RELEASE NO. 101

April 26, 1965

Order Readmitting Accountant to Practice before Commission In the Matter of Morton I. Myers, pursuant to Rule 2(e), Rules of Practice

On July 20, 1962, the Commission issued its Findings and Opinion and Order pursuant to Rule 2(e) of its Rules of Practice (Accounting Series Release No. 92, see p. 241) denying to Morton I. Myers, a certified public accountant, who was found to have engaged in unethical and improper professional conduct, the privilege of appearing or practicing before the Commission until he obtained the prior approval of the Commission and providing that no application for such approval would be entertained for a period of 1 year from the date hereof.

On March 31, 1965, Myers filed a request for reinstatement of his privilege of appearing and practicing before the Commission and represented that since the entry of the Commission's order he has conducted himself both personally and professionally in a way which has not been subject to criticism by any professional or regulatory body.

The Commission having considered the matter, and being satisfied that under all the circumstances it would not be inconsistent with the public interest at this time to terminate its order denying petitioner the privilege of practicing before the Commission;

IT IS ORDERED that the petition of Morton I. Myers for reinstatement of his privilege of appearing and practicing before the Commission be, and it hereby is, granted.

By the Commission.

ORVAL L. DUBOIS,
Secretary.

RELEASE NO. 102

December 7, 1965

SECURITIES ACT OF 1933
Release No. 4811

SECURITIES EXCHANGE ACT OF 1934
Release No. 7763

HOLDING COMPANY ACT OF 1935
Release No. 15359

INVESTMENT COMPANY ACT OF 1940
Release No. 4426

Balance Sheet Classification of Deferred Income Taxes Arising from Installment Sales

It has come to the attention of the Securities and Exchange Commission that diverse practices exist regarding the balance sheet classification of deferred income taxes arising from the use of the installment method of reporting gross profit for income tax purposes. The majority of companies having installment receivables classified as current assets classify the related deferred income taxes as a noncurrent credit item, while some classify the deferred income taxes as a current liability or as a deduction from the receivables. It is understood, that, at the end of their current fiscal years, some registrants intend to change from current to noncurrent the classification of the deferred income taxes if other companies continue to classify the related deferred income taxes as a noncurrent item. The Commission's staff has noted that some companies have recently changed their reporting practices to show such deferred income taxes as a noncurrent item while retaining the related installment receivables among current assets.

The classification of deferred income taxes related to installment receivables as a noncurrent is significant when considered in light of the practice of classifying assets and liabilities as current or noncurrent in accordance with the normal operat-

ing cycle of the business. In Regulation S-X the Commission recognized the operating cycle treatment in the determination of working capital.[1]

The installment receivables and related deferred income taxes pertaining to the same operating cycle clearly are both either current or noncurrent. There is no justification from the standpoint of either proper accounting or fair financial reporting for the use of the operating cycle approach for installment receivables and not for the related deferred income taxes. Obligations for items which have entered into the operating cycle and which mature within the operating cycle should be included in current liabilities when the related receivables are included in current assets, in order to present fairly the working capital position.[2]

The deduction of the deferred income taxes from the related installment receivables is not considered to be an appropriate procedure; the current value of the receivables is not affected by the amount of the tax deferral. The deferral is not a valuation reserve by a credit item representing cash retained in the business by the deferral of tax payments under the alternate tax provisions.

In view of the increasing use by many companies of installment sales and similar credit practices and the significance of the increasing amounts of the related deferred income taxes involved, the Commission deems it appropriate to state its opinion as to the proper reporting to be followed with respect to such deferred income taxes.[3] Where installment receivables are classified as current assets in accordance with the operating cycle practice, the related liabilities or credit items maturing or expiring in the time period of the operating cycle, including the deferred income taxes on installment sales, should be classified as current liabilities. Installment receivables not realized within 1 year and the related deferred income taxes may be classified consistently as noncurrent items. In financial statements filed with the Commission for fiscal years ending on or after December 31, 1965, assets and liabilities entering into the operating cycle shall be classified consistently as current or noncurrent items. In addition, appropriate disclosure of the classification followed and amounts involved should be given.

[1] Regulation S-X, Rules 3-13 and 3-14. *Cf.* American Institute of Certified Public Accountants Accounting Research Bulletin No. 43, Ch. 3A, Current Assets and Current Liabilities.

[2] *Cf.* "Inventory of Generally Accepted Accounting Principles for Business Enterprises" by Paul Grady, Accounting Research Study No. 7, American Institute of Certified Public Accountants, New York, 1965, pp. 28, 29 and 65.

[3] Accounting Series Release No. 4, (see p. 3) reaffirmed in Accounting Series Release No. 96, (see p. 247)

RELEASE NO. 103

May 26, 1966

INVESTMENT ADVISERS ACT OF 1940
Release No. 201

The Nature of the Examination and Certificate Required by Paragraph (*a*)(5) of Rule 206(4)-2 Under the Investment Advisers Act of 1940

Review of accountants' certificates filed under paragraph (*a*)(5) of Rule 206(4)-2 under the Investment Advisers Act of 1940, which requires that at least once a year an independent public accountant shall verify by actual examination all funds and securities of clients held by an investment adviser, indicates a wide variation in the scope of the examinations made and the content of the accountants' certificates. Under the circumstances, the Securities and Exchange Commission deems it appropriate to describe the nature of the examination to be made and the content of the accountant's certificate.

Rule 204-2(*b*) under the Investment Advisers Act of 1940 specifically requires that an investment adviser who has custody or possession of funds and/or securities of any client must record all transactions for such clients in a journal and in

separate ledger accounts for each client and must maintain copies of confirmations of all transactions in such accounts and a position record for each security in which a client has an interest. In addition, Rule 206(4)-2(*a*) provides, in general, that it shall constitute a fraudulent, deceptive or manipulative act or practice for any investment adviser who has custody or possession of funds or securities of clients to do any act or to take any action with respect to any such funds or securities unless (1) all such securities are segregated, marked for identification, and held in safekeeping in a reasonably safe place; (2) the funds are deposited in one or more bank accounts, in the name of the investment adviser as agent or trustee for clients, which contain only clients' funds and certain appropriate records with respect thereto are maintained; (3) immediately after accepting such funds and securities the investment adviser notifies the client in writing of the place and manner in which they will be maintained; (4) not less frequently than once every 3-month period each client is sent an itemized statement showing the debits, credits, and transactions in his account during the period and the funds and securities held at the end of the period; and (5) at least once each calendar year all such funds and securities are verified in an unannounced examination by an independent public accountant and a certificate of the accountant reporting on such examination is filed with the Commission.[1]

In order to make an appropriate examination the independent public accountant, at a date chosen by him and without prior notice to the investment adviser, should make a physical examination of securities and obtain confirmation as appropriate; should obtain confirmation of funds on deposit in banks; and should reconcile the physical count and confirmations to the books and records. These books and records should be verified by adequate examination of the security records and transactions since the last examination and by obtaining from clients written confirmation of the funds and securities in the clients' accounts as of the date of the physical examination. If clients' accounts have been closed or securities or funds of such clients have been returned since the last examination, these should be confirmed on a test basis. Such additional audit procedures as the accountant deems necessary under the circumstances should, of course, also be performed.

The accountant's certificate should comply with the usual technical requirements as to dating, salutation, and manual signature and should include in general terms an appropriate description of the scope of the physical examination of the securities and examination of the related books and records. In addition, the certificate should set forth:

(a) The date of the physical count and confirmation of balances of the clients' accounts;
(b) A clear designation of the place and manner in which funds and securities are maintained;
(c) Whether the examination was made with prior notice to the adviser; and
(d) The results of the examination including an expression of opinion as to whether, with respect to the rules under the Investment Advisers Act of 1940, the investment adviser was in compliance with paragraphs (*a*)(1) and (*a*)(2) of Rule 206(4)–2 as at the examination date and had been complying with Rule 204–2(*b*) during the period since the prior examination date; and whether, in connection with the examination, anything came to the accountant's attention which caused him to believe that the investment adviser had not been complying with paragraphs (*a*)(3) and (*a*)(4) of Rule 206(4)–2 during the period since the prior examination date. Any material inadequacies found to exist in the books, records, and safekeeping facilities referred to in this paragraph (d) should be identified and any corrective action taken or proposed should be indicated.

The rule requires that the accountant's certi-

[1] Rule 206(4)–2(*a*) is not applicable, however, to any investment adviser who is also registered as a broker-dealer under Section 15 of the Securities Exchange Act of 1934 if (1) such broker-dealer is subject to and in compliance with Rule 15c3–1 under the Securities Exchange Act of 1934, or (2) such broker-dealer is a member of an exchange whose members are exempt from Rule 15c3–1 under the provisions of paragraph (*b*)(2) thereof, and such broker-dealer is in compliance with all rules and settled practices of such exchange imposing requirements with respect to financial responsibility and the segregation of funds or securities carried for the account of customers.

ficate be filed with the Commission promptly after the completion of the examination. It is suggested that the certificate be filed in duplicate at the regional office of the Commission for the region in which the adviser has his principal place of business.

RELEASE NO. 104

June 1, 1966

Order In the Matter of John C. Hurdman doing business as Hurdman and Company

On the basis of information furnished to the Commission in a nonpublic investigative proceeding, the Commission has reason to believe that there may have been a lack of adherence to auditing standards by John C. Hurdman, a certified public accountant, in connection with the preparation and submission of certain material to the Commission.

John C. Hurdman, without admitting any such lack of adherence, has tendered to the Commission his resignation in which he agrees that he will not appear or practice before the Commission in the future; and the Commission being satisfied that by reason of such resignation no proceeding pursuant to Rule 2(e) of the Commission's Rules of Practice is necessary; and it being determined by the Commission that it is not inconsistent with the public interest;

IT IS ORDERED that John C. Hurdman's resignation from practice before this Commission be and hereby is accepted, and that no further proceeding be had in this matter.

By the Commission.

ORVAL L. DUBOIS,
Secretary.

RELEASE NO. 105

July 29, 1966

Order Accepting Withdrawal from Practice and Dismissing Proceedings—In the Matter of Homer E. Kerlin, pursuant to Rule 2(e), Rules of Practice.

These proceedings were instituted pursuant to Rule 2(e) of our Rules of Practice to determine whether a firm of certified public accountants, its senior partner, and Homer E. Kerlin, a junior partner, should be denied the privilege of practicing before us because of alleged unethical or improper professional conduct in connection with the preparation and certification of financial statements of the Olen Company, Inc. and its successor, the Olen Division of H. L. Green Company, Inc.

The order for proceedings alleged that the financial statements and schedules prepared or certified by the firm were materially false and misleading and did not present fairly the financial position and results of operations of Olen Company, Inc. Among other things, it was alleged that merchandise inventories were substantially overstated and that accounts payable were substantially understated, that an audit properly conducted by independent certified public accountants would have detected the inaccuracy and falsity of the inventory and accounts payable figures, and that respondents knew or should have known that the financial statements and related schedules were false, that respondents' examinations were not made in accordance with generally accepted auditing standards and did not include the auditing procedures and tests of the records which a competent, conscientious and prudent independent auditor would have used, and that respondents thereby engaged in unethical and improper professional conduct.

After the institution of these proceedings the

senior partner died. Previously the partnership had been dissolved. The remaining respondent, Kerlin, without admitting the allegations against him, tendered his withdrawal from practice and agreed that he will not appear or practice before us in the future, with the understanding that these proceedings will be dismissed as to him and that we may issue a statement with respect to our action herein.

In view of the dissolution of the partnership, the death of the senior partner, and the agreement of Kerlin not to practice before us, we conclude that it is not inconsistent with the public interest to dismiss these proceedings and accept Kerlin's withdrawal from practice before us. Accordingly, no evidentiary hearings will be held; however we shall release with this order a report of the investigation made in this matter by our staff.

In light of the foregoing, IT IS ORDERED that the withdrawal of Homer E. Kerlin from practice before the Commission be, and it hereby is, accepted, and that these proceedings be, and they hereby are dismissed.

By the Commission (Commissioner OWENS, BUDGE and WHEAT,) Chairman COHEN and Commissioner WOODSIDE not participating.

ORVAL L. DUBOIS,
Secretary.

Report of Staff Investigation with Respect to Preparation and Certification by a Firm of Certified Public Accountants of Financial Statements of Olen Company, Inc. and its Successor, the Olen Division of H. L. Green Company, Inc.

I. BACKGROUND

This report sets forth the results of the staff's investigation of the preparation and certification by a Mobile, Alabama, firm of certified public accountants ("the firm") of financial statements of Olen Company, Inc. ("Olen Co.") and its successor, the Olen Division of H. L. Green Company, Inc. ("Green Co.").

In 1958, Maurice E. Olen was president and a principal stockholder of Olen Co. which operated a chain of retail variety stores principally in Alabama and other southeastern States. Olen Co., had been incorporated in 1955 as successor to a partnership in which Olen and his father were the principal partners. The business had grown from two stores in 1945 to about 120 stores, operated through a number of wholly-owned subsidiaries, with reported retail sales of over $20 million for the fiscal year ended January 31, 1958.

The accounting firm was Olen Co.'s auditor, and its senior partner had become a certified public accountant in 1944 and began practice as a partner of another accounting firm which obtained the Olen partnership as a client in about 1947. In 1949, Homer E. Kerlin commenced work with that earlier accounting firm. In 1954, the senior partner of the firm involved in this investigation established his own practice with Kerlin as his employee and the Olen partnership as his client. In the following year Kerlin became a certified public accountant and a junior partner in this firm. Subsequent to the events described herein the partnership was dissolved, and later the senior partner died.

During the first part of 1958 Olen Co. made a public sale of 100,000 shares of its Class A common stock at $10.50 per share pursuant to a registration statement filed with the Commission under the Securities Act of 1933 ("Securities Act"). As of October 31, 1958, Olen Co. and its subsidiaries were merged into Green Co. At that time Green Co. operated through subsidiaries a chain of 224 retail stores in the United States and Canada. In the merger transaction Olen Co. stockholders were to receive 200,009 shares of Green Co. common stock, about 41 percent of which was to go to Olen himself and 5 percent to other members of the Olen family. After the merger, Olen became president of Green Co. and another Olen Co. officer, Herschel Harris, became vice president. The Olen Co. operations became the Olen Division of Green Co., retaining its separate offices, warehouses and accounting records in Mobile, Alabama.

Audited financial statements of Olen Co. for its fiscal year ended January 31, 1958, certified by the firm, were included in the registration statement filed by the company in connection with the public sale of 100,000 shares of stock, and also in the combined proxy statement of Green Co. and Olen Co. filed with the Commission in connection with

the merger.[1] These financial statements showed Olen Co. as having at that time current assets of about $4,400,000, including about $3,856,000 in merchandise inventories, stockholders equity of approximately $1,200,000 and net income after taxes of more than $450,000. The proxy statement also included unaudited Olen Co. financial statements for the 6-months period ended July 31, 1958, prepared by the firm. Before the merger was consummated the firm furnished Green Co. audited financial statements for the same period which differed only in minor respects from the unaudited statements.

After the merger, the firm prepared and certified financial statements for the year ended January 31, 1959, for the Olen Division which were to be included in Green Co.'s annual report to be filed with the Commission. However, before such report was filed, Green Co. discovered that the Olen Division merchandise inventories were substantially overstated and that its accounts payable were substantially understated. Following a reaudit by Green Co.'s auditors, it was determined that there was an an overstatement of Olen Division's net assets as of January 31, 1959, of about $4,700,000. This deficiency resulted from inventory shortages of more than $2,800,000 and unrecorded accounts payable of about $2,700,000, the aggregate amount thereof being reduced by an understatement of almost $800,000 in fixed assets which had been charged improperly to expenses instead of being capitalized. Subsequently Green Co. collected $1,600,000 from Olen as partial restitution.

On or about February 20, 1959, Olen admitted to the Green Co. board of directors that the accounts of the Olen Division had been falsified and that the merchandise inventories, fixed assets and liabilities were materially misstated, and he and Harris resigned as officers and directors of Green Co. Further investigations disclosed that the financial statements of January 31 and July 31, 1958, had also been false and misleading and that Olen Co. had in fact been operating at a loss[2] and had been insolvent. Thus shares of Olen Co. stock had been sold to the public on the basis of a false and misleading registration statement and prospectus, the approval of the merger by Green Co.'s stockholders had been solicited on the basis of a false and misleading proxy statement, and Green Co. had been led to consummate the merger on the basis of false and misleading financial statements.

For a number of years prior to January 31, 1959, at the direction of Olen, the accounts of Olen Co. and of the Olen Division had been grossly misstated. The principal methods of falsifying the accounts were (1) the failure to record invoices covering large quantities of merchandise in the accounting period in which the related merchandise was received, thereby materially understating merchandise purchases, cost of sales, and liabilities and overstating net working capital; (2) the manipulation and falsification of the retail inventory records in such a manner as substantially to overstate the retail store inventories, gross profits, net income, earned surplus, net working capital, and as at January 31, 1959, the Mobile warehouse inventory; and (3) the charging to expense of capital improvements, thereby reducing the net income for income tax purposes.

An apparent motive for this activity was to facilitate the obtaining of credit necessary to finance the rapid expansion of Olen Co.'s operations. Among other things, Olen Co.'s credit arrangements required it to maintain on a consolidated basis a two-to-one ratio between current assets and current liabilities and to maintain net working capital of at least $2,500,000. By juggling the accounts Olen Co. concealed from creditors its true financial condition and results of operations. These practices also facilitated the public sale of Olen Co. capital stock and the consummation of the merger with Green Co.

The steps taken by Olen Co.'s management to show a liquid, solvent position led to an ever-increasing balance of unrecorded liabilities. A large amount of unrecorded liabilities were paid in 1958 through the use of funds derived from the sale of Olen Co. securities and the use of about $2,500,000 of Green Co.'s working capital after the merger. It then became necessary to increase inventory figures to balance the accounts and such increases were so startling in amount that Green Co. officials

[1] The Green Co. common stock was registered on the New York Stock Exchange, and the solicitation of proxies from Green Co. stockholders was subject to the Commission's proxy rules issued pursuant to Section 14(a) of the Securities Exchange Act of 1934.

[2] Olen Co. had paid $204,398 in Federal and State income taxes for the fiscal year ended January 31, 1958, on income which had not in fact been realized.

initiated the investigation that led to the discovery of the deficiencies summarized above.

II. ACCOUNTING PROCEDURES OF OLEN CO.

Olen Co. maintained the books and records for itself and its subsidiaries, including inventory records kept on a cost and retail basis for each retail store, at its general offices in Mobile.[3] Charges for merchandise purchased for and sold to the subsidiaries were made at the end of each fiscal year through the inter-company accounts on the general ledgers of the respective subsidiaries. Merchandise purchases were delivered to the Mobile warehouse or to a designated store. In either case a numbered receiving report was prepared and the original was sent to the Olen Co. offices. All invoices were sent to the Olen Co. offices for processing and payment.

The Olen Co. accounting system was designed to operate as follows: Upon the receipt of a merchandise invoice, a voucher and a related voucher check were supposed to be prepared promptly. The voucher portion of the check was supposed to be prepared on a bookkeeping machine, with a carbon copy of the voucher portion being an entry in the voucher purchase journal showing the voucher number and the invoice date and number. The vouchers were numbered consecutively by months (for example, voucher No. 12-123 would be a December voucher) and filed numerically. The unnumbered voucher check, in triplicate, was to be placed in the unpaid vouchers file pending date on which payment was due, the total of such items at any time to represent accounts payable for merchandise at that date. On the date the remittance was due to be made, the check was to be numbered and listed numerically in the check register. The original was to be sent to the payee, the duplicate was to be filed numerically and become the disbursement record, and the triplicate copy was to be filed in the payee file for ready reference of payments made.

In fact, invoices were seldon vouchered in the same month as dated, were frequently withheld many months before being vouchered and were sometimes paid without having been vouchered. Moreover, at times when too many invoices had been recorded for the purposes of the Olen Co. management, the records were rewritten to delete large batches of invoices in order to show lesser amounts of liabilities. At least twice such deleted invoices totaling large sums were paid without having been charged to merchandise purchases or credited to accounts payable, although when they were paid the payments were charged to accounts payable. Also, on one occasion (February 1958), some invoices of prior months were vouchered a second time and paid only on the last vouchering, further distorting the accounts.

Moreover, merchandise receiving reports were not recorded on the inventory records for the respective retail stores in the central office until the month in which the related invoices for the merchandise were vouchered and charged to merchandise purchases and credited to accounts payable, which usually was several months after the merchandise had been received, placed in stock, and sold. Until so recorded, the merchandise receiving report was held in a suspense category designated "merchandise in transit," a misnomer since the receiving store had already placed the merchandise in stock and often had sold it. During 1958 a large number of old invoices were vouchered and paid from the $1,300,000 Olen Co. received from the sale of its common stock and a First Mortgage Bond and from the Green Co. funds transferred to Olen Division after the merger. Because of the resulting high charges to merchandise purchases, many merchandise receiving reports and invoices previously included in such purchases were deleted, and the retail inventory records were rewritten to reflect a lesser charge to merchandise purchases. In many instances the cost of merchandise covered by the deleted reports was deducted from purchases but the retail value was not changed.[4] This understatement of cost in relation to retail value further facilitated the distortion of profit on

[3] In October 1956, Olen Co. had acquired a retail chain known as the "Yellow Front" stores. This chain was operated through a separate wholly owned subsidiary which had its offices and a central warehouse and maintained its books and records at Tuscaloosa. The comments in this report do not cover the Yellow Front operations.

[4] The retail inventory records purported to show, among other things, the opening inventories for each fiscal year and the additions to merchandise available for sale at cost and retail and the closing inventories at the end of each month at retail.

sales in the accounts and financial statements.

Because of the deletions described above and the failure to record merchandise as received, the retail inventory records reflected closing inventories which had little relationship to the merchandise in the retail stores. Physical inventories of merchandise in the retail stores were taken several times a year under Olen Co. supervision. The book inventory figures, as shown by the retail inventory records, were "reconciled" with the physical inventory figures by adding in the "merchandise in transit" items described above. Moverover, at the end of fiscal periods arbitrary adjustments were made in the inventory records for the purpose of preparing financial statements. It was the practice at the end of each fiscal period (January 31, of each year and July 31, 1958) to increase arbitrarily and materially the retail value of the merchandise available for sale, as shown by the retail inventory records, without a corresponding increase in the recorded cost thereof. This practice increased the retail and cost values of the closing inventories, as shown by such retail inventory records, reduced the reported cost of sales and increased the reported gross profit on sales and reported net income.

Thus, the inventory figures in the Olen Co. financial statements were not based on physical count but were essentially arbitrary figures selected to achieve a predetermined result. The improper adjustments to the retail inventory records were designed to assist in bringing such inventory records into agreement with the arbitrary financial statement figures.

III. MANIPULATION OF MERCHANDISE INVENTORY RECORDS

A. Retail Store at Huntsville, Alabama

The manner in which Olen Co. manipulated inventories in its retail stores can be illustrated by an examination of Dollar Department Store No. 127 at Huntsville, Alabama. Like Olen Co.'s other stores, it sold some items at a loss, which achieved a high volume of sales but contributed to unprofitable operations. Thus, in the 2½ months from the date of the store's opening on November 14, 1957, until the end of the fiscal year on January 31, 1958, merchandise available for sale[5] which actually cost Olen Co. $171,758 was priced at $209,693 for sale at retail, for an over-all ratio of cost to retail of 81.92 percent. In that period gross profit on sales of $131,968, after allowing for an inventory shortage, was $19,128, or 14.59 percent of such sales, and the closing inventory as of January 31, 1958, after subtracting the merchandise sold and the unexplained inventory shortage, was $73,051 at retail or $59,845 at cost.[6] However, Olen Co. falsely reported gross profit on sales by the Huntsville store as $50,958, or 38.88 percent of sales, and inventory as $117,554 retail value. These reported figures were reached by misstating the retail inventory records in several respects. The more important misstatements involved arbitrary and distorted increases in the stated retail value of merchandise available for sale and in closing inventory,[7] as well as the omission from the retail inventory records of merchandise received directly from vendors on or prior to January 31, 1958.

Olen Co. continued to falsify the inventory records of the Hunstville store in the fiscal year ended January 31, 1959 by, among other things, failing to record merchandise purchases and by making deletions in such records. The closing merchandise inventory figures recorded for the period ended January 31, 1958, were first recorded as the opening inventory for the period starting February 1, 1958, but then the $117,554 retail figure was crossed out and the figure $87,554 was written above it, representing an arbitrary reduction of $30,000. Later, apparently at the end of 6 months, the retail inventory record was completely rewritten,[8] and the opening inventory was shown as

[5] "Merchandise available for sale" during the period was equal to purchases and other merchandise receipts less transfers out.

[6] The retail stores kept their merchandise records exclusively on the basis of retail prices although, as noted above, the Mobile office carried inventory figures at both cost and retail. The $59,845 cost figure for the closing January 31, 1958 Huntsville store inventory is derived by applying to the retail value the 81.92 percent cost retail ratio described in the text.

[7] Thus, merchandise available for sale was understated by $22,999 at cost and overstated by $43,892 at retail values. Similarly, the closing inventory at January 31, 1958, was overstated by $8,831 at cost and by $44,503 at retail, and gross profit on sales for the period was overstated by $31,830.

[8] Merchandise received directly from vendors amounting to $26,546 at cost and $37,323 at retail was deleted. Of the amount so deleted, merchandise amounting to $18,112 at cost and $26,247 at retail had been received at the store before February 1, 1958 and included in "merchandise in transit" at January 31, 1958.

$87,554 at retail, the $117,554 figure being entirely omitted, with the cost figure remaining at $68,676. As of July 31, 1958, arbitrary upward adjustments of $2,816 at cost and $57,283 at retail were made in the rewritten retail inventory record for the Huntsville store. Included in the figures for merchandise received from vendors after January 31, 1958, was merchandise valued at $9,458 at cost and $12,989 at retail, which was actually received prior to February 1, 1958. Also, merchandise valued at about $37,370 at cost and $50,830 at retail, actually received during the months ended July 31, 1958, was not included in merchandise purchases as of that date. As of July 31, 1958, the retail inventory records overstated inventories in that store by $8,289 at cost and $34,123 at retail value.

In the figures for the store's inventory as of January 31, 1959, merchandise purchases, totaling approximately $61,230 at cost and $84,880 at retail, received from vendors during the fiscal year, were improperly omitted from purchases, and merchandise purchases and received prior to February 1, 1958, totaling $9,603 at cost and $13,229 at retail, was improperly included in purchases for the current year. The retail inventory record, in a portion which had been erased and rewritten, further overstated the amount of merchandise received from the Mobile warehouse in January 1959 by $33,101 at cost and $57,733 at retail.

The cumulative effect of these misstatements, and other smaller misstatements and errors, was to overstate closing merchandise inventory by $28,362 at cost and $55,912 at retail, to understate cost of sales, and to overstate gross profit on sales by $34,837 for the fiscal year ended January 31, 1959. The reported gross profit was 35.88 percent of sales, whereas the actual gross profit was only 22.80 percent of sales.

The situation in the Huntsville store was typical of conditions existing throughout the Olen Co. chain. The misstatements for all stores combined were very significant in amount, particularly those with respect to charges to merchandise purchases and credits to accounts payable. Taken as a whole, the misstatements combined to conceal operating losses and produce a false showing of profit. Misstatements of this type affected the financial statements for January 31, July 31, 1958 and January 31, 1959, prepared and certified by the firm.

B. Mobile Warehouse

According to the prescribed accounting system of Olen Co., the parent, the Olen Co. merchandise purchases account was to be charged with all merchandise purchases, whether delivered by vendors to the Mobile warehouse or direct to the retail stores. The account was to be credited with the invoice cost of all merchandise delivered to the retail stores by the warehouse or direct by vendors, as shown by the retail inventory records of the respective stores. The balance in the merchandise purchases account at the end of each accounting period was transferred to the Olen Co. merchandise inventory account, thereby adjusting such account to reflect the book inventory of the Mobile warehouse as of that date. Generally accepted accounting principles and practices required that the book inventory be adjusted to the actual merchandise inventory consisting of the physical inventory of merchandise on hand in the Mobile warehouse and any merchandise in transit at the inventory date which had been taken into account by charges to merchandise purchases and credits to accounts payable. The merchandise inventories reported in the Olen Co. financial statements, certified by the firm without exception or qualification, purportedly represented the actual merchandise inventories as at the statement dates. However, the reported merchandise inventories were in fact grossly misstated book inventories having only incidental relationship to the actual merchandise inventories, because of the failure to record merchandise purchases concurrently with the receipt thereof and the manipulations of the retail inventory records.

The prescribed accounting system of Olen Co. was not adhered to. It was the practice to delay the charging of purchases to the Olen Co. merchandise purchases account for weeks and in many instances several months after the receipt of the merchandise. However, the merchandise purchases account was usually credited with the invoice cost of the shipments out of the warehouse whether or not the purchases of such merchandise had been charged to the account. Such practices resulted in the understatement of the merchandise purchases account and the book inventory account for the Mobile warehouse by the amount of the unrecorded purchases, inasmuch as the book inventory account represented the difference between the charges and credits to the merchandise pur-

chases account during the current accounting period plus the book inventory at the beginning of the period.

There was also a failure to charge merchandise purchases received direct from vendor to merchandise purchases on the retail inventory records of the respective stores until the invoices covering such purchases had been charged to the Olen Co. merchandise purchases account, which, as stated above, usually was several weeks and often several months after the merchandise had been received. This practice resulted in the understatement of merchandise purchases and cost of sales but usually did not directly affect the book inventory of the Mobile warehouse, as the credit to the Olen Co. merchandise purchases account for merchandise transferred or delivered to the retail stores was the amount of the purchases shown by the retail inventory records. However, on occasion invoices which had been charged to merchandise purchases on the retail inventory records of the stores were not charged to the Olen Co. merchandise purchases account, through omission or deletion from the voucher purchase journal, and as a result the book inventory of the warehouse was understated by the amount thereof.

An example of the practices which tended to understate the book inventory of the Mobile warehouse was the deletion from the voucher purchase journal for January 1958, and thereby from the charges to the Olen Co. merchandise purchases account and the credits to accounts payable, of vouchers covering merchandise purchased and received during that and the preceding months totaling about $525,000. Presumably the purpose of this deletion was to reduce the amount of accounts payable to be reflected in the Olen Co. balance sheet as of January 31, 1958, in order to improve the ratio of current assets to current liabilities as at that date. The deleted vouchers covered invoices for merchandise received into the Mobile warehouse and invoices for merchandise received by the retail stores direct from vendors and included in direct purchases on the respective retail inventory records and in turn credited to the Olen Co. merchandise purchases account. However, corresponding deletions of the related items were not made on the retail inventory records and from the credits to the Olen Co. merchandise purchases account. The deletions understated the merchandise purchases for the fiscal year ended January 31, 1958, and as made understated the book inventory account of the Mobile warehouse as at January 31, 1958, by about $525,000. The understated book inventory, in the amount of $112,210, was reflected in the Olen Co. financial statements as at January 31, 1958, certified by the firm without exception or qualification.

Conversely, during the following fiscal year ended January 31, 1959, Olen Co. and its successor, Olen Division, using the proceeds from sales of captial stock, other financing, and transfers of funds from Green Co. bank accounts, undertook to pay the invoices for a large volume of merchandise purchased and received prior to February 1, 1958, or in transit at that date, a great many of which had not been recorded in merchandise purchases and accounts payable until after January 31, 1958, if at all. This resulted in the gross overstatement of the Olen Co. merchandise purchases account and book inventory account, despite the deletion of vouchers totaling about $248,000 from the voucher purchase journal as at June 30, 1958, similar to the deletion of the $525,000 described above, the failure to record merchandise purchases totaling over $2,700,000, and the manipulation of the retail inventory records to overstate the inventories in the retail stores at January 31, 1959, by about $700,000. As of January 31, 1959, when the actual physical inventory in the Mobile warehouse was about $1,138,000, the book inventory as shown in the Olen Division's general ledger was $3,239,116 and the financial statements of the Division, certified by the firm without exception or qualification, again purportedly as the result of a physical inventory the taking of which was observed by the firm, reflected the inventory at $3,243,182, although a tabulation of the physical inventory records after the substantial alterations explained below totaled $2,640,137. It was the startling contrast between the merchandise inventories stated at $3,856,917 in the consolidated financial statements as at January 31, 1958, and at about $8,400,000 as at January 31, 1959, both certified by the firm without exception or qualification, that impelled Green Co. to order a reaudit of the Olen Division by another accounting firm.

The Olen Co. employees who took the physical inventory as of January 31, 1959 admitted that, at Olen's directions, they made many substantial alterations in the count of various items of mer-

chandise in order to show a large inventory. For example, an inventory ticket showing a count of 400 pairs of shoes was changed to show 14,400 pairs. By that means the dollar amount of the physical inventory was raised from the actual amount of about $1,138,000 to $2,640,137, which figure was given to the firm. Although the firm observed the taking of the physical inventory and later checked the inventory tickets after alteration, they claimed that they failed to notice the count falsifications because they were deceived by the Olen Co. employees. However, many inventory tickets had been altered to show such large quantities that anyone familiar with the business, as was the firm which had observed the taking of inventories in the warehouse over a period of years, could not have failed to notice such irreguarities. Morever, even the grossly inflated $2,640,-137 figure was then discarded, and the even further inflated figure of approximately $3,243,000 was used for warehouse inventory in the financial statements which the firm prepared and certified. The only apparent basis for the use of this arbitrary figure is that it was about the amount required to conform the accounts with the predetermined amounts arising from the previously described manipulations of merchandise purchase accounts.

IV. THE FINANCIAL STATEMENTS CERTIFIED BY THE FIRM

This report turns now to a more specific consideration of the deficiencies in the financial statements prepared and certified by the firm in the light of the distortions and inaccuracies in Olen Co.'s records as described above.

A. The Securities Act Registration Statement

The registration statement filed by Olen Co. in April 1958 with respect to its public offering of 100,000 shares of stock included balance sheets as of January 31, 1958, for Olen Co. on a corporate and consolidated basis, and income statements for the period January 1, 1953 through January 31, 1958, for Olen Co. on a corporate and consolidated basis and for its predecessor partnership. The firm's certificate recited 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, except that we were not present to observe procedures followed in determining quantities of inventories as of January 31, 1956, or at prior balance sheet dates, as to which we satisfied ourselves by means of other auditing tests and procedures."

The certificate concluded with the opinion that the financial statements fairly presented the financial position and the results of operations of Olen Co., its subsidiaries and its predecessor partnership, in conformity with generally accepted accounting principles.

In a pre-filing conference with members of the Commission's staff on March 25, 1958, at which the partners of the firm were present, it was stated to the staff that Olen Co. had an internal audit staff; that inventories for the stores were stated at retail, with perpetual inventory records; and that some retail store inventories were checked four times a year and others at least twice a year. It was further stated that for the years other than those ended January 31, 1957, and January 31, 1958, the firm's audits did not include observation of inventories but that because the firm had done all of the accounting work for Olen Co. and its predecessors since 1947, it felt able to certify the financial statements without qualification. Moreover, in a conference held by the firm in connection with the public offering of the capital stock, it was stated to representatives of the underwriters that "merchandise in transit" was Olen Co.'s terminology and was a misnomer; that it represented "the net of unrecorded purchases and sales between the date of the book inventory and the date of the physical inventory required because of a time lag in posting the book inventories."

As indicated in the previous discussion and explained more fully below, these representations and those in the certificate accompanying the financial statements were materially false and misleading. The financial statements included in the registration statement were seriously inaccurate in many respects, and particulary in that merchandise inventories, fixed assets, and accounts payable were materially misstated, resulting in material overstatement of net income, retained earnings, and stockholders' equity.

In the consolidated balance sheet as at January 31, 1958, accounts payable trade (amounts

owing for merchandise) were stated at $1,668,198. An examination of Olen Co.'s records shows that invoices totaling approximately $4,600,000 dated as of January 31, 1958, or earlier were paid after that date, thus indicating that there were unrecorded liabilities representing accounts payable as of January 31, 1958, of about $2,900,000. It also indicates that the accounts payable trade as of January 31, 1957, reported at $988,176, were probably understated by a substantial amount also representing unrecorded merchandise purchases.

The notes to the financial statements in the registration statement listed the values of inventories entering into the determination of the cost of sales, such inventory figures for January 31, 1958, being $112,210 for the Mobile warehouse, and $3,856,917 on a consolidated basis including the retail stores' inventories. As this report's earlier discussion of the manipulation of merchandise inventory records shows, these inventory figures were flagrantly false.

Olen Co.'s records were in such condition that even a cursory examination of the merchandise voucher records, the disbursing records, the merchandise receiving records, the accounts payable records, or the merchandise inventory records, would have disclosed the inaccuracy and falsity of the merchandise and accounts payable figures. The invoice numbers and dates were reflected on the vouchers and usually on the voucher checks and voucher purchase journal. Each invoice usually bore the number of the related receiving report and of the voucher on which the invoice was recorded, the latter number indicating the month in which the voucher was prepared. Any review of these records would have disclosed the delay in vouchering invoices. For example, only a very few of the first 500 vouchers in the month of February 1958 covered invoices dated in that month. Any examination would have disclosed the existence of material amounts of unrecorded purchases and accounts payable at the end of any month. Also, the voucher portions of many checks had been prepared on typewriters rather than on bookkeeping machines and many pages of the journal were originals rather than carbon copies, again indicating that the system as designed had not been followed.

In addition each merchandise receiving report bore the date on which the merchandise was received by the retail store, and the related invoice and month-keyed voucher numbers. Thus it would have been immediately apparent to an auditor examining the retail inventory records and the supporting merchandise receiving reports that there were wide descrepancies between the dates merchandise was received and the dates on which related invoices had been vouchered, and the accounts payable, therefore, could not have been correctly stated. The firm's representatives observed the taking of the inventory in the Mobile warehouse; they could hardly have been unaware of the obvious inaccuracy of the reported warehouse inventory figure of $112,210. A check of the retail inventory records and the underlying documents for the retail stores would have readily disclosed the falsity of such records and the composition of "merchandise in transit" as actually representing unrecorded invoices for merchandise. Schedules located in Olen Co. files showed "merchandise in transit" as of December 31, 1957, of over $1,900,000 and of over $1,600,000 as of January 21, 1958.

In connection with their audit of the Olen Co. accounts and records as at January 31, 1958, the firm's employees observed the taking of physical inventories in about one-third of the retail stores in addition to the Mobile warehouse. Also, the physical inventory records of the retail stores were reconciled with the related book inventories shown by the respective retail inventory records, as indicated by copies of such reconciliations in the firm's working papers and in the Olen Co. files. In any verification of the inventory records it would have been necessary to account for all of the receiving reports issued, which were pre-numbered in bound books. Such a review would have disclosed the nature of the "merchandise in transit," the large amounts of unrecorded invoices at all times, and the discrepancies arising from the manipulation of the inventory records and the extensive vouchering after January 31, 1958, of invoices for merchandise received prior thereto.

In addition, appropriate testing of accounts payable by direct confirmation with principal suppliers would have disclosed the failure to record purchases in the fiscal year in which the goods and services were received and the existence of large amounts of unrecorded purchases and liabilities. Proper confirmation procedures most certain-

ly would have brought to light discrepancies in accounts payable of the magnitude of $2,900,000.

The net amount of fixed assets, after depreciation, included in the Olen Co. consolidated balance sheet as of January 31, 1958, was $649,531. An accountant then employed by the firm observed during the course of the January 31, 1958 audit that certain items which should have been charged to fixed assets were charged to expense. He reported this fact to Kerlin, but the misstatements of fixed assets were not corrected. That Kerlin had an intimate knowledge of this practice, the purpose of which presumably was to reduce the reported net income for income tax purposes, is indicated by the fact that on several occasions he complained to Olen Co.'s office manager that too many capital improvements were being charged to expense. After Green Co. discovered the falsity of the financial statements, the firm prepared schedules indicating that over $1,272,000 of fixed asset items had been charged to expense during the period January 1, 1953 through January 31, 1959,[9] including about $614,500 during the fiscal year ended January 31, 1958.

It was also the practice of Olen Co. not to accrue the purchases of services, supplies and other nonmerchandise items but to voucher them at the time of payment. This practice, which resulted in an understatement of accrued liabilities at January 31, 1958, of about $250,000, was readily apparent from any review of the accounts and records. Many of the unrecorded invoices covering these liabilities as at January 31, 1958, were dated several months prior thereto, as could have been readily determined by a review of the records when vouchered and paid after that date.

As a result of the falsification and irregularities in Olen Co.'s books and records, income, retained earnings and stockholders' equity were all grossly overstated on the books of account and in the financial statements. Consolidated retained earnings as of January 31, 1958, were stated in the the prospectus as $662,239, and consolidated net income after provision for $313,966 of income taxes was stated at $692,959 for the 2 years and 6 Months ended January 31, 1958. Adjusting for the misstatements of fixed assets and the unrecorded liabilities, it appears that in fact Olen Co. had an accumulated operating deficit of about $1,800,000 as of January 31, 1958, and that instead of the stockholders' equity of about $1,200,000 shown in the financial statements there was a capital deficit of about $1,080,000 as of January 31, 1958.

[9] A lower net adjustment of $798,102, after certain deletions and adjustments for depreciation, was later made by Green Co. to the fixed asset accounts of the Olen Division.

B. The Proxy Statement

As previously noted, the combined proxy statement of Green Co. and Olen Co., used in September 1958 to solicit stockholders' approval of the merger of the two companies, included financial statements of Olen Co. as of January 31, 1958, certified by the firm, as well as unaudited financial statements of Olen Co. for the 6 months ended July 31, 1958, also prepared by the firm. In accordance with the conditions of the merger agreement, audited July 31, 1958, financial statements were prepared and certified by the firm and were furnished to Green Co. in October 1958 before the merger was consummated. Those statements were substantially identical to the unaudited ones and for convenience the July 31, 1958 statements, will be discussed in terms of the certified statements.

The firm's certificate covering such statements represented that the examination had been made in accordance with generally accepted auditing standards and accordingly included such test of the accounting records and such other auditing procedures as were considered necessary in the circumstances. Without qualification, the certificate also stated that the statements presented fairly the financial position at July 31, 1958, and the results of operations for the 6 months then ended, in conformity with generally accepted accounting principles. In fact, the July 31, 1958, statements, were materially false and misleading in substantially the same respects and for the same reasons as the January 31, 1958 statements, whose serious deficiencies have already been described.

Thus, again, merchandise inventory figures bore little relation to actual physical inventories but represented arbitrary figures designed to reflect a favorable current position and to reduce the cost of sales of retail stores to desired amounts. The merchandise inventory for the Mobile warehouse was misstated in several ways. It was based on the book inventory as of January 31, 1958, which was

grossly misstated as explained above. Moverover, the Olen Co. merchandise purchases account was charged with numerous invoices for purchases prior to February 1, 1958, which were vouchered and recorded subsequent thereto. Also, as stated heretofore, vouchers for merchandise purchases totaling about $248,000 were deleted from the voucher purchase journal as at June 30, 1958, thereby further misstating accounts payable, merchandise purchases and the warehouse book inventory. In addition, numerous invoices for merchandise purchases subsequent to January 31, 1958, totaling several hundred thousand dollars, were not vouchered and recorded in accounts payable and merchandise purchases. As explained previously, arbitrary charges, in such amounts as would enable the stores to report a desired cost of sales and gross profit margin, were made to the merchandise purchases on the retail inventory records of the respective retail stores. Such arbitrary charges formed the basis for the credits to the Olen Co. merchandise purchases account for merchandise delivered to the retail stores.

The retail stores inventories contained misstatements of the kind discussed above in connection with the store at Huntsville. These included misstatements of opening inventories, merchandise purchases, ratio of cost to retail value, and arbitrary adjustments of opening inventories, purchases and closing inventories. Although physical inventories of merchandise in the retail stores were taken periodically, the distorted "book" inventories were reflected in the financial statements.

A subsequent analysis by Green Co. representatives indicated that as of July 31, 1958, accounts payable trade totaled about $4,170,000. The firm's audited July 31, 1958 financial statements, listed such liabitities in the amount of $1,354,768. It has already been noted that substantial numbers of vouchers had been deleted from the records in January and June 1958, thus understating accounts payable by at least $773,000. Fixed assets, net income, retained earnings and stockholders' equity were all materially misstated. Retained earnings, shown to be $737,123 at July 31, 1958, were grossly overstated in that, among other things, accounts payable were understated by about $2,800,000.

During the course of the July 31, 1958 audit, the accountant who had in the earlier audit observed the improper charges to expense accounts of disbursements for purchases of capital assets found in a file separate from the paid-invoice file a number of invoices for nonmerchandise items received prior to July 31, 1958, in some instances several months prior thereto, which had not been recorded at that date. A sampling of such invoices totaled about $80,000. On the following day he attempted to ascertain the extent of such unrecorded items, but was told by the Olen Co. office manager that the requested files were being used, that he could not see them at that time, and that in the future, when the auditors wished to see any files, they should ask her or one of Olen Co.'s clerks for them. The accountant made a list of the unrecorded vouchers or invoices he had seen and asked the office manager for them. When the file folders were given to him, the unrecorded items had been removed and he was told that they had never been in the folders. He reported these events to Kerlin.

Concerned that the same situation might exist in connection with merchandise purchases, the accountant then examined the voucher register for dates on and after August 1, 1958, and found recorded in it invoices dated prior to that date, many of which were several months old, representing more than $700,000 worth of merchandise purchases which had been omitted from the accounts as of July 31, 1958. He reported this discovery to Kerlin also. Thereafter, upon learning that the financial statements were being certified without exception, despite the omission of material amounts of liabilities and purchases, he protested and submitted his resignation from the firm.

C. The Financial Statements Prepared for the Green Co. Annual Report

The financial statements for the Olen Division as of January 31, 1959, which were prepared and certified by the firm and were intended for inclusion in the Green Co. annual report to the Commission on Form 10–K, were also materially inaccurate in important respects.

Accounts payable for merchandise continued to be grossly understated. They were shown as totaling $2,129,420. A later analysis developed that Olen Division owed trade creditors about $4,840,334 at January 31, 1959, so that the reported figure was understated by about $2,700,000.

On the other hand, as noted above, merchandise

inventory in the Mobile warehouse, which had been grossly understated at $112,210 in the January 31, 1958 statements, was now grossly overstated at about $3,243,000 as of January 31, 1959, as a result of extensive charges made to merchandise purchases when many previously unrecorded invoices were paid after the stock issue and the merger. As has been described, although the physical inventory in the warehouse actually aggregated only about $1,138,000, Olen employees raised the quantities on many of the inventory count tickets so as to show $2,640,137, and even that figure was arbitrarily raised another $603,000 to approximately the book figure. Although, as stated, the firm's representatives observed the taking of the warehouse inventory and made test counts, they did not retain the inventory count tickets prepared by Olen employees and such tickets were falsified before they were turned over to the firm. However, the firm and its predecessors had been auditing the financial statements of the Olen Division and its predecessors over a substantial period and were certainly familiar with its affairs. Anyone familiar with the business could not fail to question the incredible increase in the warehouse inventory from $112,210 to $2,640,137 in 1 year, let alone the higher figure of $3,243,000 actually used by the firm.

Furthermore, a representative of Green Co.'s auditors went to Mobile to expedite the completion of the audit of the Olen Division, since the accounts thereof were to be included in Green Co.'s Form 10-K as at January 31, 1959. He discussed the very large merchandise inventory and its unexplained ballooning from the relatively small inventory as at January 31, 1958, with the firm and stated that he was going to recommend that a second physical inventory of the Mobile warehouse be taken. Despite this warning, the firm certified the false financial statements for inclusion in Green Co.'s Form 10-K and forwarded them to Green Co.'s offices in New York. In the meantime, Olen had been confronted with the apparent overstatement of the inventories and had confessed that the accounts had been falsified. The firm then attempted to retrieve the false financial statements.

The firm's representatives also observed the taking of physical inventories in a number of the retail stores in connection with the audit as at January 31, 1959, and were represented to have reconciled the physical inventories with the related book inventories, as shown by the retail inventory records. The inventories in the retail stores at January 31, 1959, as reported in the financial statements certified by the firm were grossly overstated by about $700,000. The staff's investigation showed that an examination of the retail inventory records would have readily disclosed the falseness of the reported inventories.

Moreover, the firm employed grossly defective procedures to confirm the amounts due to trade creditors, which as has been seen were understated on the books in the magnitude of $2,700,000. Confirmations were sent to suppliers named on two lists prepared by Olen Division personnel which omitted several of the largest regular suppliers of merchandise to Olen Division, to six of whom about $740,000 was owed at January 31, 1959 and from whom the receiving records showed that large shipments were received during the latter part of January and the first 10 days of February 1959. Where as here requests are made for confirmation of merchandise accounts payable, it is customary to request confirmations from major suppliers during the period under audit regardless of whether or not the records show amounts due to them. [10] It is also a basic auditing procedure to check the receiving records for a short time prior and subsequent to the balance sheet date to determine that all merchandise received prior to the balance sheet date or in transit at that date has been included in the accounts. [11] The firm either did not employ these basic procedures although they were certified public accountants of many years experience to whom such procedures should have been well known, or they disregarded the results of such procedures.

As has been previously noted the firm's analysis of the records indicated that about $1,272,000 of capital items had been charged to expenses in the period 1953 through January 31, 1959. About $242,780 of this amount had been so charged in the year ending January 31, 1959.

As a result of the various misstatements, retained earnings and equity were materially overstated. Thus, after appropriate adjustments, including those necessary to give effect to a net

[10] Montgomery, *Auditing* 333 (7th Ed., 1949).

[11] *Accountant's Handbook*, 12–64 (4th Ed., 1961); Peloubet *Audit Working Papers* 124 (1949); Bell and Johns, *Auditing* 184 (1942); Montgomery, *Auditing* 334 (7th Ed., 1949).

increase of $798,102 in the fixed asset accounts,[12] the reported retained earnings as of January 31, 1959, of $1,134,998 would be changed to a deficit of $1,016,211.

V. THE FIRM'S RESPONSIBILITIES

As seen from the foregoing, the firm prepared and certified financial statements which were materially false and misleading. These financial statements were included in filings with the Commission and in documents on the basis of which securities were offered and sold to the public and proxies were solicited and obtained from stockholders with respect to the merger of Green Co. and Olen Co. Contrary to the representations in the certificates, the examinations of such financial statements had not been made in accordance with generally accepted auditing standards, nor did such financial statements fairly present the financial position of Olen Co. or the results of its operations in accordance with generally accepted accounting principles. The deficiencies in the financial statements resulted from the reflection therein of accounts which the firm must have known were grossly false.

A public accountant's examination is intended to be an independent check upon management's accounting of its stewardship. Thus he had a direct and unavoidable responsibility of his own, particularly where his engagement relates to a company which makes filings with the Commission or in which there is a substantial public interest.

Within the procedures followed by the firm, there were numerous circumstances which, if investigated adequately, must have revealed the gross inaccuracies in the financial statements. The direct physical contact with inventories that the firm had through their representatives, who observed the inventory taking in the warehouse and in many of the stores and made test counts, should have served to preclude the use of the completely unrealistic inventory figures reflected in the financial statements. The discrepancies were of such a gross and extensive nature that they could not have been overlooked. It is unbelievable, under the circumstances, that the firm did not know that the merchandise inventories were grossly misstated.

The same situation prevailed with respect to accounts payable. As discussed above, any reasonable review of the system of internal check and control would have disclosed that the system of recording purchases was not operating as it was supposed to. There are indications that the practices with respect to the failure to record merchandise purchases extended back at least to 1954. The juggling of the accounts payable records was so clumsy and open that any review of the accounting procedures and controls would have disclosed numerous unrecorded invoices of material amount and the composition of the "merchandise in transit." A scanning of transactions recorded in voucher and disbursement records the first few days after the balance sheet date, a step customarily included in auditing procedures, would have disclosed numerous instances of unrecorded liabilities and purchases as of the balance sheet dates.

Thus, ordinary tests of the accounts and records would have disclosed an inordinate number of errors and omissions. This in itself would have called for further testing and employment of extended auditing procedures,[13] which would have revealed that recording invoices concurrently with the receipt of the related merchandise and services was the exception rather than the rule. It is not conceivable that so many gross misstatements over so extended a period of time could have remained undiscovered by anyone following accepted auditing procedures. The discovery of gross misstatements in the accounts is certainly one of the major purposes of an independent audit.

Indeed, the Olen records were so permeated with evidence of falsification and juggling of accounts that it is clear that either the firm made no audit worthy of the name, or, if they did follow proper auditing procedures as they contended, they must have known that the financial statements they prepared and certified were false. Other circumstances support this latter conclusion. Thus, as noted above, an accountant working on the audit brought to the firm's attention major discrepancies in the course of the July 31, 1958 audit, and when they were disregarded, he resigned in protest. Moreover, in the January 31, 1959 audit, the firm not only failed to question the inflated warehouse inventory figure of $2,640,137 presented by Olen's employees, but included in the financial statements it certified a figure further inflated by another

[12] See n. 9, p. 267.

[13] Montgomery, *Auditing* 46–47 (7th Ed., 1949).

$603,000 and having no apparent basis other than that it approximated the book inventory figure as carried in the Olen Division records. The firm knew that some capital expenditures were being charged to expense accounts. An independent public accountant would be derelict in his responsibilities if he knowingly certified to financial statements containing materially false and misleading amounts, even though he were of the opinion that such items offset each other. When an independent public accountant in the course of an examination gains knowledge of facts which are of material importance to investors, he is under a duty to report such facts to investors in his certificate or report if they are not set forth in the financial statements themselves.[14]

The firm stated that after their certification of the January 31, 1959 statements, responses were received from 27 suppliers to whom requests for confirmation of accounts payable had been sent, and such responses showed that accounts payable recorded at $340,030 were understated by $144,600. They asserted that they were pressured by Green Co.'s auditors to finish their audit quickly and that had they been allowed to complete their examination they would have discovered the falseness of the accounts payable figures. Nevertheless, they did certify the financial statements and although Green Co.'s auditors expressed concern over the tremendous increase in the merchandise inventory before the firm submitted their certificate, they certified the financial statements without exception or qualification, using in the balance sheet the arbitrarily inflated warehouse inventory figure of about $3,243,000 which was about $603,000 more than the falsified inventory count the Olen employees submitted. It is not possible to excuse their conduct on the ground that it was caused by undue rushing of the audit. It is obviously improper for a certifying accountant to permit himself to be stampeded into an inadequate audit or an untrue certification. Nor can alleged undue pressure to get the January 31, 1959 audit completed, explain the serious deficiencies in the January 31 and July 31, 1958 audits.

Kerlin claimed that, although at times his duties included supervision of auditing of Olen Co.'s books and records insofar as they related to cash, receivables, insurance, prepaid expenses, fixed assets, payroll taxes, sales taxes, notes payable, capital, the entire operation of one group of stores and the observation of the inventories of three retail stores, he never supervised or participated in the examination of accounts payable or in the observation of warehouse inventory. However, it cannot be accepted that Kerlin was concerned with only a part of the Olen Co. audits. Both the accountant above referred to working on the audits and Olen's office manager stated that Kerlin was in over-all charge of the Olen Co. and Olen Division audits. He was the principal partner of the firm next to the senior partner and concededly participated actively in the audits. It is also noted that Kerlin had worked on the Olen Co. audits for quite a number of years, on detail work in the earlier years, and later, in a supervisory capacity.

On the basis of its investigation the staff considers it to be clear that the firm was guilty of unethical and improper professional conduct. In its opinion the conduct described herein represented a complete abdication of the responsibilities of an independent public accountant.

May 1, 1966

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[14] Resources Corporation International. 7 S.E.C. 689, 740 (1940).

RELEASE NO. 106

August 12, 1966

HOLDING COMPANY ACT OF 1935
Release No. 15540

Adoption of Revisions of the Uniform System of Accounts for Mutual Service Companies and Subsidiary Service Companies, Under the Public Utility Holding Company Act of 1935, to Permit Orderly Destruction of Certain Records of Service Companies

On May 10, 1966, the Securities and Exchange Commission published for comment a proposal under the Public Utility Holding Company Act of 1935 (Release 35-15466) to revise its Uniform System of Accounts for Mutual Service Company and Subsidiary Service Companies ("System of Accounts"), so as to establish, as an Appendix thereto, a regulation entitled: "REGULATION TO GOVERN THE PRESERVATION AND DESTRUCTION OF RECORDS OF MUTUAL AND SUBSIDIARY, SERVICE COMPANIES" ("Regulation"). Heretofore the System of Accounts had required that service companies subject thereto retain their records permanently, unless otherwise authorized by the Commission. The purpose of the proposal is to eliminate this provision and substitute therefor appropriate procedures for the orderly destruction of records, the continued retention of which is deemed no longer necessary or appropriate in the public interest or for the protection of investors or consumers.

After considering all comments and recommendations submitted by interested persons, the Commission, acting pursuant to the authority contained in Sections 13, 15 and 20 of the Public Utility Holding Company Act of 1935, has adopted the proposed regulation, subject to the following changes:

1. In paragraph (i) of Item 15-Payroll Records, under the column headed "Period of Retention" at page 11 of the proposed regulation, the language reading "6 years after termination of employment" is changed to read "3 years after close of fiscal year, provided employment and salary changes are recorded in the records described in Item 24(a).
2. In paragraph (2) of Item 24—*Employment Records*, under the column headed "Period of Retention" at page 15 of the proposed regulation the language reading "2 years after termination of employment" is changed to read "6 years after termination employment."
3. In paragraph (d) of Item 31—*Other Records*, under the column headed "*Description of Records*" at page 17 of the proposed regulation, the word "effecting" in line 7 of such paragraph is changed to read "affecting."
4. In paragraph 8 of General Requirements at page 4 of the proposed regulation, in the fifth line thereof, the word "and" is changed to read "or."

For the purpose of implementing the regulation, the following revision of the General Instructions of the System of Accounts also was adopted by the Commission:

At page 3 of the said General Instructions, the third paragraph thereof under the heading entitled "Records" is deleted and the following paragraph is substituted therefor:

"No company shall destroy any records except as authorized by the provisions of the 'Regulation to Govern the Preservation and Destruction of Records of Mutual and Subsidiary Service Companies' annexed hereto as an Appendix."

The Commission finds that the foregoing action provides relief to the affected companies and that it would be to their advantage if the regulation were made effective immediately. Accordingly, the foregoing action is declared effective August 12, 1966. Copies of the regulation will be furnished upon request.

By the Commission.

ORVAL L. DUBOIS,
Secretary.