RELEASE NO. 88

May 24, 1961

Findings and Opinion of the Commission In the Matter of Myron Swartz pursuant to Rule II(e), Rules of Practice.

ACCOUNTING—PRACTICE AND PROCEDURE

Denial of Privilege to Practice Before Commission
Unethical and Unprofessional Conduct

Where certified public accountant made it possible for false and misleading financial statements and certificates to be circulated on his stationery over his signature, and thereafter without disclosing falsity of such statements continued to perform accounting services, including preparation of incorrect and misleading statements for filing with Commission, for same persons, and where in subsequent Commission investigation he testified falsely with respect to certain of such matters, *held*, accountant engaged in unethical and improper professional conduct and is disqualified from practicing before Commission.

APPEARANCES:

Ellwood L. Englander and *Theodore Focht*, of the Office of the General Counsel, for the Office of the Chief Accountant of the Commission.

Edward T. Tait, for respondent.

FINDINGS AND OPINION OF THE COMMISSION

By GADSBY, Commissioner:

This case, brought under Rule II(e) of our Rules of Practice,[1] involves charges of professional misconduct against an accountant, Myron Swartz, indulged in in connection with the preparation and use of certain financial statements of Eastern Investment and Development Corporation ("Eastern") and Cornucopia Gold Mines ("Cornucopia"). There is a further accusation that respondent gave false testimony under oath in prior Commission proceedings.[2] Swartz is a certified public accountant and a member of the American Institute of Certified Public Accountants and the Pennsylvania Institute of Certified Public Accountants. During the period of 1957 and 1958 involved here, he practiced in Pittsburgh, Pennsylvania as a sole proprietor under the name Myron Swartz and Company.

At the time covered by this record, Eastern was a substantial stockholder in Cornucopia, and both companies were under the control of Earl Belle, Murray and Burton Talenfeld and their father, Edward Talenfeld. Swartz testified under oath in July 1958 in the course of an investigation conducted by our staff, which testimony became a part of the record in proceedings under Section 19 (a) (2) of the Securities Exchange Act of 1934 as the result of which we withdrew the registration of Cornucopia's common stock on the American Stock Exchange. We found in such proceedings that Cornucopia had violated the reporting requirements of the Exchange Act by failing to disclose pertinent and accurate information regarding its condition and affairs and by filing reports, including financial statements, which contained false and misleading information.[3]

Among other things, we found that Cornucopia and Eastern had obtained substantial bank loans after bank officials had discussed with Belle and and Talenfeld brothers certain financial statements of Eastern as of July 31, and December 31, 1957. These financial statements were false and misleading in their presentation of assets, liabilities and capital, and the certificate covering the July statements, at least, falsely stated that an audit had been made.[4] The certificates accompanying the July 31, 1957, statements were admittedly on Swartz's office stationery and bore his signature.

---

[1] 17 CFR 201.2(e).

[2] Respondent has waived a hearing and other procedural steps, has agreed that the record herein shall include his prior testimony, has stipulated to certain testimony that would be presented if a hearing were held, and has agreed that on the basis of this evidence we may conclude that he has engaged in unethical and improper professional conduct within the meaning of Rule II(e) and may take appropriate action pursuant to that rule. Our findings are based upon the record thus made.

[3] *Cornucopia Gold Mines*, Securities Exchange Act Release No. 6339 (August 11, 1960).

[4] Securities Exchange Act Release No. 6339, p. 5.

During the staff's investigation of the Cornucopia matter in 1958, Swartz testified that he had provided Belle with about 10 copies of his letterhead stationery signed in blank and that Belle had had the certificates typed over Swartz's signature and attached them to the false and misleading financial statements. He then further testified the first and only time he did any work for Eastern was in the summer of 1957 when, at Belle's request, he met Belle on a Sunday afternoon at Eastern's office in Pittsburgh, and after an examination of Eastern's books prepared a draft of a balance sheet as of July 31, 1957. Swartz stated that Belle painted a glowing picture of the expanding prospects of Eastern and Cornucopia and held out to him the expectation that he (Swartz) would have a profitable future as the accountant for the entire business enterprise. Swartz was then only 27, and in his first year of practice. It appears also from Swartz's testimony that he had met Belle at school, that their families were friendly and that Belle had received much publicity as a young financial genius. Swartz testified that he agreed to give Belle his working papers and copies of his business stationery signed in blank in order that Belle, who was leaving for New York that day, could have the balance sheet and the certificate typed there.

Swartz further testified that he did not learn that his confidence in Belle had been misplaced until November 1957, when he discovered that his signed letterheads had been used to certify false financial statements and to state falsely that he had made an audit. Swartz said that he then confronted Belle in the presence of the Talenfeld brothers and threatened to inform the proper authorities, but that he was dissuaded from doing so by Belle, who pointed out that the false statement had already been in circulation and that Swartz himself bore some responsibility in the matter because he had furnished the letterheads signed in blank. Swartz admitted that he had continued to work after November 1957 for Belle and Belle-controlled companies and that, even after he had learned that his name had been used a second time to circulate another false statement of Eastern as of December 31, 1957, he was again deterred from disclosing the improprieties by Belle's warnings of adverse consequences should such disclosure be made.

In February 1960, Swartz made a voluntary statement admitting that a material part of the testimony he had thus given during the 1958 investigation was false.[5] Specifically, he stated that he had not examined Eastern's books in the summer of 1957 as he had previously testified; indeed, he had never examined Eastern's books. Swartz admitted that his testimony that the Eastern July 31, 1957, financial statements were prepared in Pittsburgh was incorrect and that in fact they had been prepared in New York. He also admitted that his testimony asserting that the first work for Eastern he was doing during the summer of 1957 was incorrect and that in fact he had on an earlier date signed an Eastern financial statement as of March 31, 1957. These admissions indicate that this entire earlier testimony about meeting Belle in Pittsburgh, examining the books there and giving Belle letterheads signed in blank only because Belle had to leave for New York that same day, was false. In addition, Swartz stated that the reason he did not reveal the existence of the Eastern statement of March 1957 in his testimony in 1958 was that, prior to such testimony, he was told by Murray Talenfeld that the latter had collected all the copies of the Eastern statement and that this Commission therefore could not know of it, and he was requested by Talenfeld not to reveal its existence. Thus it appears that Swartz testified falsely in July 1958 when he stated that although he had talked to the Talenfelds prior to his testimony, they had not discussed or said anything with regard to what he should or should not say in his testimony.

As noted, even though Swartz had learned in November 1957, of the circulation over his signature of false Eastern financial statements as of July 31, 1957, he continued to work for Belle. There is no evidence which would indicate that Swartz took steps to insure that no further blank signed certificates remained in Belle's possession. In fact, as we have already described, false Eastern statements as of December 31, 1957, were circulated over Swartz's name despite his asserted refusal to prepare such statements. However, Swartz admittedly prepared for Belle a draft of a

[5] Swartz voluntarily appeared at the U.S. Attorney's Office in Pittsburgh and stated that he wished to clear his conscience by giving an accurate account of his involvement in the Cornucopia matter.

pro forma balance sheet of Cornucopia and its subsidiaries purporting to reflect conditions as of January 31, 1958, containing figures dictated to Swartz by Belle which Swartz himself has characterized as figments of Belle's imagination. Swartz contended that it was his understanding these figures were for Belle's personal use only, as a presentation of Belle's hope of what the companies would be. In fact, it appears that this pro forma balance sheet was forwarded by Belle to one of the banks from which loans were obtained for Cornucopia and Eastern.[6] It is difficult to understand how, in view of Belle's circulation of the false July 1957 statements, Swartz could have accepted at face value Belle's statements as to the use to be made of such a balance sheet.

Under the foregoing facts, it is clear and we so find that Swartz, being under oath, gave false testimony before us in the 1958 proceedings.

Early in 1958, Swartz undertook to prepare two sets of certified financial statements as of December 31, 1957, one for Cornucopia to be filed with this Commission in connection with Cornucopia's annual report under Section 13 of the Securities Exchange Act, and the other for Cornucopia and its subisdiaries to be filed with us in connection with Cornucopia's proxy solicitation material pursuant to Section 14 of that Act. According to Swartz, Belle requested him to write up the value of the assets in the statement for the subsidiaries so as to show a larger net worth, and Swartz refused. However, it is stipulated that the financial statements of Cornucopia which were certified by Swartz were materially false and misleading in certain other respects.[7]

In March 1958, Swartz furnished Cornucopia's attorney with certain information for inclusion in the company's proxy statement, and in April 1958 he made inquires of a member of our staff with respect to the financial statements required with the proxy statement. However, the financial statements as filed with us by Cornucopia in May 1958 as a part of its annual report and proxy material were not certified by Swartz, but by another accountant who had been employed by certain of Cornucopia's subsidiaries and to whom Swartz had delegated some detail work in connection with his audits of these companies. This other accountant had not audited Cornucopia's books and records but evidently had substantially copied the statements prepared by Swartz. In June 1958, Swartz wrote a letter, which was actually drafted by Belle, to an officer of a bank who had inquired regarding the certification of the Cornucopia statements. That letter stated that Swartz had prepared the financial statements of the Pittsburgh companies of Cornucopia and would have had no hesitation in certifying them, but that he had submitted them to the other accountant for a single certification for all the companies.

It seems clear from the foregoing that Swartz's conduct throughout his connection with the affairs of Eastern and Cornucopia was manifestly unethical, improper and unprofessional. Without even seeing the books and records of Eastern, he certified financial statements of that company as of March 31, 1957, and he furnished Belle with blank signed stationery which was later used to circulate false financial statements as of July 31. Even assuming that Swartz had embarked upon this course of conduct without a full appreciation of what was involved, he did nothing to make appropriate disclosures of the improprieties once he discovered them and was aware of the seriousness of the misconduct involved. On the contrary, Swartz continued to perform services, including the preparation of certified financial statements of Cornucopia, which are stipulated to have been incorrect and misleading. Finally, respondent testified falsely with respect to certain of these matters in the investigation conducted by our staff.

Swartz has agreed that we may find that he engaged in unethical and improper professional conduct within the meaning of our Rule II(e), but asks that we take into account his youth and inexperience and the circumstances under which the conduct occurred. He asserts he had no reason to question the integrity of Belle, who was being publicly hailed as a financial genius and had the capacity to sway older and wiser men than Swartz, including the officials of the banks which yielded to Belle's persuasions. Swartz states that when he signed the March Eastern statements he believed the figures given to him were correct and

[6] See *Cornucopia Gold Mines*, Securities Exchange Act Release No. 6339, p. 6 (August 11, 1960).

[7] As to the deficiencies in the financial statements of Cornucopia filed with us and based on the statements prepared by Swartz, see *Cornucopia Gold Mines*, Securities Exchange Act Release No. 6339, pp. 8-9 (August 11, 1960).

unwisely relied upon Belle's promise that he would have an opportunity to make a complete audit of Eastern. Swartz further asserts that when he became aware of Belle's perfidy he told Belle that he would not participate further in his schemes, but Belle intimidated him by having Belle's attorney cite cases to Swartz in which certified public accountants had been disgraced by being punished for wrongful professional conduct. Finally, it is emphasized that Swartz voluntarily corrected his earlier testimony and testified before us without compulsion, that he has been under mental strain as a result of the acts performed for Belle for the past 3 years and has experienced a personal punishment greater than that which disciplinary action in this proceeding would impose, and that his errors will not be repeated.

We have given consideration to all these factors, as well as to Swartz's testimony that he refused to engage in certain misconduct when requested by Belle, but in our opinion these considerations do not detract significantly from the serious nature of the misconduct in which he did engage. In addition, even if credence is given to Swartz's assertions that he was intimidated by Belle and did not make proper disclosure for fear of the personal consequences described by Belle, there is no evidence or claim that Swartz was coerced into continuing to work for Belle and his companies. On the contrary, the indications are that Swartz in continuing to perform services was motivated by the hope of compensation not only for past unpaid work but also for potential future business. His conduct in this respect, particulary in certifying financial statements for filing with this Commission and his communications in connection therewith with our staff and with an inquiring bank, without disclosing what he knew of the improprieties involved, is especially to be condemned.

In view of the gravity of the misconduct here involved and in view of the high standard of honesty and professional conduct we must demand of accountants and others practicing before this Commission if we are to fulfill our responsibility to protect the public interest, we must conclude that Swartz should be denied the privilege of practicing before us in the future.

An appropriate order will issue.

Chairman CARY and Commissioners HASTINGS, WOODSIDE, and FREAR join in the above opinion.

ORVAL L. DUBOIS,
Secretary.

RELEASE NO. 89*

July 26, 1961

SECURITIES ACT OF 1933
Release No. 4396

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 14483

SECURITIES EXCHANGE ACT OF 1934
Release No. 6601

INVESTMENT COMPANY ACT OF 1940
Release No. 3294

Revision of Articles 7 and 12 of Regulation S-X

The Commission today adopted a general revision of Articles 7 and 12 of Regulation S-X which govern the form and content of financial statements and related schedules filed by insurance companies other than life and title insurance companies. This revision reflects changes in requirements of the Annual Statement filed with State regulatory authorities and developments in insurance reporting since these articles were originally adopted.

As a result of the reluctance on the part of independent public accountants to express an opinion in respect of the financial statements included in the Annual Statement and the accounting principles and practices reflected therein as required by

* The text of the revised Articles and Amendments have been omitted.

Rule 2-02(c) of Regulation S-X without taking exception to certain insurance accounting practices, there has grown up the practice of reconciling the statutory capital share equity and net income or loss with capital share equity and net income or loss as determined in accordance with generally accepted accounting principles and practices. Special note 2 of Rule 7-05 gives recognition to this practice where such differences are deemed to be material, the principal differences being in the accounting for nonadmitted assets and commissions and expenses incurred in writing insurance.

Statutory Basis

The foregoing action is taken pursuant to the Securities Act of 1933, particulary Sections 6, 7, 8, 10 and 19(a) thereof, the Securities Exchange Act of 1934, particularly Sections 12, 13, 15(d) and 23(a) thereof, the Public Utility Holding Company Act of 1935, particularly Sections 5(b), 14, and 20(a) thereof, and the Investment Company Act of 1940, particularly Sections 8, 30, 31(c) and 38(a) thereof.

The revised articles shall be effective with respect to financial statements for any fiscal year ending on or after December 31, 1961, filed as a part of any registration statement, application for regristration or report. However, if a registrant so elects, the revised articles may be applied to financial statements filed prior to that date.

By the Commission

ORVAL L. DUBOIS,
Secretary.

RELEASE NO. 90

March 1, 1962

SECURITIES ACT OF 1933
Release No. 4458

Certification of Income Statements

It has come to the attention of the Commission that wide variations have developed in certificates of independent accountants contained in registration statements filed under the Securities Act of 1933 with respect to representations concerning the verification of inventories of prior years in first audits. This development has been noted particularly in situations involving the offering of securities of closely held corporations which have failed to maintain and preserve accounting records and data necessary to permit verification of financial statements. In some cases a question arises whether the certifying accountant intended to limit his opinion as to the fairness of presentation of the income statements.

The following is the pertinent part of an example of this type of certificate:

> "* * * Except as noted in the succeding paragraph, our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
> "Since this was our initial examination of the Financial Statements of the Company, September 30, 1961, was the only date at which we observed the taking of physical inventories. However, based on other tests we applied, including tests of gross profits and review of physical inventory records, we have no reason to believe that inventories at September 30, 1958, 1959, and 1960, were not also fairly stated.
> "In our opinion, with the foregoing comment regarding inventories * * *."

In view of the large number of companies which are now offering securities to the public for the first time and which have this problem, the Commission deems it advisable to remind the financial community that the Securities Act requires that registration statements contain a certificate of an independent accountant based on an audit conducted in accordance with generally accepted auditing standards and meeting the reporting requirements of the Commission.

After testimony was taken from 12 expert witnesses called by the Commission in the investigation of McKesson & Robbins, Inc.,[1] the membership of American Institute of Accountants at the 1939 annual meeting approved the extension of of auditing procedures to require observation of inventory taking.

In January 1942 the Commission, to avoid any possible interruption in the production and delivery of war material, announced a liberalized policy with respect to physical inventory verification by independent public accountants. (Accounting Series Release No. 30.) After specifying information to be furnished in the certificate the release said:

> "In many cases, it is probable that by means of their alternative and extended procedures the independent public accountants will have satified themselves as to the substantial fairness of the amounts at which inventories are stated, and in such case a positive statement to that effect should be made. In some cases it may be that, while the scope of procedures followed will not be such as to have so satisfied the accountants, they will be able to take the position that on the basis of the work done they have no reason to believe that the inventories reflected in the statements are unfairly stated.
>
> "Of course, if the scope of the work done or results obtained from the procedures followed or the data on which to base an opinion are so unsatisfactory to the accountants as to preclude any expression of opinion, or to require an adverse opinion, that situation must be disclosed not only by an exception running to the scope of the audit, but also by means of an exception in the opinion paragraph as to the fairness of the presentation made by the financial statements. * * *"

In the Drayer-Hanson matter (Accounting Series Release No. 64, March 15, 1948) (see p.110) the accountants' opinion included a now-familiar sentence: "On the basis of the examinations and tests made by us, we have no reason to believe that the inventories as set forth in the accompanying statments are unfairly stated." The Commission found in this case that in addition to the work done on the inventories, other effective procedures could have been applied and hence that the representation cited was entirely without justification.

The first-time audit situation was considered in Accounting Series Release No. 62, (see p. 107) which dealt with the circumstances under which independent public accountants may properly express an opinion with respect to summaries of earnings. Concluding that the accountant can express an opinion on completion of a first audit, the release said "It is recognized that some auditing procedures commonly applicable in the examination of financial statements for the latest year for which a certified profit and loss statement is filed, such as the independent confirmation of accounts receivable or observation of the inventory-taking, are either impracticable or impossible to perform with respect to the financial statements of the earlier years and, hence, would not be considered applicable in the circumstances."

This statement in the Commission's release is consistent with interpretations of "extensions of auditing procedure" approved by the membership of the Institute at the 1939 annual meeting. Such extension of auditing procedures to require observation of inventories and confirmation of receivables applies where either of these assets represents a significant proportion of the current assets or of the total assets of a concern. As to inventories, Codification of Statements on Auditing Producedure says "The procedures, it will be noted, must be *both* practicable and reasonable. In the province of auditing, *practicable* means 'capable of being done with the available means' or '. . . with reason or prudence'; *reasonable* means 'sensible in the light of the surrounding circumstances.' For example, the observation of physical inventories at the beginning of the period or year under examination would seldom, if ever, be practicable or reasonable in initial or 'first' audits. However, the independent accountant must satisfy himself as to such inventories by appropriate methods."

It seems clear from the discussion above that if an accountant reports that his examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as he considered necessary in the circumstances, an exception as to

---

[1] See Report on Investigation and Testimony of Expert Witnesses, G.P.O. 1940 and 1939.

failure to observe beginning inventories is contradictory and should be omitted. A middle paragraph explaining that the certificate covers a first audit is informative and in some cases is essential to describe the alternative procedures applied. A negative type conclusion to this paragraph appears to be a carry-over from wartime usage and is not acceptable. Lost and inadequate records may give rise to questions as to the reliability of the results shown in the finacial statements and may make it impracticable to apply alternative audit procedures. Alternative procedures must be adequate to support an unqualified opinion as to the fairness of presentation of the income statements by years.

If, as a result of the examination and the conclusions reached, the accountant is not in a position to express an affirmative opinion as to the fairness of the presentation of earnings year by year, the registration statement is defective because the certificate does not meet the requirements of Rule 2-02 of Regulation S-X. If the accountant is not satisfied with the results of his examination he should not issue an affirmative opinion. If he is satisfied, any reference from the opinion paragraph to an explanatory paragraph devoted solely to the scope of the audit is inconsistent and unnecessary. Accordingly, phrases such as "with the foregoing explanation as to inventories" raise questions as to whether the certifying accountant intended to limit his opinion as to the fairness of the presentation of the results shown and should be omitted.

A "subject to" or "except for" opinion paragraph in which these phrases refer to the scope of audit, indicating that the accountant has not been able to satisfy himself on some significant element in the financial statements, is not acceptable in certificates filed with the Commission in connection with the public offering of securities. The "subject to" qualification is appropriate when the reference is to a middle paragraph or to footnotes explaining the status of matter which cannot be resolved at statement date.

RELEASE NO. 91

July 20, 1962

Findings and Opinion of the Commission In the Matter of Arthur Levison and Levison and Company, pursuant to Rule 2(e), Rules of Practice.

ACCOUNTING—PRACTICE AND PROCEDURE

Denial of Privilege to Practice Before Commission

Where certified public accountant certified materially false and misleading financial statements including statements filed with the Commission and stated in his certificates that he had examined the companies' financial accounts and records and that such examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and other auditing procedures as he considered necessary under the circumstances, when in fact he had not even seen the companies' books and records but relied instead entirely on statements which another certified public accountant either had prepared or the accountant assumed he had prepared; and he was not independent with respect to the company whose financial statements were filed with the Commission, *held*, accountant engaged in unethical and improper professional conduct and will be denied privilege of practicing before the Commission.

APPEARANCES:

Ellwood L. Englander, Theodore H. Focht and *George P. Michaely, Jr.*, of the Office of the General Counsel, for the Office of the Chief Accountant of the Commission.

Louis Schultz, for respondent.

FINDINGS AND OPINION OF THE COMMISSION

PER CURIAM:

The question before us is whether Arthur Levison, a certified public accountant who at times relevant here practiced accounting in New York under the name Levison and Company, should be denied, temporarily or permanently, the privilege of appearing or practicing before

this Commission, pursuant to Rule 2(e) of our Rules of Practice.[1]

After a private hearing, our staff and respondent filed proposed findings and briefs, and the hearing examiner submitted a recommended decision in which he recommended that Levison be denied the privilege of practicing before this Commission in the future. Respondent filed exceptions and we heard oral argument.

This proceeding is another outgrowth of the investigations relating to Cornucopia Gold Mines ("Cornucopia") and Eastern Investment and Development Corporation ("Eastern"), an affiliated company.[2] In 1957 Cornucopia and Eastern, which had acquired a substantial amount of Cornucopia stock, were both controlled by Murray Talenfeld, Burton Talenfeld and Earl Belle. Levison was a salaried employee of Frank Proctor & Associates, Inc. ("Proctor Associates"), and had performed work in connection with the books and records of two companies located in Long Island, New York, Century Controls Corp. ("Century") and Carl W. Schutter Corp. ("Schutter Corp."), which were being managed by Proctor Associates. Near the end of that year Cornucopia acquired control of five companies, including Century and Schutter Corp., from a group of sellers which included Proctor Associates. Levison was retained as an employee of the Cornucopia group, performing work for Century and Schutter Corp. and drawing a salary from these companies. Levison also served as a director of Century for several months prior to December 1957. Early in 1958, Levison, at Belle's request, agreed to certify certain financial statements of Cornucopia. Thereafter, in addition to fees from Cornucopia, he continued to receive monthly compensation from Century and Schutter Corp. for services such as furnishing monthly reports and financial advice to the management of those companies and advising and assisting their bookkeeping staffs.

Levison certified materially false and misleading financial statements of Cornucopia as of December 31, 1957. These statements were filed with us in May 1958 as part of the Cornucopia's annual report for 1957 pursuant to Section 13(a) of the Securities Exchange Act of 1934. In addition, he certified two financial statements of Eastern, one as of January 31, 1957, and the other as of April 30, 1957, which also contained materially false and misleading information.

The Cornucopia certificate stated "We have examined the financial accounts and records of Pittsburgh office of Cornucopia" and referred to a report of an examination of Cornucopia's Spokane office by another firm of certified public accountants, which was attached. The Eastern certificates stated "We have audited the books and records of Eastern." Each certificate included the recital that "Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances."

In fact, as Levison admits, he had made no audit of, nor had he ever seen, the books and records either of Cornucopia or of Eastern. The Cornucopia statements certified by him were copied, with some figure and wording changes, from statements prepared and certified by Myron Swartz, another accountant. The Eastern statements certified by Levison were copied from unsigned draft statements given to him by Belle. Levison testified that he was under the impression that these statements had also been prepared by Swartz after an examination of Eastern's books, although he did not know whether Swartz had made any audit.

The facts set out above demonstrate that Levison's certifications constituted improper and unethical professional conduct on each of two grounds:

First, Levison was disqualified under Rule 2-01(b) of our Regulation S-X[3] from certifying

[1] 17 CFR 201.2(e).

[2] In *Cornucopia Gold Mines*, Securities Exchange Act Release No. 6339 (August 11, 1960), we found it necessary for the protection of investors to withdraw the registration on the American Stock Exchange of Cornucopia's stock. Disciplinary proceedings against other accountants who performed services for Cornucopia and Eastern are described in *Myron Swartz*, Accounting Series Release No. 88 (May 24, 1961), (see p. 231) and *Morton I. Myers*, Accounting Series Release No. 92 (July 20, 1962) (see p. 241).

[3] Rule 2-01(b) of our Regulation S-X provides that an independent public accountant must be independent in fact, and it specifically recites that an accountant will not be considered independent with respect to any company if he is, or was during the period of the report, connected with the company or its subsidiaries as an employee.

the financial statements of Cornucopia since he was not in fact an independent public accountant with respect to Cornucopia. The services performed by Levison for Century and Schutter indirectly through Proctor Associates and thereafter, following the acquisition of these companies by Cornucopia, directly, were not of a character which would support a finding that Levison was, in fact, independent with respect to Cornucopia within the meaning of our rule. This conclusion is buttressed by Levison's own testimony (referred to hereafter) indicating that he was subject to the dominant influence or direction of Belle and the Talenfelds.

Second, Levison certified the Cornucopia and Eastern financial statements without having audited or seen the books and records of either company. In defense of this flagrant violation of our rules and the standards of his profession, he asserts that he believed in good faith that proper audits had been made by Swartz, that the financial statements were true and correct, that he was not aware that financial statements were false and misleading and that accordingly he was entitled, under Rule 2-05 of our Regulation S-X and Rule 6 of the Rules of Professional Conduct of the American Institute of Certified Public Accountants (A.I.C.P.A.), to rely on examinations made by Swartz, a certified public accountant. Such a defense is without merit because it rests upon a basic misconstruction of the cited rules.

Our Rule 2-05 provides that where "the principal accountant relies on an examination made by by another independent public accountant of certain of the accounts" of the concern whose financial statements are being certified, the certificate of such other accountant need not be filed if no reference is made to such other accountant's examination or, where such reference is made, if "the principal accountant" states in his certificate that he assumes full responsibility for such examination. Aside from the fact that the rule is not available to an accountant who is not himself independent, it is obvious that the rule speaks with reference to a situation where the principal accountant under whose supervision and control an audit is being made relies to a limited extent on an examination by another independent public accountant of "certain of the accounts."

It is not necessary in this case to fix the limits of the extent of permissible reliance because Levison did not examine any of the accounts of either Cornucopia or Eastern. Furthermore, Levison had no control or supervision over any examination in fact made by Swartz. On the contrary, he referred to Swartz as his superior and to himself as having been under the supervision of Swartz.[4] Accordingly, Levison was not the "principal" accountant permitted by our rule to rely on the examination of another independent public accountant. In our opinion, Rule 6 of the A.I.C.P.A.[5] provides no greater support for the defense asserted by Levison than does our Rule 2-05. It would strip all use and meaning from a certification to construe this rule as sanctioning

---

[4] In addition to certifying the financial statements of Cornucopia filed as a part of its annual report on Form 10-K, Levison also certified the financial statements of various of Cornucopia's subsidiaries, including Century and Schutter Corp., which were included in Cornucopia's proxy material filed with us in May 1958 pursuant to Section 14 of the Securities Exchange Act. Those statements had been copied from statements which Levison understood had been prepared by Swartz, with however several changes showing higher cash figures or omitting contingent liabilities. Although Levison had performed no work at all in connection with the Cornucopia and Eastern statements, Swartz delegated to him certain tasks with respect to the preparation of the statements of the subsidiaries and he states that he worked under Swartz's supervision in preparing the statements of Century and Schutter Corp. With respect to the differences between the financial statements of the subsidiaries as prepared by Swartz and as certified by him, Levison asserts that the changes were given to him by Swartz and that he made such changes in reliance on Swartz without any knowledge that they were false or misleading. As to the deficiencies in the statements for the subsidiaries, see *Cornucopia Gold Mines*, Securities Exchange Act Release No. 6339, pages 13-14. Although Levison's certification of the statements of the subsidiaries is not put in issue by the order for proceedings, it is clear from our discussion above that Levison's examination of certain of the accounts under the supervision of Swartz as the principal accountant would not under Rule 2-05 justify Levison's certification of the statements of the subsidiaries.

[5] At all pertinent times that rule provided: "A member shall not sign a report purporting to express his opinion as the result of examination of financial statements unless they have been examined by him, a member or an employee of his firm, a member of the Institute, a member of a similar association in a foreign country, or a certified public accountant of a State or territory of the United States or the District of Columbia."

a practice whereby an accountant having no participation in, or control or supervision of, an audit may nevertheless certify statements prepared and examined entirely by another accountant. We construe Rule 6 to require responsible supervision and control of the audit on the part of the certifying accountant.[6]

It should be emphasized that reliance on either rule in connection with Levison's certification of the Eastern statements is scarcely more than frivolous since these statements were prepared by Levison on the basis of unsigned drafts given to him by Belle.

CONCLUSIONS

Having found that Levison engaged in improper and unethical conduct, we must determine what sanction is appropriate under all the circumstances. In this connection, consideration may appropriately be given to the fact that Levison knew, at the time he was requested to certify the Cornucopia statements, that these statements were to be filed with this Commission. Further, his testimony demonstrates that he was not independent of Cornucopia's management: When he was asked by Belle to certify, Levison felt that he was disqualified for several reasons and that Swartz was the accountant who should make the certification. He was "not at all happy about it" and preferred not to make the certification. Nevertheless, relying on the assurances of Belle and the Talenfelds that "it was all right" and upon Belle's statement that "it was an honor to to present the statement to the S.E.C. and he would prefer that [Levison] get that honor," Levison allowed himself to be persuaded or directed to make the certifications. He then prepared these statements on his own stationery labelling each page with the number of our form and the number of the appropriate Commission rule under which the filings were made with us.

Respondent asserts that this was his first experience in an auditing engagement and he believed he was justified in certifying statements examined by Swartz who in effect was his superior; that he has never been in difficulty before and has an excellent reputation in his community; and that he has cooperated with our staff and voluntarily appeared and testified fully in the Cornucopia investigation. He states that he has learned his lesson and that he and his family have already suffered through adverse publicity and financial hardship and urges that any further sanction should be limited to at most a temporary suspension of his right to practice. We do not find these arguments persuasive.

We have carefully considered all the factors cited by respondent, as well as the nature and circumstances of his activities in relation to the Cornucopia and Eastern financial statements.

In our opinion, Levison's conduct constitutes a serious breach of the standards of his profession and of his responsibilities to us and to the public, warranting the denial to him of the privilege of practicing before us.

An appropriate order will issue.[7]

By the Commission (Chairman CARY and Commissioners FREAR and WHITNEY), Commissioners WOODSIDE and COHEN not participating.

ORVAL L. DUBOIS,
Secretary.

[6] The attitude of the accounting profession itself is indicated by the statements of John L. Carey, then Executive Director of the A.I.C.P.A., that "Rule 6 serves to put the public on notice that when the name of a member of the Institute appears, it may safely be assumed that he has supervised the work and assumes responsibility for it." Carey, *Professional Ethics of Certified Public Accountants*, p. 104 (1956). And compare our statement in *Red Bank Oil Company*, 21 S.E.C. 695, 702 (1946): "We doubt the propriety of the principal accountant undertaking to express his opinion with respect to financial statements when, as to so large a percentage of the revenues and assets, his opinion is founded merely on the reports of other accountants not subject to his supervision, control or direction." In that case the principal accountant relied on another accountant's report for a unit of the business which accounted for about 45 percent of the assets. This is to be contrasted with the present case, where Levison not only relied on Swartz's reports with respect to all of the assets of Cornucopia and Eastern, but he was not in any respect "the principal accountant."

[7] We have considered the recommended decision of the hearing examiner and the exceptions thereto, and to the extent such exceptions involve issues which are relevant and material to the decision of this case, we have by our Findings and Opinion herein ruled upon them. We hereby expressly sustain such exceptions to the extent that they are in accord with the views set forth herein, and we expressly overrule them to the extent that they are inconsistent with such views.

ORDER DENYING PRIVILEGE OF PRACTICING BEFORE THE COMMISSION

Proceedings having been instituted prusuant to Rule 2(e) of the Commission's Rules of Practice to determine whether Arthur Levison, a certified public accountant, should be denied the privilege of practicing before the Commission;

A private hearing having been held, proposed findings, briefs, a recommended decision by the examiner and exceptions thereto having been filed and the Commission having heard oral argument;

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

IT IS ORDERED, pursuant to Rule 2(e) of the Rules of Practice, that Arthur Levison be, and he hereby is, denied the privilege of practicing before the Commission.

By the Commission

ORVAL L. DUBOIS,
Secretary.

RELEASE NO. 92

July 20, 1962

Findings and Opinion of the Commission In the Matter of Morton I. Myers, pursuant to Rule 2(e), Rules of Practice.

ACCOUNTING—PRACTICE AND PROCEDURE

Denial of Privilege to Practice Before Commission
Unethical and Improper Professional Conduct

Where certified public accountant, on basis solely of information supplied on telephone which was materially false and misleading, prepared balance sheet for proposed corporation and sent it to client with covering letter addressed to corporation's "Board of Directors" stating that balance sheet had been prepared from corporation's books and records, *held*, accountant engaged in unethical and improper professional conduct warrenting suspension of his privilege to practice before the Commission.

Where junior partner of accounting firm improperly prepared and transmitted balance sheet wholly without authority or approval of senior partner contrary to firm's rules, but junior partner was demoted to employee status when occurrence was learned by firm's controlling partner, and there is no evidence of any other instance of improper practice by members or employees of firm, *held*, under circumstances disciplinary action against the firm not warranted.

APPEARANCES:

Ellwood L. Englander and *Theodore Focht*, of the Office of the General Counsel for the Office of Chief Accountant of the Commission.

Milton V. Freeman and *Edgar H. Brenner*, of Arnold, Fortas & Porter, for respondents.

FINDINGS AND OPINION OF THE COMMISSION

PER CURIAM:

These are proceedings under Rule 2 (e) of our Rules of Practice [1] to determine whether Morton I. Myers, a certified public accountant engaged in practice in Pittsburgh, Pennsylvania, and the accounting firm of which he was formerly a member, should be denied, temporarily or permanently, the privilege of appearing or practicing before this Commission. The order for proceedings alleges that respondents engaged in unethical and improper professional conduct in the preparation and transmittal of a materially false and misleading balance sheet of Eastern Investment and Development Corporation ("Eastern").

After a hearing before a hearing examiner, our staff and respondents filed proposed findings and briefs, the hearing examiner submitted a recommended decision in which he recommended that Myers be denied the privilege of practicing before

[1] 17 CFR 201.2(e).

us except with our prior approval and that no disqualification be ordered with respect to the respondent accounting firm, the parties filed exceptions and briefs and we heard oral argument. The accounting firm has moved that its name be deleted from the caption of the proceeding.

The material facts are undisputed. On January 28, 1957, Myers, who had worked as an accountant for about 10 years and had been a certified public accountant for about 6 years, received a telephone call from Burton Talenfeld, Eastern's treasurer, whom he had known casually since their childhood and for whom Myers' firm had done some accounting work. Talenfeld said that he and his family were planning to organize an industrial redevelopment program. He requested Myers to prepare a balance sheet for Eastern as of December 31, 1956, on the basis of information he supplied over the telephone, which assertedly was for Talenfeld's personal use to show his family the effect of putting certain assets "into this proposed corporation." Myers prepared the requested balance sheet, in which he derived the item "Capital $802,600.24" by subtracting total liabitities from total assets as furnished by Talefeld, and sent it to Talenfeld together with a covering letter on the accounting firm's letterhead addressed to Eastern's "Board of Directors" which stated "We have reviewed the books and records of [Eastern] and have prepared therefrom a balance sheet as of December 31, 1956." In fact, Myers had not seen any books or records of Eastern, and his sole source of information for the balance sheet was his telephone conversation with Talenfeld. The balance sheet, which was materially false and misleading, was given to a bank from which Eastern thereafter obtained a $100,000 loan to finance its purchase of control of Cornucopia Gold Mines, whose stock was then listed on the American Stock Exchange,[2] and it appears was also shown to representatives of a credit rating service which thereafter issued an analytical report on Eastern.

The senior partner of the accounting firm normally reviewed all of the firm's work and signed it personally, with the exception of monthly or quarterly statements, which Myers was authorized to sign. Under the firm's rules Myers was not authorized to sign the Eastern statement, which he prepared and transmitted at a time when the senior partner was out of the office. Myers did not discuss the matter with the senior partner, who did not learn of the statement until August 1958 when Myers was served with a subpoena to testify in an investigation by this Commission relating to Cornucopia Gold Mines. At that time he severely reprimanded Myers. The partnership was terminated and was succeeded by another firm in which Myers is not a partner but is an employee.

We find that Myers, in preparing the Eastern balance sheet on the basis of mere telephone information and transmitting it with a covering letter addressed to a "Board of Directors" when he knew the corporation was only a proposed one, and falsely stating that he had reviewed the books and records, engaged in unethical and improper professional conduct.

Myers urges several factors in mitigation. He asserts that his conduct, though admittedly improper, represented an isolated instance of negligence during the tax season when he was overworked and tired, and he points to the fact that the statement was not to be filed with this Commission but one which he believed was solely for the use of the Talenfeld family. He also points to the adverse consequences he has already sustained from publicity incident to the Cornucopia case and from the loss of his position as partner in the accounting firm.

We have considered these factors. However, even viewing Myers' conduct as an isolated instance, in our opinion it is utterly inconsistent with the high professional standards which the public interest requires of accountants and members of other professions practicing before us. We conclude that the respondent should be disqualified from practicing before this Commission unless and until he shall obtain our prior approval: *Providing*, That no application for such approval will be entertained for a period of 1 year after the date of our order in this proceeding.

[2] The preparation of the balance sheet and related circumstances are described in *Cornucopia Gold Mines*, Securities Exchange Act Release No. 6339, p. 3, fn. 4 (August 11, 1960), where we found it necessary for the protection of investors to withdraw the registration on the Exchange of Cornucopia's stock because, among other things, of its failure to disclose all its dealings with Eastern.

Our findings in Rule 2(e) proceedings with respect to other accountants who performed work for Eastern and Cornucopia are set forth in *Myron Swartz*, Accounting Series Release No. 88 (May 24, 1961) (see p. 231) and *Arthur Levison*, Accounting Series Release No. 91 (July 20, 1962) (see p. 237).

The remaining question is whether we should take any adverse action with respect to the accounting firm. As noted above, Myers was not authorized to sign the Eastern statement and did so contrary to the firm's rules and at a time when the senior partner was absent from the office. The senior partner disciplined Myers as soon as he learned of the incident, and no other instance of improper professional practice by a member or employee of the firm is cited in the record.[3] While an accounting firm is responsible in a professional sense for statements issued in its name by one of its partners, it does not follow that in every case where a firm partner is found, as here, to have engaged in unethical and improper professional conduct, the firm itself must be subjected to disciplinary action by us. In the circumstances of this case, we find that disciplinary action against the firm as such is not warranted and we grant its motion that its name be deleted from the caption of these proceedings.[4]

An appropriated order will issue.

By the Commission (Chairman CARY and Commissioners FREAR and WHITNEY), Commissioners WOODSIDE and COHEN not participating.

ORVAL L. DUBOIS,
Secretary.

[3] The hearing examiner found that the senior partner over the years had established a firm of substance which had achieved a good reputation and was highly regarded in the community.

[4] We have considered the recommended decision of the hearing examiner and the exceptions thereto, and to the extent such exceptions involve issues which are relevant and material to the decision of this case, we have by our Findings and Opinion herein ruled upon them. We hereby expressly sustain such exceptions to the extent that they are in accord with the views set forth herein, and we expressly overrule them to the extent that they are inconsistent with such views.

ORDER DENYING PRIVILEGE OF PRACTICING BEFORE COMMISSION

Proceedings having been instituted pursuant Rule 2(e) of the Commission's Rules of Practice to determine whether Morton I. Myers, a certified public accountant, should be denied the privilege of practicing before the Commission;

A hearing having been held, proposed findings, briefs, a recommended decision by the hearing examiner and exceptions thereto having been filed and the Commission having heard oral argument;

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

IT IS ORDERED, pursuant to Rule 2(e) of the Rules of Practice, that Morton I. Myers be, and he hereby is, denied the privilege of appearing or practicing before the Commission unless and until he shall obtain the prior approval of the Commission: *Provided*, That no application for such approval will be entertained for a period of 1 year from the date hereof.

By the Commission.

ORVAL L. DUBOIS,
Secretary.

DATE: July 20, 1962.

RELEASE NO. 93*

July 23, 1962

SECURITIES ACT OF 1933
Release No. 4514

SECURITIES EXCHANGE ACT OF 1934
Release No. 6857

Adoption of Form 11–K and Rule 15d–21 and Amendments to Form 10–K and Regulation S–X

The Securities and Exchange Commission has adopted regulations governing the filing of annual reports pursuant to Section 15(d) of the Securities Exchange Act of 1934 relating to employee stock purchase, savings and similar plans. Proposed regulations relating to the filing of such reports were published for comment on June 13,1961 (Securities Exchange Act Release No. 6576). As a result of further consideration of these proposals and the comments and suggestions received in regard thereto, certain changes have been made in the proposed regulations.

A new Form 11-K has been adopted for use in filing annual reports with respect to such plans. A new Rule 15d–21 has been adopted which provides that separate annual and other reports need not be filed with respect to any plan if the issuer of the stock or other securities offered to employees through their participation in the plan files annual reports on Form 10-K or U5S and furnishes to the Commission as a part of its annual report on such form the information, financial statements and exhibits required by Form 11-K and furnishes to the Commission copies of any annual report submitted to employees in regard to the plan. A new general instruction has been added to Form 10-K which specifies the procedure to be followed where an issuer elects to file information and documents pursuant to Rule 15d-21.

Regulation S-X, the Commission's accounting regulation, has been amended by adding thereto a a new Article 6C which prescribes the form and content of financial statements filed for employee stock purchase, savings and similar plans. These new requirements are applicable to reports filed on the new Form 11-K.

RELEASE NO. 94

November 5, 1962

SECURITIES EXCHANGE ACT OF 1934
Release No. 6932

Order In the Matter of Nathan Wechsler, pursuant to Rule 2(e), Rules of Practice

It appearing that the Office of the General Counsel has charged that respondent Nathan Wechsler engaged in conduct which should disqualify him from appearing or practicing before the Commission, and it appearing that respondent has denied the charges and has also denied that he practices or enjoys the privilege of practicing before the Commission, and

It further appearing that respondent has applied to the Commission for a discontinuance of further proceedings in this matter on the ground that his health will be seriously impaired if the matter proceeds, and it appearing from the record in this case, upon the basis of medical evidence presented, that respondent's health is presently seriously impaired, that such impairment may continue for a period of several years, and that the continuation of proceedings in this matter creates a significant risk of serious aggravation of his condition;

* Form 11-K, text of Rule 15d-21 and amendment to Form 10-K have been omitted from this Release.

It also appearing that respondent has tendered to the Commission a formal writing in which he agrees that he will not practice before this Commission in any way in the future, and in which he recognizes and agrees that his resignation is permanent; and the Commission being satisfied that by reason of said formal writing no further proceedings in this matter are necessary; and it being determined by this Commission that it is not inconsistent with the public interest;

IT IS ORDERED that respondent's resignation from appearance or practice of any kind before this Commission be, and the same is hereby accepted, and that no further proceedings be had in this matter.

By the Commission.

ORVAL L. DUBOIS,
Secretary.

RELEASE NO. 95

December 28, 1962

SECURITIES ACT OF 1933
Release No. 4566

SECURITIES EXCHANGE ACT OF 1934
Release No. 6982

Accounting for Real Estate Transactions Where Circumstances Indicate that Profits were not Earned at the time the Transactions were Recorded

A number of recent cases have come to the attention of the Commission in which the gross profits on certain real estate transactions were taken into income under circumstances which indicate that they were not realized in the period in which the transactions were recorded.

The recognition of profit at the time of sale, in accordance with generally accepted accounting principles, is appropriate if it is reasonable to conclude, in the light of all the circumstances, that a profit has been realized. "Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured."[1] Thus, recognition of profit is appropriate only when a bona fide sales transaction has taken place, and then only to the extent that the consideration received in the in the transaction can be reasonably evaluated.

In some of the situations coming before us it appears from the attendant circumstances that the sale of property is a mere fiction designed to create the illusion of profits or value as a basis for the sale of securities. Moreover, even in bona fide transactions the degree of uncertainty as to ultimate realization of profit may be so great that business prudence, as well as generally accepted accounting principles, would preclude the recognition of gain at the time of sale. Circumstances such as the following tend to raise a question as to the propriety of current recognition of profit:

1. Evidence of financial weakness of the purchaser.
2. Substantial uncertainty as to amount of costs and expenses to be incurred.
3. Substantial uncertainty as to amount of proceeds to be realized because of form of consideration or method of settlement; e.g., nonrecourse notes, noninterest-bearing notes, purchaser's stock, and notes with optional settlement provisions, all of indeterminable value.
4. Retention of effective control of the property by the seller.
5. Limitations and restrictions on the purchaser's profits and on the development or disposition of the property.
6. Simultaneous sale and repurchase by the same or affiliated interests.
7. Concurrent loans to purchasers.
8. Small or no down payment.
9. Simultaneous sale and leaseback of property.

[1] Accounting Research Bulletin No. 43, Chapter 1, Section A, American Institute of Certified Public Accountants.

Any such circumstance, taken alone, might not preclude the recognition of profit in appropriate amount. However, the degree of uncertainty may be accentuated by the presence of a combination of the foregoing factors. In the following illustrative cases, taken from recent filings, the Commission deemed it inappropriate to recognize gross profit as recorded as having been realized at the time of the sale.

CASE NO. 1

On the last day of its fiscal year a registrant engaged principally in the development of real estate sold a block of 1,000 lots to a nonaffiliated construction company for $1 million, receiving a cash payment of $100,000 and a nonrecourse note of $1 million due in 1 year, secured only by the lots transferred. Interest was limited to 6 percent for 1 year or $120 per house. A profit of $500,000 before taxes was recorded on the transaction.

The transaction was subject to, among others, the following conditions and arrangments:

a. Each lot was to be released upon payment of $1,000 plus interest at the time of closing the sale of a house and lot.
b. The registrant was to make the determination of when the houses were to be constructed and to arrange the construction loans.
c. The registrant was to be exclusive sales agent for the construction company, arrange financing and conduct closings with the home buyers
d. The construction company was to be paid a maximum of $500 profit and an additional $100 to cover overhead expenses on each house sold. Profits to be received by the construction company were to be applied against the note owed to the registrant.

CASE NO. 2

In September 1961 a registrant sold a block of improved properties to another corporation for consideration of $3,500,000 in cash, a $3,500,000 noninterest-bearing note, and 50,000 shares of the Class A stock of the purchaser which had a current market price of $15 per share. This sale was recorded at these amounts and showed a gain of $2 million after provision of $500,000 for possible loss and $1 million for Federal income taxes. The noninterest-bearing note is payable during the period from 1970 to 1980. Until 1968 the puchaser has the option of liquidating the note by the issuance of capital stock, the number of shares to be determined by dividing the face amount of the note, $3,500,000, by the lesser of $15 per share or 125 percent of the then current market price. After 1968 registrant may call for payment of the note in stock at $17 per share, and, if such call is made, the purchaser may elect to pay the note in full in cash.

CASE NO. 3

In September 1961 a registrant acquired approximately 500 acres of undeveloped land for $300,000 in cash and a mortgage of $900,000 and immediately sold the property to an affiliate of the original seller for $2,200,000. The purchaser paid $300,000 in cash, issued a $1 million noninterest-bearing deed of trust note maturing in 18 months, and assume the $900,000 mortgage. Simultaneously the registrant loaned $1 million to the purchaser on a 6 percent note maturing in 18 months and made a commitment to loan an additional $1 million. Registrant recorded a gross profit of $1 million against which a reserve for possible loss in the amount of $260,000 was provided.

CASE NO. 4

In June 1961 a registrant purchased 20,000 acres of undeveloped land for $1 million cash and a 5 percent note for $3 million. Simultaneously, the registrant sold the property to another company for a $2 million noninterest-bearing deed of trust note payable in installments of $1 million in June 1962, $500,000 in June 1963 and $500,000 in June 1964, and for the assumption by the purchaser of the $3 million first lien note. A gross profit on the sale of $1 million was recorded and a reserve of $400,000 was provided for a possible loss.

CASE NO. 5

A registrant purchased a tract of land for a cash payment of $100,000 and a 10-year nonrecourse noninterest-bearing note in the amount of $800,000 with annual maturities of $80,000. On the same date the land was sold to a nonaffiliated

group for a cash payment of $15,000 and a nonrecourse noninterest-bearing purchase money note for $1,785,000. The latter obligation requires annual payments of approximately $100,000 for 7 years and a payment of approximately $1,100,000 at the end of the 8th year. At the time of the sale the registrant also advanced to the purchaser $350,000 for use in advertising. The proceeds from the sales of land by the purchaser are assigned to the registrant until the $350,000 advance is paid. The registrant recorded a profit of $900,000 at the date of sale.

CASE NO. 6

Shortly before the close of its fiscal year a registrant recorded the sale of a block of 150 lots for a total consideration of $375,000. Cash of $75,000 was paid on the settlement date and the purchaser then took title to 30 lots. The balance of the consideration consisted of four notes of $75,000 each bearing interest at 5 percent per annum, due 6, 12, 18, and 24 months after settlement. The purchaser was to take title to 30 lots at the time of settlement of each note. The notes were secured only by a mortgage on the property, and there was no personal liability on the purchaser to complete the payments. In a registration statement filed shortly after the close of the fiscal year this transaction was recorded as a sale in the total amount of $375,000 with an indicated gross profit of $44,000 on the uncollected portion after provision for deferred taxes of $47,000.

CASE NO. 7

In early 1960 a registrant sold to an unaffiliated purchaser a manufacturing plant and another building used in its operations for a total consideration of $1,500,000 reflecting a profit of $600,000 after taxes. The consideration was realized in the form of cash and assumption of an existing mortgage. The seller simultaneously leased these same properties back at an annual rental of $160,000 for a period of 25 years. The registration statement as effective reported the profit as deferred and to be amortized against rental payments over over the life of the leases.

RELEASE NO. 96

January 10, 1963

SECURITIES ACT OF 1933
Release No. 4574

SECURITIES EXCHANGE ACT OF 1934
Release No. 6990

HOLDING COMPANY ACT OF 1935
Release No. 14787

INVESTMENT COMPANY ACT OF 1940
Release No. 3611

Accounting for the "Investment Credit"

In view of the extensive public discussion of the accounting for the investment credit provided in the Revenue Act of 1962 and the fact that the Accounting Principles Board of the American Institute of Certified Public Accountants has concluded that the investment credit should be reflected in income over the productive life of acquired property,[1] the Securities and Exchange Commission deems it appropriate to respond to inquiries with respect to the application of the Commission's accounting and disclosure requirements to this matter.

In Accounting Series Release No. 1, published April 1, 1937, the Commission announced a program for the purpose of contributing to the development of uniform standards and practice in major accounting questions. Accounting Series Release No. 4 (see p.3) recognizes that there may be sincere differences of opinion between the Commission and the registrant as to the proper principles of accounting to be followed in a given situation and indicates that, as a matter of policy, dis-

[1] Opinion No. 2, Accounting for the "Investment Credit."

closure in the accountant's certificate and footnotes will be accepted in lieu of conformance to the Commission's views only if such disclosure is adequate and the points involved are such that there is substantial authoritative support for the practice followed by the registrant, and then only if the position of the Commission has not been expressed previously in rules, regulations, or other official releases of the Commission, including the published opinions of its Chief Accountant. This policy is intended to support the development of accounting principles and methods of presentation by the profession but to leave the Commission free to obtain the information and disclosure contemplated by the securities laws and conformance with accounting principles which have gained general acceptance.

In recognition of the substantial diversity of opinion which exists among responsible persons in the matter of accounting for the investment credit, the Commission will accept either a method which reflects the investment credit in income over the productive life of the acquired property or a method which reflects 48 percent of the investment credit (the maximum extent to which the credit can normally increase net income) in income as a reduction of the tax expense of the year in which the credit arises and defers the balance of 52 percent to subsequent accounting periods during which depreciation allowances for tax purposes are reduced because the statutory requirement reduces the basis of the property for tax purposes by the amount of the investment credit. The amount of such deferral should be segregated from taxes currently payable. The 100 percent flow-through to income of the investment credit benefit in the year in which it arises will be accepted in the case of regulated industries when authorized or required by regulatory authorities. In all cases full disclosure of the method of accounting followed and amounts involved should be made where material.

In any case it is the Commission's opinion that the full cost of the property should be reported and that the credit should not be made directly to the asset account. Income tax expense should not be stated in excess of the amount payable for the year. No objection will be taken to the recording of additional depreciation equal to the amount of the deferral arising from the above methods of accounting for the investment credit. The amounts involved should be segregated at least in the appropriate notes and schedules required by our accounting regulations.

The certification rules of the Commission require that the accountant's certificate shall state clearly the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein. The term "accounting principles and practices" should be read in the light of the discussion of broad principles and practices in the booklet "Audits of Corporate Accounts," [2] which was recognized as a significant guide to the profession at the time of drafting our original accounting and certification requirements.

It is recognized that an accountant who certifies to financial statements reflecting a method of reporting contrary to the majority opinion of the Accounting Principles Board is assuming the burden of justifying departure from the recommened procedure and must take into consideration whether he is departing from an accepted procedure and consequently whether he must qualify his certificate with respect to the fairness of the presentation in the financial statements or to a departure from generally accepted accounting principles and practices. In the usual case where an accountant takes exception to a principle or practice followed, the amount involved is material. In view of the substantial diversity of opinion as to

---

[2] This booklet consists of a series of letters passing between the Institute's special committee on cooperation with stock exchanges and the committee on stock list of the New York Stock Exchange during the years 1932–1934 with a view to making the accounts published by corporations more informative. This endeavor resulted in the demonstration that certain accounting principles were so generally accepted that they should be followed by all listed companies, the adoption of these principles as rules by the American Institute of Accountants membership, the requirement by the New York Stock Exchange that certified financial statements be included in all listing applications, and the development of an accountant's certificate which would be more informative and more clearly understood by investors and which is substantially the same as the certificate in general use today.

A note to the booklet states that a letter expressing the recommendations of the American Institute of Accountants committee was placed in evidence "in a hearing before the U.S. Senate Committee on Banking and Currency January 12, 1933."

the proper method of accounting for the investment credit, if an accountant deems it necessary to qualify his opinion under various circumstances the Commission will accept certificates containing appropriately worded qualifications in accordance with Rule 2–02(d) of Regualtion S–X when an alternative accounting treatment acceptable to the Commission is followed by the registrant.

RELEASE NO. 97

May 21, 1963

Findings and Opinion of the Commission In the Matter of Harmon R. Stone, pursuant to Rule 2(e), Rules of Practice.

ACCOUNTING—PRACTICE AND PROCEDURE

Denial of Privilege to Practice Before Commission
Inadequate Audit
Lack of Independence

Where accountant, who certified financial reports of registered broker-dealer filed with Commission, failed to perform various auditing procedures specified in Commission's Minimum Audit Requirements for such reports and failed to comply with generally accepted auditing standards in that he did not properly obtain confirmations of customers' accounts and closed accounts and did not properly balance securities positions or verify securities in transfer, and where he certified financial statements of a mutual fund for periods when company of which he was a principal stockholder and co-manager made loans collateralized by securities to salesmen and customers of broker-dealer which was principal underwriter and a broker for the fund and, through an affiliate, its investment adviser, *held*, accountant inadequately performed his professional duties and engaged in activities incompatible with required professional independence and his privilege of practicing before Commission will be suspended for period of 60 days.

APPEARANCES:

James E. Dowd, of the Boston Regional Office of the Commission, for the Office of the Chief Accountant of the Commission.

Jason M. Poster, of Poster, Wilinsky and Goldstein, for respondent.

FINDINGS AND OPINION OF THE COMMISSION

By COHEN, Commissioner:

These are proceedings under Rule 2(e) of our Rules of Practice [1] to determine whether Harmon R. Stone, a certified public accountant with offices in Chestnut Hill, Massachusetts, should be denied, temporarily or permanently, the privilege of appearing or practicing before us.

The order for proceedings alleges that Stone inadequately performed his professional duties and engaged in improper professional conduct. It states that in connection with the preparation and certification of four financial reports of Keller Brothers Securities, Co., Inc. ("Keller"), a registered broker-dealer,[2] during the period April 30, 1957 to June 30, 1960, Stone failed to comply with certain of the Minimum Audit Requirements set forth in the instructions to our Form X–17A–5 applicable to such reports and with generally accepted auditing standards. It also recites that between February and May 1961, Trinity Investment Company ("Trinity"), a finance company located in Stone's

[1] 17 CFR 201.2(e). That rule provides, in pertinent part, that this Commission may "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 notice of and opportunity for 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] Keller and Herman J. Keller, its vice president, were permanently enjoined from violating the anti-fraud and net capital provisions of the Securities Exchange Act of 1934, and receivers were appointed to administer their assets. *S.E.C.* v. *Keller Brothers Securities Co., Inc.*, D. Mass., Cal. No. 61–367, May 5, 1961; October 6, 1961.

offices and of which Stone was one of three stockholders and an officer and co-manager, made loans to customers and employees of Keller collateralized by securities.

Stone filed an answer admitting the allegations in the order but stating that he prepared and certified the Keller statements in good faith in the belief he had complied with all applicable requirements. In lieu of a hearing he submitted various statements and affidavits as to his character and professional competence, and he waived post-hearing procedures. He further stipulated that we may also consider any relevant and material information reported to us by our staff and may, on the basis of such information, the allegations in the order, and his answer, conclude that he performed his professional duties in an inadequate manner and engaged in improper professional conduct within the meaning of Rule 2(e).

On the basis of Stone's admissions, prior testimony given by him to the staff in connection with an investigation of Keller, and the other material submitted to us, we make the following findings:

Stone has been a certified public accountant since 1950 and has been a sole practioner at least since 1954. He has performed accounting services for Keller from its inception in 1956 and for a predecesor partnership which had commenced business in 1954. In addition to certifying to Keller's financial statements he was at all times available to Keller and its bookkeeper for accounting advice and also performed monthly audits which consisted primarily of reconciling the bank statements and preparing financial statements for management purposes. He was also the certifying accountant for Mutual Securities Fund of Boston, a registered investment company of which Keller was the distributor and for which Keller through an affiliate provided investment advice until around the middle of 1961.

Inadequacy of Audits

Stone's certificates to the Keller financial statements which were filed with us on Form X-17A-5 recited that his examination of Keller's records was made in accordance with generally accepted auditing standards, and included tests of accounting records and other auditing procedures considered necessary in the circumstances and a review of the procedures followed for safeguarding the securities of customers. However, in all four audits—all of which were performed in the same manner—Stone omitted many of our specific audit requirements and failed to comply with generally accepted standards and procedures followed by independent accountants in audits of broker-dealers.

Stone did not properly obtain confirmations of customers' accounts or of closed accounts. Although he requested all customers whose accounts showed money balances at the audit date to report any discrepancies in such balances ("negative confirmation"), he did not request any confirmation as to the securities shown in these accounts. In addition, no requests for confirmation were sent to customers whose accounts showed a zero money balance, even though such accounts contained securities, or whose accounts had been closed since the previous audit. The Minimum Audit Requirements applicable to our Form X-17A-5 require that written acknowledgements ("positive confirmation") of the accuracy of the money balances, securities positions, and open contractual commitments other than uncleared regular way purchases and sales, be obtained with respect to all accounts with customers. Generally accepted auditing standards and procedures applicable to the audit of a broker-dealer require that ordinarily accounts closed out during the period since the last audit be confirmed by direct correspondence with the customer on a test basis. [3] These positive confirmations not only serve the purpose of establishing the accuracy of the money balances receivable and payable but also of the amount of securities in customers' accounts.

The audit procedures followed by Stone in his examination of Keller's securities record [4] were also inadequate in that he failed to properly balance the securities positions. He prepared a list of securities quantities from the short positions of the securities record showing items in physical possessions, safekeeping and transfer, and purchased but not yet received from sellers. His verification consisted of physically counting securities in Keller's office and requesting positive written confirmation of the purchased but unreceived items. He did not prepare a comparable list of the long securities positions of the securities record or compare the

[3] *Audits of Brokers or Dealers in Securities.* American Institute of Accountants (1956), pp. 30–31.

[4] The securities record, or position record, is maintained in securities quantities only and consists of a separate sheet for each security traded by the broker-dealer, showing separately the location of or responsibility for the security (short position) and the ownership or right to possession (long position).

short and long securities positions with the securities reflected in the customers' accounts. Our Minimum Audit Requirements call for balancing of positions in all securities and commodities as shown by the books and records. In verifying the securities positions it is essential to verify the accuracy of all classes and designations of both long and short positions.

In addition Stone failed adequately to verify securities in transfer in that he did not obtain written confirmation of securities in the hands of transfer agents at the audit date. He asserted that items in transfer had been verified by examination at a later date during the course of the audit after they had been received at Keller's office, but the circumstances do not indicate that the application of this procedure of verifying securities in transfer was an acceptable alternative to the written confirmations.[5]

Stone's audits with respect to the Keller financial statements thus omitted many specifically required and basic procedures. Generally accepted auditing standards require that the independent accountant first take physical control, preferably at an unannounced time, of all cash, securities and other transferable evidence of ownership, and maintain such control until those items are inspected, counted and compared with the records. The auditor must then perform additional verification procedures including the balancing of the securities record and obtaining positive confirmation of customers' accounts and of securities in the hands of others such as those in transfer. The latter steps are necessary for the adequate verification of accounting records which reflect location and ownership of the assets which are inspected and counted. Stone's failure to properly perform these latter audit procedures negated the effectiveness of his audits with respect to Keller.[6] His audit fell far short of the objective review required for the purpose of safeguarding funds and securities of customers and failed to give the public the protection which an audit is designed to achieve. Stone's certificates stating that his examinations were made in accordance with generally accepted auditing standards were accordingly false and misleading.

Dealings with Keller's Salesmen and Customers

We have also given consideration to the effect on Stone's status as an independent accountant of the loan transactions executed by Stone on behalf of Trinity with Keller's salesmen and customers in the period between February and May 1961. The loans were collateralized by securities and arranged through one of Keller's salesmen, who was paid a commission of 20 percent of the interest charged the borrower.[7]

The financial report of June 30, 1960, certified by Stone was the last report filed with us by Keller because Keller was placed in receivership in May 1961. However, at the time of the Trinity loan transactions Stone was performing the same accounting services for Keller and Mutual that he had previously performed. In the case of Mutual, Stone's selection as an independent public accountant was made on a year-to-year basis, and was ratified annually by vote of the shareholders pursuant to the requirements of Section 32(a) of the Investment Company Act. Stone certified Mutual's financial statements for periods when the loans were outstanding and has continued to do so up to the present time.[8] As has been noted, Keller and its affiliate acted as Mutual's distributor and investment adviser, and Keller's president was a member of Mutual's board of trustees.

By virtue of the Trinity loans Stone, as a principal stockholder of Trinity, assumed a relationship with Keller which was inconsistent with his position as an independent accountant. Independence requires avoidance of any relationship which might impair objectivity as an auditor, including material financial relationships with officers or employees of the client.[9] Stone acquired a personal

[5] See *Audits of Brokers or Dealers in Securities, supra*, pp. 25–26.

[6] In the case of Stone's audits of Mutual Securities Fund of Boston, he verified securities positions and other items by inquiries to the Fund's custodian bank, which supplied the information from its records, and we find no inadequacy in those audits.

[7] Trinity made loans to other debtors, but did not make loans collateralized by securities to customers or employees of any broker-dealer other than Keller.

[8] Mutual's prospectuses filed with us both before and after May 1961 contain financial statements certified by Stone under the caption "Report of Independent Certified Accountants."

[9] See *C.P.A. Handbook* (1952), Ch. 5, pp. 19–20 which states that a certified public accountant should "avoid any financial relationship with officers or employees of client corporations, in the form of borrowing or lending, or participation in the profits of investments, or in any similar manner." See also

financial stake in the repayment of the Trinity loans by the borrowing Keller salesmen and customers. He thus had an interest in Keller's continued operation and solvency, on which the repayment of the loans by those persons might have been dependent. He also had an interest in securities collateral, which was being delivered from and to Keller in connection with the loans. Keller, in turn, had material transaction with, and and interests in, Mutual by virture of the underwriter's sales charges it received in connection with the sale of Mutual shares as well as brokerage commissions earned in connection with the purchase and sale of securities on behalf of Mutual. Keller's affiliate also received investment advisory fees from Mutual and Keller's president received trustee's fees, both of which were determined on the basis of the value of Mutual's net assets.[10]

Under the circumstances Stone's activities on behalf of Trinity were incompatible with his role as independent accountant. Although the receivership prevented Stone from certifying Keller's financial statements subsequent to the Trinity transactions, he admitted that he still considered himself the auditor of record for Keller. Stone's continuance of this relationship as a public accountant for Keller was not in accord with the ethics of the profession.[11] Moreover, his certification of Mutual's financial statements during the period of these loans deprived mutual's shareholders of the protections afforded by an independent examination of the fund's financial condition as contemplated by the Investment Company Act and our Regualtion S-X. In our opinion it constituted improper professional conduct.

CONCLUSIONS

Stone has been a certified public accountant in Massachusetts since 1950. Apart from these proceedings there is no evidence that his professional conduct has ever been questioned, and he has submitted statements from a large number of persons who attest as to his character and competence in other accounting work. We do not believe that our findings in these proceedings raise a basic question as to his personal integrity. In this connection we note that Stone responded to our staff's examination into this matter with full cooperation and candor. However, we also cannot condone the serious discrepancies between proper auditing standards and the procedures Stone utilized in the audit of Keller's accounts. Accordingly, we conclude that he should be denied the privilege of practicing before us for a period of 60 days.

An appropriate order will issue.

Chairman CARY and Commissioners WOODSIDE, FREAR, and WHITNEY join in the above opinion.

ORVAL L. DUBOIS,
Secretary.

ORDER DENYING PRIVILEGE OF PRACTICING BEFORE COMMISSION

Proceedings having been instituted pursuant to Rule 2(e) of the Commission's Rules of Practice to determine whether Harmon R. Stone, a certified public accountant, should be denied, temporarily or permanently, the privilege of practicing before the Commission;

Respondent having filed an answer admitting the allegations in the order for proceedings, submitted a stipulation and waived a hearing and other procedural steps:

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

---

Codification of Statements on Auditing Procedure, American Institute of Accountants (1951), p. 8: "to be recognized as independent, [the auditor] must be free from any obligation to or interest in management, owners, creditors—or others entitled to rely on his report—which might influence his judgment as to the fairness of the financial statements."

[10] The financial statements in Mutual's annual report to stockholders filed with us in May 1961, which were certified by Stone, include items of investment advisory and trustee's fees paid in the period ending April 28, 1961.

[11] Rule 4 of the Rules of Professional Conduct of the American Institute of Certified Public Accountants provides that "A member shall not engage in any business or occupation conjointly with that of a public accountant, which is incompatible or inconsistent therewith."

IT IS ORDERED, pursuant to Rule 2(e) of the Rules of Practice, that Harmon R. Stone be, and he hereby is, denied the privilege of practicing before the Commission for a period of 60 days from the date hereof.

By the Commission.

ORVAL L. DUBOIS,
Secretary.

DATE: May 21, 1963

RELEASE NO. 98

November 13, 1963

SECURITIES EXCHANGE ACT OF 1934
Release No. 7169

Maintenance of Records of Transactions by Broker-Dealers as Underwriters of Investment Company Shares

It has come to the attention of the Commission that some broker-dealers who act as underwriters of investment company shares do not record on their books and records transactions arising from the sale and redemption by them of such shares. Such transactions should be recorded in a separate account for each customer including each investment company and each broker-dealer distributing or redeeming such shares. Such transactions may not properly be recorded in the "fail" records in lieu of maintaining separate accounts for each customer as the customary arrangement that payment shall be against delivery on a traditional settlement date is not present in the sale of investment company shares.

Failure by an underwriter to record such assets and liabilities in its accounts would result in violation of Rule 17a-3 under Section 17(a) of the Securities Exchange Act of 1934 which prescribes that every member of a national securities exchange who transacts a business in securities directly with other than members of a national securities exchange, and every broker or dealer who transacts a business in securities through the medium of any such member, and every broker or dealer registered pursuant to Section 15 of the Securities Exchange Act of 1934, as amended, shall make and keep current, among other records relating to his business, ledgers (or other records) reflecting all assets and liabilities, income and expense and capital accounts including ledger accounts as to each customer. As the Commission has held on repeated occasions, the requirement that records be maintained carries with it the implicit further requirement that such records must be true and correct.

RELEASE NO. 99

February 28, 1964

Order Dismissing Proceedings In the Matter of Roberts & Morrow, pursuant to Rule 2(e), Rules of Practice.

On August 16, 1963, the Commission initiated proceedings pursuant to Rule 2(e) of the Rules of Practice of the Commission to determine whether Roberts & Morrow, a partnership of certified public accountants, practicing as such with offices located at 953 S.W. First Street, Miami 36, Florida, and certain of its partners, should be disqualified from and denied temporarily or permanently the privilege of appearing or practicing before the Commission. The charges arose from the certification of the financial statements included in a registration statement filed by Miami Window Corporation, on February 25, 1959, in which respondents had represented in the certificate that the

summary of earnings and financial statements in the registration statement fairly presented the financial position and the results of operations of Miami Window Corporation, and that its audit had been made in accordance with generally accepted auditing standards. The registration statement was the subject of stop-order proceedings (Securities Act Release No. 4503).

Respondents have filed a motion to discontinue this proceeding on the ground, *inter alia*, that the Commission lacks a quorum of Commissioners qualified to act in this matter. The Commission does not concede that any of the grounds urged for dismissal are valid. However, the Commission has considered the representations of respondents (1) that from the time of institution on August 21, 1959, of the public stop-order proceeding in regard to Miami Window Corporation, and to some extent before that time during which a private investigation by staff of the Commission was being conducted, the respondents suffered the loss of a substantial portion of their practice before the Commission; (2) that the publication of the Commission's opinion on June 21, 1962, had a further adverse effect on the respondents' practice, which effect has continued, and (3) that improved auditing procedures have been put into effect by the partnership. In view of these circumstances and the fact that the discrepancies were called to the Commission's attention by respondents and company officials, and also because of the possibility of extensive and time-consuming litigation on procedural matters not relating to the merits of the case and resulting delay in these already protracted proceedings, the Commission has determined to issue an order terminating these proceedings without a hearing. Accordingly,

IT IS ORDERED that these proceedings are dismissed.

By the Commission.

ORVAL L. DUBOIS,
Secretary.

DATE: FEBRUARY 28, 1964

RELEASE NO. 100*

October 6, 1964

SECURITIES ACT OF 1933
Release No. 4727

SECURITIES EXCHANGE ACT OF 1934
Release No. 7433

HOLDING COMPANY ACT OF 1935
Release No. 15143

INVESTMENT COMPANY ACT OF 1940
Release No. 4057

Adoption of Article 7A and Rule 12-31 of Regulation S-X

The Securities and Exchange Commission today adopted an amendment to Regulation S-X consisting of a new section designated Article 7A and Rule 12-31 to govern the form and content of financial statements and related schedules filed by life insurance companies.

The financial statements, schedules and special notes are based on information either in the annual statements filed by life insurance companies with State regulatory authorities or otherwise readily available.

Specific regulations for life insurance companies are deemed necessary because of the increasing number of life insurance companies filing financial statements with the Commission in registration statements and annual reports in order to provide for reasonable uniformity in financial reporting. The amendments are based on experience gained from the examination of financial statements and schedules filed with the Commission, on comments received from interested persons as a result of notice to adopt these amendments, and on discussions with representatives of industry associations, State regulatory authorities, and public accountants.

* Text of amendments have been omitted.