, and leaving as an amount due only about $15,000 believed to be collectible. Yet all this time Seaboard never classified the advances due from Tampa as due from a subsidiary. Respondents should not have placed reliance on management's classification of the underlying companies, but should have made independent inquiry to ascertain whether subsidiary relationships existed in other accounts.

Seaboard also owned all the stock of Varet through the medium of Knitted Specialties, and the amounts due from both of these companies (an aggregate of $682,561) should also have been shown as due from subsidiaries. As noted, Varet was organized by Seaboard in November 1947 to take over Fairhue and Varet Knitting Mills. The Varet stock was held by a Seaboard nominee; Seaboard employees were elected officers and directors

[48] Regulation S-X, Rule 5-02, para. 7.

[49] One of TN's predecessor firms had audited Seaboard's 1946 statements and Brown had been in charge of that audit. Tampa was not shown as a subsidiary in the 1946 statements.

of Varet and took control of its office and affairs. On December 31, 1947, however, Seaboard sold the Varet stock to Knitted Specialties, which it had formed for the purpose, lending the latter the money with which to acquire the stock and placing the Knitted Specialties stock in the name of one of its attorneys as nominee.

Respondents knew the Varet stock had been acquired in November 1947 by a nominee of Seaboard, and therefore checked to ascertain the status of that stock at December 31. The check showed that as of that date the Varet stock had been acquired by Knitted Specialties, and that Seaboard had loaned Knitted Specialties the money for this purpose. Respondents state that they were thereby satisfied that the Varet stock was owned by another company and Varet was no longer a subsidiary of Seaboard, and made no further inquiry as to the ownership of Knitted Specialties or the circumstances surrounding the transfer of the stock. They claim that if Varet was in fact a subsidiary this was concealed from them. However, in our opinion, respondents should have realized under all the circumstances that a question existed, and the failure of Seaboard's counsel or others to mention the subject voluntarily was not sufficient excuse for not pursuing an independent inquiry.[50]

In addition to the Tampa and Varet situations, we also find that a parent-subsidiary relationship existed with certain of the other companies indebted to Seaboard, and that the amounts due from these companies should have been portrayed accordingly.

As to three of the debtors, Amity, Bridgeport and Maddocks Potato Products, Inc. ("Maddocks"), although Seaboard was not the actual holder of stock all the surrounding circumstances suggested that in effect it was the real owner of their stock. But in any event, it held the power of control which under the definition of "subsidiary" in the Form 10-K instructions is the determinative factor and may exist in the absence of stock ownership.[51] Respondents contended that these companies were not rendered subsidiaries because of Seaboard's dominant creditor influence over them, and that it would impose an impossible burden upon accountants to require them to determine whether a company owning no stock in another company has control over that company by virtue of their business relations. However, the situation prevailing with respect to those companies as of December 31, 1947, and Seaboard's relationship with them was such that it was apparent that Seaboard had become more than a dominant creditor, but had, for all practical purposes, taken over these companies.

As previously noted, Amity's operations were unsuccessful, and in March 1947 a contract was entered into between Seaboard and Amity which declared Amity in default and gave Seaboard extremely broad powers of control over Amity's operations. Amity's stock originally was owned in equal amounts by William G. Church and Armand DeMott. Although the Amity stock appeared worthless, Seaboard bought the stock owned by Church and DeMott in order to secure it without the risk of bankruptcy proceedings. In September 1947, Seaboard bought Church's half of the stock for $18,400, the unpaid balance of his indebtedness to Seaboard, and simultaneously sold the stock for $100 to Joseph R. Zalenka, then head of Seaboard's business advisory service and a Seaboard director.[52] In December 1947, Seaboard advanced $30,000 to Amity to buy DeMott's stock; the shares, endorsed in blank, were turned over to Seaboard and retained by Seaboard until March 4, 1948, when they were delivered to Amity. Thus, as of December 31, 1947, Seaboard, which had advanced more than $1 million to Amity, was in possession of 50 percent of Amity's stock[53] and the other 50 percent was in the name of Seaboard's former employee, Zelenka,

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[50] The confirmation request sent by respondents to Varet in the course of the audit was returned signed by one of Seaboard's men as president of Varet; the indebtedness of Knitted Specialties was not confirmed and Blomquist's working papers noted that a second confirmtion request was "held up."

[51] TN's own Guide for Report Writing as of December 31, 1947, stated that control may exist otherwise than through stock ownership.

[52] Zelenka, who had been trying to work out the Amity account for Seaboard, resigned his Seaboard positions and was named president of Amity.

[53] In a memorandum of December 18, 1947, Rose advised the Seaboard directors that DeMott's stock had been acquired by Amity under an option to Seaboard. Respondents contend there is no reference to Rose's memorandum in Blomquist's working papers and that the inference is that it was not shown to him. However, Blomquist referred in his working papers to other portions of Rose's report to the board on that date. Furthermore, Werntz testified that the reports concerning the debtors presented at the directors' meetings were available to TN.

who had paid only $100 therefor. Zelenka did not exercise independent control over Amity's operations, and obtained Babcock's approval with respect to a variety of matters, including for example a change in Amity's working hours.

With respect to Bridgeport, its survival in the face of substantial losses through 1946 and 1947 dependent upon continuous advances from Seaboard, which had reached a total of approximately $1,500,000 by December 31, 1947. In October 1947, Seaboard organized a company named Stratford Corporation ("Stratford"), and loaned it $49,200 to acquire Bridgeport's shares from its president, which shares were thereupon pledged with Seaboard as collateral for the loan. Thereafter, Seaboard installed three persons in the management of Bridgeport and sold the Stratford shares to one of them for $10,000, which it lent him for that purpose on the security of his note collateralized by the Stratford shares.

After the nominal owner of the Stratford shares became ill in December 1947 and left Bridgeport, those shares were still held by Seaboard as collaterial. In January 1948, Seaboard sold 100 shares of Stratford stock each to the other two persons and to an employee of Seaboard's advisory service, and advanced them each $1,000 to acquire such shares. Seaboard sold the remaining 700 shares to Stratford for $7,000, and the former owner's note was marked paid.

There can be little doubt that at December 31, 1947, Seaboard controlled Bridgeport, its management and its policies. Substantially all of Bridgeport's assets and all of its stock and the stock of Stratford were pledged with Seaboard and no one had any money invested in Bridgeport except Seaboard.

Maddocks was incorporated early in 1946 by H. Ross Maddocks for the purpose of manufacturing certain potato products. Advances were made by Seaboard both to Maddocks and to Mr. Maddocks, who acquired the stock of the new company and pledged it with Seaboard. The company, which apparently made no sales during 1946, sustained a net loss of $7,667 for the 7 months period ending December 31, 1946, and in 1947, on sales of $2,333, sustained a net loss of $26,960. As of December 31, 1947, Maddocks, with current assets of only $8,581 had an earned surplus deficit of $34,641 and it and Mr. Maddocks owed Seaboard a total of approximately $94,000.

Under a contract entered into in April 1946 Seaboard, among other things, was given the right to name all officers and directors of Maddocks, except that Mr. Maddocks was to be the president and one of the directors, and Seaboard was given an option to purchase the former's stock if he desired to dispose of it or died and the right to purchase any additional stock issued in the future.

The respondents contend that there is no evidence that the April 1946 contract was in any of the Seaboard files given to Blomquist for examination, and that, since there is no reference to it in his working papers, the reasonable inference is that he never saw the document. However, the facts which clearly were known to the respondents should at least have caused them to make some inquiry as to the possible existence of a parent-subsidiary relationship between Seaboard and Maddocks, and such inquiry, if diligently pursued, would have revealed the existence of such a relationship in fact.[54]

The situation with respect to Ripley and Technical similarly indicated that Seaboard possessed the power to direct their management and policies.

Seaboard's pervasive interest in and control of all seven of the companies discussed above was such a crucial factor in any presentation of Seaboard's financial condition as of December 31, 1947, that even if there had been a reasonable doubt whether such companies should properly be listed as subsidiaries, at the least some other appropriate disclosure of the situation was required.[55]

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[54] Among the facts which were known to the respondents was that Maddocks' books and records were kept at Seaboard's offices and that the confirmation request was signed by Burns, Seaboard's treasurer, as treasurer of Maddocks.

[55] We have already noted in connection with the discussion of the reserve question that respondents did propose the inclusion in their certificate of a paragraph intended to describe the nature of the companies then indebted to Seaboard; this paragraph, however, was deleted at management's request. In this connection it should be noted that the definition of control in the Form 10-K instructions included the following: "If in any instance the existence of control is open to reasonable doubt, the registrant may state the material facts pertinent to the possible existence of control, with a disclaimer of any admission of the actual existence of effective control."

Respondents' Responsibilities

Respondents assert that their 1947 report very clearly pointed out that Seaboard was in difficult straits and that its financial condition had seriously deteriorated in 1947, citing that respondents had insisted on the substantial increase in the reserve, the substantial advances excluded from current assets, and the note regarding the large advances to three companies. They contend that a charge of lack of independence cannot be justified in face of the fact that TN refused to certify the statements in the form desired by management and insisted on the significant changes mentioned above before an unqualified certificate was given.

Respondents did make suggestions that very substantial amounts be added to the reserve for losses and excluded from current assets, that the certificate include a paragraph intended to reflect the conditions of Seaboard's accounts, and that a note be added regarding the concentration of advances to three companies. But the results finally shown in the financial statements and the accompanying certificate fell far short of the initial recommendations; and the financial statements and the certificate as a whole minimized and even nullified to a certain extent the unfavorable disclosures that were made.[56]

The basic deficiency of the financial statements was that they did not portray realistically the financial affairs of Seaboard.[57] No one reading such statements and TN's certification would have understood that Seaboard's major accounts in general were losing money and in default on their obligations to Seaboard; that advances carried as current assets not realizable within 1 year included substantial amounts on which the debtors were in default and which could not be expected to be paid within 1 year because of the deteriorated condition of such debtors; that three principal debtors which together owed Seaboard more than $3 million (Amity, Bridgeport and Varet) had no equity and were in default, and that Seaboard had foreclosed on one and instituted management changes in the other two under circumstances which clearly demonstrated Seaboard had taken over control; and that substantial amounts shown as income represented service charges and interest due from debtors which were not able to pay, and had not been paying any interest or service charges except through additional advances from Seaboard. It seems clear that the efforts of the Seaboard management were directed to the objective of concealing and minimizing the true unfavorable condition of the company and that respondents were swayed by the wishes of the management and their certificate did not prevent the accomplishment of the management's purpose.[58]

Respondents assert that the certified financial statements were adequate to put Seaboard's bank creditors on notice as to the deteriorated condition of Seaboard and resulted in the banks taking im-

[56] For example, while the increase of $750,000 in the reserve for losses, though inadequate, was substantial, the related notes sought to soothe the feelings of concern this increase might have occasioned by stating that all accounts considered doubtful were already written off and that if any part of the reserve was deducted from the related advance assets would be understated, and by implying that the reserve increase was provided as an extra precaution against possible future losses that might result from general business conditions.

[57] Cf. *Associated Gas and Electric Company*, 11 S.E.C. 975, at 1058 (1942):

". . . We should have hesitated to criticize the accountants on individual items had we not been unequivocally satisfied that the financial statements, looked at as a whole, were not truthfully informative and should never have been certified.

"We think, moreover, that too much attention to the question whether the financial statements formally complied with principles, practices and conventions accepted at the time should not be permitted to blind us to the basic question whether the final statements performed their function of enlightenment, which is their only reason for existence."

[58] There is no evidence that respondents profited financially or otherwise by handling the audit as they did. However, it would seem that accountants rarely do benefit from a failure to perform their functions properly. See Kostelanetz, "*Accountants' Responsibilities and the Criminal Law*," The New York Certified Public Accountant (July 1943), p. 401:

"It must be observed that derelictions by accountants are for the most part not a result of greed to share in the loot produced by fraud. On the contrary, accountants have been led astray by their desire to help their clients out of a particular embarrassment by stretching a point of auditing or accounting principle. Unless the affairs of the client improve, the accountants subsequently find themselves committed to the same intentional errors but to a greater degree, until a day of reckoning when third parties, usually creditors, stockholders, or the government, delve into the affairs of the client and discover the fraud . . . almost invariably the facts show that except for the retention of a particular client of doubtful value accountants have not profited by the scheme, . . ."

mediate action, so that by September 1948, within 6 months after the delivery of those statements to the banks, Seaboard was in liquidation. However, a public accountant whose duty it is to convey full information does not fulfill his obligations by simply giving so much information as is calculated to induce requests for more.[59] Although when they saw the financial statements the banks were sufficiently concerned to asked Seaboard for supplementary information, it was not until this supplementary information, which was substantially the same as that furnished respondents by Seaboard in the course of the audit, was furnished to the banks that they really became alarmed and instituted inquiries and surveys independent of the management.[60]

The responsibility of a public accountant is not only to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statements which he certifies. The function of an independent public accountant has been described as follows by the executive director of the American Institute of Accountants:

". . . Whenever he certifies a financial statement the certified public accountant is potentially, at least, rendering a service to two or more parties whose interests may come into conflict—management and stockholder, borrower and lender, purchaser and seller. He may, and often does, serve simultaneously competitors in the same line of business, without fear on the part of either client that he will favor the one or the other. It is the peculiar obligation of the certified public accountant, which no other profession has to impose on its members, to maintain a wholly objective and impartial attitude toward the affairs of the client whose financial statements he certifies. The certified public accountant acknowledges a moral responsibility (and under the Securities Act this is made a legal and financial responsibility) to be as mindful of the interests of strangers who may rely on his opinion as of the interests of the client who pays his fee. This is at the same time a heavy burden and a proud distinction. It marks the certified public accountant as an individual of the highest integrity; a toughminded technician whose judgment cannot be unbalanced by the strongest pressures, who stakes a hard-earned professional reputation on his ability to express a fair and just opinion on which all concerned may rely; in the broad sense, a highly useful servant to society as a whole.

". . . The certified public accountant, therefore, in providing accounting statements which all concerned may accept as disinterested expressions, based on technically sound procedures and experienced judgment, may serve as a kind of arbiter, interpreter, and umpire among all the varied interests. Thereby he can eliminate the necessity for costly separate investigations by each party at interest, as well as endless doubts, delays, misunderstandings, and controversies which are so much sand in the economic machine." [61]

The public accountant must report fairly on the facts as he finds them whether favorable or unfavorable to his client.[62] His duty is to safeguard

[59] *Associated Gas and Electric Company*, 11 S.E.C. 975, 1058 (1942); Cf. *Missouri Pacific Railroad Company*, 6 S.E.C. 268, 277 (1939); *Universal Camera Corporation*, 19 S.E.C. 648, 654 (1945).

[60] The banks had Seaboard employ TN to make a survey of the principal debtors of Seaboard as of June 30, 1948, "entirely independent of what Mr. Babcock and his immediate associates at the head office may have to say about the several situations." TN's survey, completed about July 15, 1948, showed that Seaboard's advances increased substantially by June 30, 1948, that the debtors' conditions were precarious, and that as of June 30, 1948, an estimated reserve for losses of $2,500,000 was required if efforts were made to work out the situations over a period of 1 to 3 years and of $4,150,000 if liquidation proceedings were initiated immediately. This was so disturbing that the banks engaged two men experienced in the commercial credit field to take a quick look at Seaboard's operations. The banks also had Seaboard engage a new general manager selected by them, had an engineering survey made by industrial engineers, and an audit by the public accounting firm of S. D. Leidesdorf & Co. as of July 31, 1948. The banks also had questions as to adequacy of the financial statements certified by TN as of December 31, 1947, and engaged S. D. Leidesdorf & Co. to review the Seaboard books and records which would have been available to accountants making an audit as of December 31, 1947. Following all this Seaboard's accounts, with the exception of Ripley, were liquidated with very substantial losses.

[61] John L. Carey, *Professional Ethics of Public Accounting* (1946), pp. 13-14.

[62] See e.g. *The Journal of Accountancy*, December 1946, p. 453:

"Technical accounting ability is essential for success in

the public interest, not that of his client. As this Commission pointed out In the Matter of *Cornucopia Gold Mines:*[63]

". . . The insistence of the Act [Securities Act of 1933] on a certification by an 'independent' accountant signifies the real function which certification should perform. That function is the submission to an independent and impartial mind of the accounting practices and policies of registrants. The history of finance well illustrates the importance and need for submission to such impartial persons of the accounting practices and policies of the management to the end that present and prospective security holders will be protected against unsound accounting practices and procedures and will be afforded, as nearly as accounting conventions will permit, the truth about the financial condition of the enterprise which issues the securities. Accordingly, the certification gives a minimum of protection against untruths and half-truths which otherwise would more easily creep into financial statements. . . . It [the certificate] is a material fact, for it gives meaning and reliability to financial data and makes less likely misleading or untrue fiancial statements. . ."

CONCLUSIONS

We have found that the Seaboard balance sheet as of December 31, 1947, was materially misleading in that an inadequate reserve was reflected therein for accounts known to be doubtful of collection, current assets were overstated, advances to subsidiaries were not so designated, and the notes relating to the reserve for losses and to current assets improperly described the nature of the reserve and the basis for inclusion of advances in current assets; and that Seaboard's income statement for the year 1947 was materially misleading, particularly in that insufficient provision was made for losses on uncollectible accounts.

We have also found that in certifying such financial statements the respondents failed to comply with generally accepted auditing standards and rules and regulations of the Commission, and failed to fulfill their responsibilities as independent accountants by their reliance upon the unsupported and questionable representations of the Seaboard management in agreeing to accept a reserve figure which was materially inadequate and was substantially less than that which they had recommended; by agreeing to the transfer to noncurrent assets of advances in an inadequate amount substantially lower than they had recommended, without any proper basis therefor; by their failure to insist upon the proper classification of advances to subsidiaries on the Seaboard balance sheet; by their failure to insist upon the Seaboard income account being charged with an adequate provision for losses on uncollectible accounts; and by their agreeing, at the insistence of management, to the deletion from their final certificate and from a note to the financial statements of a paragraph regarding the financial situation of the debtors at December 31, 1947.

Under these circumstances we conclude that the TN firm and the individual respondents now before us, Mendes and Werntz, engaged in improper professional conduct within the meaning of Rule II(e).[64] We accordingly turn to the question of what disciplinary action is appropriate.

Respondents assert that the TN firm has earned the confidence of the business and banking community by its demonstrated ability and honesty and has a large number of important clients; that the individuals involved all have eminent backgrounds and that the Seaboard audit is only a very small part of their professional careers of many years in which they have demonstrated their integrity; that the Seaboard audit involved difficult problems of judgment which had to be re-

the field of public accountancy, but it is the quality of a certified public accountant's integrity and his independence more than his ability that determine the extent of his usefulness to society. No matter how highly skilled a certified public accountant might be, *if he could not be depended upon to see that the financial statements which he certifies are honestly presented, whether his client likes it or not, he would be not only valueless in the public accounting profession, he would be a business menace.* But a public accountant of only ordinary technical accounting ability, whose integrity and courage are unassailable, may be a tower of strength in his business community." (Address by Carman G. Blough. *Italics supplied.*)

[63] See 1 S.E.C. 364, 367 (1936).

[64] The Seaboard certificate was signed in the TN firm name. We have held that where a firm of public accountants permits a report or certificate to be executed in its name it will be held responsible therefor. Accounting Series Releases Nos. 67 and 68 (1949).

solved promptly; and that the respondents did insist on substantial changes in the statements and refused to issue an unqualified certificate unless such changes were made.

They also point to the lapse of time since the audit was made, and note that the death prior to this proceeding of Brown, who it is asserted was the partner in charge and primarily responsible for the conduct of the Seaboard audit, shifted the burden of defending his conduct or explaining the reasons for his decisions to the other individuals. Respondents state that Carol F. Hall, who did take an active part in the discussions with Seaboard, did not undertake to re-examine all the audit work done by Brown but only to lend the benefit of his senior judgment.[65] They also point out that Mendes, then the managing partner in TN's New York office, took only a small part in the Seaboard audit, and retired from active practice in 1952 after a long career. With respect to Werntz, respondents refer to the fact that he had joined one of the TN predecessor firms in 1947 after a career of teaching and service with this Commission and had no experience in public accounting prior to the Seaboard audit, and that in view of these facts and since Werntz was at the time an employee and not a partner, Brown as the partner in charge had the overriding responsibility and Werntz did not make the decisions.[66] Werntz was reassigned to an out-of-town engagement and did not attend the conferences after March 12, 1948, and respondents state that the final reserve figure represented the judgment of Brown and Hall and that some of the other questions developed and were settled while Werntz was away.

Finally respondents urge that the present TN firm was in its infancy in 1947, that of its 49 percent active partners, 25 were not partners at the time of the Seaboard audit, and that any disqualification of the firm would impinge unfairly on them.

We recognize that Brown, and to a lesser degree Hall, had the more active responsibility for the decisions made in the course of the audit and that Werntz made a number of suggestions which were not ultimately followed and did not participate in all the conferences. Nevertheless Werntz, who expected in due course to be and was subsequently admitted to partnership, participated most actively in the audit and conferences through March 12; in his testimony he has associated himself with the audit procedures and the decisions regarding the reserve for losses and has vigorously defended them. Mendes as the senior partner in the New York office was responsible for the review of the certificate issued in the name of the firm and of the financial statements to which such certificate related; he was specifically consulted with respect to the Seaboard situation, and attended at least one conference with management. He was aware of the serious problems that existed, and if in fact he was as unfamiliar with some of the circumstances as his testimony indicates, he failed to give the matter the attention it required.

After careful consideration of all pertinent factors, including those stressed by respondents, we are of the opinion that respondents Touche, Niven, Bailey & Smart, Henry E. Mendes and William W. Werntz should be denied the privilege of practicing before this Commission for a period of 15 days.

Rulings on Exceptions

During the course of the hearings, exceptions were taken by the respondents to rulings of the hearing examiner admitting certain testimony and exhibits. The matter objected to related for the most part to events occurring prior to March 19, 1948, the date of certification, but which the respondents claimed to have been neither known to nor obtainable by them, and to events occurring subsequent to that date. We agree with respondents' position that their conduct should be judged in the light of the facts known or reasonably available at the time of their audit and in arriving at our conclusions on the issues, we have limited ourselves to such facts. To the extent that we have referred herein to events that took place after March 19, 1948, such reference has been only for informational purposes, or where appropriate as a comment on respondents' own references to subsequent events.

On the basis of a careful examination of the evidence involved and the rulings of the hearing examiner, we are of the opinion that such rulings

[65] As previously noted, Hall, who has since died, was originally named as a respondent. He testified in the hearings.

[66] Werntz, who became a partner in 1950, is presently the managing partner of the TN New York office.

were correct, except in a few minor instances not resulting in any prejudice to respondents.[67]

With respect to exceptions taken to the recommended decision, to whatever extent such exceptions involve issues which are relevant and material to the decision in this case, we have by our opinion herein already fully ruled upon them. We hereby expressly sustain those exceptions to the extent that they are in accord with the views set forth herein, and we expressly overrule those exceptions to the extent that they are inconsistent with such views.

An appropriate order will enter.

By the Commission (Chairman ARMSTRONG and Commissioners ORRICK, PATTERSON, HASTINGS, and SARGENT).

ORVAL L. DUBOIS,
Secretary.

[67] Certain documents and testimony relating to specific events occurring subsequent to the date of certification which the respondents could not have known or foreseen, such as a letter from Zelenka to Babcock in April 1948 which in effect tenders his resignation as president of Amity, should not have been admitted into evidence, and we have not relied on such material in reaching our decision.

ORDER TEMPORARILY DENYING ACCOUNTANTS' PRIVILEGE OF PRACTICING BEFORE THE COMMISSION

A proceeding having been instituted pursuant to Rule II(e) of the Commission's Rules of Practice to determine whether Touche, Niven, Bailey & Smart, a firm of certified public accountants, and Henry E. Mendes, Carol F. Hall, William W. Werntz, and Oscar Blomquist, presently or formerly partners or employees of said firm, should be disqualified or denied, temporarily or permanently, the privilege of appearing or practicing before the Commission;

A private hearing having been held after appropriate notice, the hearing officer having filed a recommended decision, and a brief having been filed and oral argument heard;

It appearing that Carol F. Hall died subsequent to the institution of the proceedings; and

The Commission having this day issued its Findings and Opinion, on the basis of said Findings and Opinion

IT IS ORDERED, pursuant to Rule II(e) of the Rules of Practice, that Touche, Niven, Bailey & Smart, Henry E. Mendes and William W. Werntz be denied the privilege of practicing before the Commission for a period of 15 days, beginning May 1, 1957.

IT IS FURTHER ORDERED that the proceeding be discontinued as to Carol F. Hall, and be dismissed as to Oscar Blomquist.

By the Commission.

ORVAL L. DUBOIS,
Secretary.