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Accounting Series Releases

Compilation of RELEASES to 195

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

pendent accountants of the parent company may be engaged to examine the financial statements of the division or subsidiary.

Inquiry has been made whether in the situation where the financial statements of a division or subsidiary which represents a nonmaterial segment of an international business are examined by another accounting firm or its affiliated firm, Rule 2-01 of Regulation S-X[3] is construed so as to preclude all the partners of such other accounting firm or its affiliated firm from owning any securities of the parent company of the subsidiary in order for the other accounting firm to be considered independnet as to the parent company or the subsidiary.

We believe that the purposes of Rule 2-01 would be adequately served by a less restrictive construction. Insofar as ownership of securities by partners is concerned, the other accounting firm would be held to be not independent only if securities of the parent company or the subsidiary are owned by any of the partners of the other accounting firm or its affiliated firm who are located in the office which makes the examination of the division or subsidiary or who are otherwise engaged in such examination.

This interpretation relates exclusively to the ownership of securities and does not extend to any other relationship prescribed by Rule 2-01.

[3] Rule 2-01 of Regulation S-X provides that "an accountant will be considered not independent with respect to any person or any of its parents or subsidiaries in whom he has, or had during the period of report, any direct financial interest or any material indirect financial interest." Where the "accountant" is a firm, the Commission has construed the restriction to apply to each partner of the firm whether or not he has any connection with the examination. Note—Rule 2-01 of Regulation S-X was subsequently revised in Accounting Series Release No. 125 (June 23, 1972) and the cited section now reads:

"an accountant will be considered not independent with respect to any person or any of its parents, its subsidiaries, or other affiliates (1) in which, during the period of his professional engagement to examine the financial statements being reported on or at the date of his report, he or his firm or a member thereof had, or was committed to acquire, any direct financial interest or any material indirect financial interest, or (2) with which, during the period of his professional engagement to examine the financial statements being reported on, at the date of his report or during the period covered by the financial statements, he or his firm or a member thereof was connected as a promoter, underwriter, voting trustee, director, officer, or employee, except that a firm will not be deemed not independent in regard to a particular person if a former officer or employee of such person is employed by the firm and such individual has completely disassociated himself from the person and its affiliates and does not participate in auditing financial statements of the person or its affiliates covering any period of his employment by the person. For the purposes of Rule 2-01 the term "member" means all partners in the firm and all professional employees participating in the audit or located in an office of the firm participating in a significant portion of the audit."

RELEASE NO. 113
October 21, 1969

INVESTMENT COMPANY ACT OF 1940
Release No. 5847

Statement Regarding "Restricted Securities"

The Securities and Exchange Commission today made public the following statement.

"Restricted Securities"

The Commission is aware that many investment companies have been acquiring substantial quantities of securities that cannot be offered to the public for sale without first being registered under the Securities Act of 1933 ("restricted securities"). For the year 1968, annual reports filed by registered investment companies indicate that open-end and closed-end companies together held

in excess of $4.2 billion of restricted equity securities. Open-end companies—excluding exchange funds—accounted for about $3.2 billion of these restricted securities which represented 4.4 per cent of their total net assets. The acquisition by investment companies of such securities raises certain problems under the securities laws of which shareholders, distributors, managements and directors of these companies should be aware. This statement discusses these problems. No inference should be drawn from publication of this statement, however, as to the desirability or merits of the acquisition of restricted securities by a registered investment company.

Problems for the Seller

Section 4(2) of the Securities Act of 1933 exempts from the registration requirements of that Act "transactions by an issuer not involving any public offering." This is the so-called "private offering" provision in the Securities Act. The securities involved in transactions effected pursuant to this exemption are referred to as restricted securities because they cannot be resold to the public without prior registration. They are also sometimes referred to as "investment letter securities" because of the practice frequently followed by the seller in such a transaction, in order to substantiate the claim that the transaction does not involve a public offering, of requiring that the buyer furnish a so-called "investment letter" representing that the purchase is for investment and not for resale to the general public.

The private offering exemption of Section 4(2) of the Securities Act is available only where the offerees do not need the protections afforded by the registration procedure. As the Court of Appeals for the Second Circuit recently stated in *Katz* v. *Amos Treat & Co.* CCH Fed'l. Sec. Law Rep. ¶92,409 (1969):

> "The Supreme Court has instructed that the applicability of the exemption should turn on whether the particular class of persons affected need the protection of the Act. *SEC* v. *Ralston Purina Co.*, 346 U. S. 119, 125 (1953)."

The test of the availability of the Section 4(2) exemption is whether the offerees are in such a position with respect to the issuer as to have access to the kind of information that would be made available in a registration statement filed pursuant to the Securities Act. This test is no different when the offeree is an investment company.

Problems for the Buyer

1. The Problems of Valuation

It is critically important that an investment company properly value its portfolio securities. It is obvious, for example, that any distortion in the valuation of a restricted security held by an investment company will distort the price at which the shares of the investment company are sold or redeemed. It is also clear that investment managers who are compensated on the basis of net asset value or performance may be unduly compensated if a restricted security, purchased at a discount from the market quotation for unrestricted securities of the same class, is overvalued. In such a case, investors may also be misled by the reported performance of the investment company.

The acquisition of restricted securities by both open-end and closed-end investment companies creates serious problems of valuation. Section 2(a)(39) of the Investment Company Act of 1940 and Rule 2a-4 thereunder requires that in determining net asset value, "securities for which market quotations are readily available" must be valued at current market value while other securities and assets must be valued at "fair value as determined in good faith by the board of directors."

Readily available market quotations refers to reports of current public quotations for securities similar in all respects to the securities in question. No such current public quotations can exist in the case of restricted securities. For valuation purposes, therefore, restricted securities constitute securities for which market quotations are *not* readily available. Accordingly, their fair values must be determined in good faith by the board of directors and this obligation necessarily con-

tinues throughout the period these securities are retained in the company's portfolio.

Restricted securities should be included in the portfolio of a company and valued to determine current net asset value on the date that the investment company has an enforceable right to demand the securities from the seller.

Where the investment company negotiates the acquisition of the restricted securities directly with the owner of the securities, there are three significant dates. The first occurs when the investment company and the seller orally agree upon the price and the amount of the securities (the "handshake date"). At this point, there would not seem to be any enforceable right of the investment company to demand the securities from the seller since, in most states, particularly those which have adopted the Uniform Commercial Code, there is no enforceable right unless there exists some writing "sufficient to indicate that a contract has been made for sale of a stated quantity of described securities at a defined or stated price" (Section 8-319(a) of the Uniform Commercial Code). If the terms of the oral understanding do not contemplate compliance with any condition by the seller, it is suggested that the investment company procure, from the seller, a signed memorandum setting forth the price and quantity of securities to be sold. Upon receipt of that memorandum, an enforceable right would be obtained. The securities should be valued as of that date.

In those situations where the oral understanding contemplates the execution of a formal contract of purchase and sale, no enforceable right exists until the time the formal contract is signed (the "contract date"). If the formal contract does not require compliance with any conditions by the seller, an enforceable right is then obtained, and the securities should be valued as of that date.

Where the formal contract requires compliance with stated conditions which the investment company believes should not be waived, no enforceable right is obtained until the stated conditions are satisfied. In that situation, the valuation date should be the date upon which the conditions are satisfied (the "closing date").

Restricted securities are often purchased at a discount, frequently substantial, from the market price of outstanding unrestricted securities of the same class. This reflects the fact that securities which cannot be readily sold in the public market place are less valuable than securities which can be sold, and also the fact that, by the direct sale of restricted securities, sellers avoid the expense, time and public disclosure which registration entails.

As a general principle, the current fair value of restricted securities would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale. This depends upon their inherent worth, without regard to the restrictive feature, adjusted for any diminution in value resulting from the restrictive feature. Consequently, the valuation of restricted securities at the market quotations for unrestricted securities of the same class would, except for most unusual situations, be improper.[1] Further, the continued valuation of such securities at cost would be improper if, as a result of the operations of the issuer, change in general market conditions or otherwise, cost has ceased to represent fair value. In such circumstances, maintaining the value of the restricted securities at cost would mislead investors as to the value of the portfolio of the investment company which holds restricted securities.

Instead of valuing restricted securities at cost or at the market value of unrestricted securities of the same class, some investment companies value restricted securities held in their portfolio by applying either a constant percentage or an absolute dollar discount to the market quotation for unrestricted securities of the same class. The automatic valuation of restricted securities by such a method, however, would also not appear to

[1] See *Proposed Guidelines For The Preparation Of Form N-8B-1*, Investment Company Act Release No. 5633, p. 21 (March 11, 1969). Note—The guidelines were subsequently adopted in Investment Company Act Release No. 7221 (June 9, 1972).

satisfy the requirement of the Act that each security, for which a market quotation is not readily available, be valued at fair value as determined in good faith by the board of directors.

Thus, it would be improper in valuing restricted securities automatically to maintain the same percentage discount (from the market quotation for unrestricted securities of the same class) that was received when the restricted securities were purchased, without regard to other relevant factors such as, for example, the extent to which the inherent value of the securities may have changed.

Furthermore, the valuation of restricted securities by reference to the market price for unrestricted securities of the same class assumes that the market price for unrestricted securities of the same class is representative of the fair value of the securities. This may not be the case when the market for the unrestricted securities is very thin, *i.e.*, only a limited volume of shares are available for trading. With a thin market, the news of the investment company's purchase of the restricted securities may, by itself, have the effect of stimulating a public demand for the unrestricted securities, the supply of which has not been increased, and thus lead to a spiralling increase in the valuation of both the restricted and unrestricted securities.

Moreover, if in valuing restricted securities, the diminution in value attributable to the restrictive feature is itself affected by factors subject to change, such as the length of time which must elapse before the investment company may require the issuer to cause the securities to be registered for public sale, the valuation should reflect any such changes.

Some companies value restricted securities, acquired at prices below the market quotations for unrestricted securities of the same class, by automatically amortizing the difference over some chosen period on the assumption that it will be possible to sell them at the market price for unrestricted securities at the expiration of the time period. Under prevailing conditions, however, it cannot always be determined either that the securities will, in fact, be effectively registered at the expiration of that period or that their public sale will otherwise be possible. For example, the issuer may be unable or unwilling to register at the expiration of the estimated period, and public sale at the end of that period without registration may not be lawful. Consequently, the practice of automatically amortizing the discount over an arbitrarily chosen period creates the appearance of an appreciation in the value of the securities which has not, in fact, occurred, and, accordingly, is improper.

An undertaking by the issuer to register the securities within a specified time period would not dictate a different result. In view of the many factors that may alter the date of the proposed public offering, it is at best speculative to use such an undertaking alone as the basis for amortizing the discount.

Similarly, the possible adoption by the Commission of the more definite holding periods contained in proposed Rules 101, 160, 161, 162, 163, 164, and 180, Securities Act Release No. 4997 (dated September 15, 1969) would also not alter the conclusion that amortization of the discount may be improper. The more definite holding periods there proposed are available only if certain specified conditions are met.

In summary, there can be no automatic formula by which an investment company can value restricted securities in its portfolio to comply with Section 2(a)(39) and Rule 2a-4. It is the responsibility of the board of directors to determine the fair value of each issue of restricted securities in good faith; and the data and information considered and the analysis thereof should be retained for inspection by the company's independent auditors. While the board may, consistent with this responsibility, determine the method of valuing each issue of restricted security in the company's portfolio, it must continuously review the appropriateness of any method so determined. The actual calculations may be made by persons acting pursuant to the direction of the board.

2. The Problems of Portfolio Management

In addition to valuation, restricted securi-

ties present special problems of portfolio management.

The concept of the Securities Act exemption of a private placement of securities is premised on the belief that in such a situation the investor has such information concerning the issuer that he is able to fend for himself without need for the disclosures that would be provided by an effective registration statement. Correlatively, where the investor is a registered investment company, it would seem to be the fiduciary duty of the persons responsible for the investment decisions of the investment company to obtain, prior to purchase, the necessary information to make an independent analysis of the investment merits of the particular restricted securities.[2] Also, in order to enable the continuing valuation of such securities, the investment company should require the seller to undertake to provide, to the extent known to the seller, information on a continuing basis as to any subsequent private sales of the issuer's securities. The investment company should also assure itself that it is in the position to obtain the appropriate financial information at appropriate times. It is assumed that any public disclosures, such as that made in periodic reports filed pursuant to the Securities Exchange Act, are carefully considered by the investment company portfolio manager.

There is also the paradox of too much success to consider. For example, if restricted securities rapidly appreciate in value, perhaps because of an improvement in the business of the issuer, an investment company may find instead of having, for example, 5 per cent of its assets invested in a particular company, it has instead, 25 per cent of its assets in that company. The investment company to which this happens suffers a loss in diversification and may find that it has become overly sensitive to any adverse developments in the affairs of that particular portfolio company.

The foregoing factors in portfolio management relate to both open-end and closed-end management companies. There are additional special factors that relate only to open-end companies.

Section 2(a)(31), when read together with Section 5(a), of the Investment Company Act requires that the holders of redeemable shares issued by an open-end investment company be entitled to receive approximately their proportionate share of the issuer's current net assets, or the cash equivalent thereof, upon presentation of the security to the issuer or to a person designated by the issuer. Section 22(e) of the Act provides that, absent specified unusual conditions, payment of the redemption price must be made within seven days after the tender of a redeemable security to an investment company or its agent designated for that purpose.

It is desirable that an open-end company retain maximum flexibility in the choice of portfolio securities which, on the basis of their relative investment merits, could best be sold where necessary to meet redemptions. To the extent that the portfolio consists of restricted securities, this flexibility is reduced.

Restricted securities may not be publicly sold—nor can they be distributed to redeeming shareholders as an in-kind redemption. While they may be sold privately, there may not be sufficient time to obtain the best price since the date of payment or satisfaction may not be postponed more than seven days after the tender of the company's redeemable securities for redemption. A private sale within that period may result in the investment company receiving less than its carrying value of the restricted securities. This would result in a preference in favor of the redeeming shareholders and a diminution of the net asset value per share of shareholders who have not redeemed. Therefore, instead of arranging a private sale of restricted securities, an open-end company that is faced with redemptions may decide to sell unrestricted securities which it would otherwise have retained on the basis of comparative investment merit.

Significant holdings of restricted securities

[2] See *The Value Line Fund* v. *Marcus* ('64-'66 Transfer Binder) CCH Fed'l. Sec. Law Rep. ¶91,523 at p. 94,970 (S.D. N. Y. 1965).

not only magnify the valuation difficulties but may also present serious liquidity questions. Because open-end companies hold themselves out at all times as being prepared to meet redemptions within seven days, it is essential that such companies maintain a portfolio of investments that enable them to fulfill that obligation. This requires a high degree of liquidity in the assets of open-end companies because the extent of redemption demands or other exigencies are not always predictable. It has been with this in mind that the staff of the Commission has for several years taken the position that an open-end company should not acquire restricted securities when the securities to be acquired, together with other such assets already in the portfolio, would exceed 15 per cent of the company's net assets at the time of acquisition. The Commission, however, is of the view that a prudent limit on any open-end company's acquisition of restricted securities, or other assets not having readily available market quotations, would be 10 per cent.[3] When as a result of either the increase in the value of some or all of the restricted securities held, or the diminution in the value of unrestricted securities in the portfolios, the restricted securities come to represent a larger percentage of the value of the company's net assets, the same valuation and liquidity questions occur. Accordingly, if the fair value of restricted holdings increases beyond 10 per cent, it would be desirable for the open-end company to consider appropriate steps to protect maximum flexibility. The Commission will re-examine appropriate limitations in this area in light of all the policy objectives of the Investment Company Act.

3. The Problem of Disclosure

Section 8(b)(1)(D) of the Investment Company Act requires that an investment company include, in its registration statement filed with the Commission under the Act, information as to its policy with respect to "engaging in the business of underwriting securities issued by other persons." Item 4(c) of Form N-8B-1 requires that a registrant under the Act describe its policy or proposed policy with respect to "the underwriting of securities of other issuers." In response to this item, registrant's policy with respect to the acquisition of restricted securities should be disclosed.[4] In view of the fact that policies listed under Item 4 are fundamental policies which cannot be changed without prior shareholder approval, the importance of adopting a clear policy with regard to such investments is apparent.

The prospectus of a registered investment company should also fully disclose the company's policy with respect to restricted securities.[5] It is also clear that an investment company which has a policy of acquiring restricted securities is responsible for full and adequate disclosure with respect to all matters relating to the valuation of such securities. Specifically, there should be included, in a note to the financial statements, (1) identification of any restricted securities and the date of acquisition, (2) disclosure of the methods used in valuing such securities both at the date of acquisition and the date of the financial statements, (3) disclosure of the cost of such securities and the market quotation for unrestricted securities of the same class both on the day the purchase price was agreed to (the so-called "handshake date"), and on the day the investment company first obtained an enforceable right to acquire such securities, and (4) a statement as to whether the issuer or the registrant will bear costs, including those in-

[3] The Commission is aware that certain open-end companies may have acquired restricted securities in excess of 10 per cent of net assets. It is assumed that such companies will not undertake commitments, beyond any obligation existing on this date, to acquire restricted securities until, in the normal course of business, such holdings are not in excess of 10 per cent of current net asset value.

[4] See *Proposed Guidelines For the Preparation of Form N-8B-1*, Investment Company Act Release No. 5633, p. 7 (March 11, 1969). Note—See Note 1 regarding the adopted guidelines.

[5] See *Proposed Guidelines For The Preparation Of Forms S-4 and S-5*, Investment Company Act Release No. 5634, pp. 11, 13 (March 11, 1969). Note—The guidelines were subsequently adopted in Investment Company Act Release No. 7220 (June 9, 1972).

volved in registration under the Securities Act, in connection with the disposition of such securities.

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder makes it unlawful, among other things, for any person, in connection with the purchase or sale of securities, to employ any device, scheme, or artifice to defraud or to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made not misleading, or engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any persons.

The offering price of securities issued by a management investment company is premised upon the net asset value of such shares as determined pursuant to Section 2(a)(39) of the Act and Rule 2a-4 thereunder and is so represented in its prospectus. The improper valuation of restricted securities held by such a company would distort the net asset value of the shares being offered or, in the case of an open-end company, redeemed, and would therefore constitute a fraud and deceit within the meaning of Section 10(b) and Rule 10b-5.

An open-end company, of course, represents to investors, in its prospectus, that it will, as required by Section 22(e) of the Act, redeem its securities at approximate net asset value within seven days after tender. To the extent a material percentage of the assets of an open-end company consist of restricted securities which cannot publicly be sold without registration under the Securities Act, the ability of the company to comply with the provisions of the Investment Company Act relating to redemption, and to fulfill the implicit representations made in its prospectus with respect thereto, may be adversely affected.[6] In any such situation, the investment company concerned and the persons responsible for the sale of its securities should give careful consideration to the possible application of the provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

[6] See *Proposed Guidelines For The Preparation Of Form N-8B-1*, Investment Company Act Release No. 5633, p. 7 (March 11, 1969). Note—See Note 1 regarding the adopted guidelines.

RELEASE NO. 114

December 31, 1969

INVESTMENT COMPANY ACT OF 1940
Release No. 5943

SECURITIES EXCHANGE ACT OF 1934
Release No. 8788

SECURITIES ACT OF 1933
Release No. 5035

Adoption of Amendments to Rule 6-02-9 of Article 6 of Regulation S-X and Rule 2a-4 under the Investment Company Act of 1940 with Respect to Provision by Registered Investment Companies for Federal Income Taxes

On August 20, 1969, the Securities and Exchange Commission published notice (Investment Company Act Release No. 5780) that it had under consideration the amendment of Rule 6-02-9 of Article 6 of Regulation S-X and a related amendment of Rule 2a-4 under the Investment Company Act of 1940 ("Act").

Article 6 of Regulation S-X governs the form and content of financial statements filed by management investment companies (other than those which are issuers of periodic payment plan certificates) under the Act, the Securities Act of 1933 and the Securities Exchange Act of 1934. Rule 6-02-9 of Article 6 requires that appropriate provision

shall be made in the financial statements of such companies for Federal income taxes.

Rule 2a-4 under the Act defines the term "current net asset value" of redeemable securities issued by registered investment companies used in computing periodically the current price of such securities for the purpose of distribution, redemption, and repurchase. Subparagraph (a)(4) of Rule 2a-4 provides that in computing such current net asset value expenses shall be included to the date of calculation.

The proposed amendment of Rule 6-02-9 of Regulation S-X would specifically provide that a company which retains realized capital gains and designates such gains as a distribution to shareholders in accordance with Section 852(b)(3)(D) of the Internal Revenue Code ("Code") shall, on the last day of its taxable year (and not earlier), make provision for taxes on such undistributed capital gains realized during such year. The amendment would also revise the reference in Rule 6-02-9 to the section of the Code defining a company's status as a "regulated investment company" to its present designation of Subtitle A, Chapter 1, Subchapter M. The proposed amendment of Rule 2a-4 under the Act would add a sentence to subparagraph (a)(4) to require that appropriate provision shall be made for Federal income taxes in accordance with Rule 6-02-9 of Regulation S-X.

The primary purpose of the proposed amendment is to assure that regulated investment companies excepted by provisions of the Code from payment of Federal income taxes on net income and realized gains distributed to shareholders will make appropriate provision for taxes on any realized undistributed capital gains designated as distributions to shareholders under the provisions of the Code. Most regulated investment companies follow the practice of distributing realized capital gains to shareholders, thereby relieving such companies of the payment of Federal income taxes on such gains. However, under the provisions of Section 852(b)(3)(D) of the Code, a regulated investment company which elects to do so may retain realized long-term capital gains and, in effect, pay the tax on those gains on behalf of the shareholders. Every such shareholder at the close of the company's taxable year shall include in his tax return his pro rata portion of the company's realized capital gains as if it had been distributed to him, accrue his capital gains tax thereon, and elsewhere in his tax return is allowed credit or refund for his pro rata share of the capital gains tax which has been paid for his benefit by the company but which is deemed to have been paid by him. At the same time, such shareholder shall increase the tax basis of his shares by the excess of his pro rata portion of the realized gains over the tax credit or refund allowed to him.

The question of the appropriate method of tax accrual or adjustment of net asset value by investment companies which retain realized capital gains under Section 852(b)(3)(D) of the Code was considered by the National Association of Investment Companies (the predecessor to the present Investment Company Institute) and the Committee on Relations with the S.E.C. of the American Institute of Accountants in 1956 following the enactment of the provisions of the Code in its present form. On November 2, 1956, the Association sent a memorandum to its members stating in part that the question had been considered by the Committee which was of the opinion that, since for a company intending to proceed under Section 852(b)(3)(D) the tax on realized undistributed capital gains would be on the shareholder and not the company, no allowance need be made, either for possible Federal income tax on unrealized appreciation or for Federal income tax on capital gains realized during the year. The memorandum stated that at the end of a company's taxable year the Federal income tax to be paid on realized but undistributed capital gains would be carried in an accrual account until paid.

The above procedure is followed as the generally accepted accounting practice by regulated investment companies which elect to retain realized capital gains and pay the tax on behalf of shareholders. Most of such companies are capital exchange funds which issued their shares for securities in tax-free exchanges and which are not making public offerings of shares. Of a total 34 active ex-

change funds, 30 elected for their fiscal years ended in 1968 to retain realized capital gains, in whole or in part, and pay the tax on behalf of the shareholders. All except four of these exchange funds followed the practice of making provision for such taxes on the last day of the taxable year. The four funds which did not follow the general practice, made provision for taxes on realized undistributed capital gains throughout the year as the gains were realized.

The proposed amendments to the rules would codify the generally accepted practice of making provision, on the last day of the taxable year of the investment company, for taxes on realized undistributed capital gains designated as distributions to shareholders. The amended rules would not affect the rights of any person who may have redeemed shares prior to the adoption of the amendments.

Under the provisions of the Code, the taxes on realized capital gains retained by the company are payable by the company only on behalf of those persons who are shareholders on the last day of the taxable year in which the gains were realized. It is only those persons who are shareholders on the last day of the taxable year who are deemed under the provisions of the Code to have paid the tax imposed on the designated capital gains retained by the company and who, accordingly, are allowed credit or refund for the tax so deemed to have been paid by them and are entitled to increase the tax basis of their shares by the excess of their pro rata portion of the realized gains over the tax credit or refund allowed to them. Accrual of the tax by the company at any time prior to the last day of its taxable year therefore reduces the net asset value of the shares of holders who redeem or sell their shares during the year and who consequently receive no credit for the tax so accrued.

After consideration of the comments and suggestions received from interested persons, the Commission has determined to adopt the amendments to the rules.

The amendment of Rule 6-02-9 of Article 6 of Regulation S-X is adopted pursuant to Sections 8, 30, 31(c) and 38(a) of the Investment Company Act of 1940; Sections 7 and 19(a) of the Securities Act of 1933; and Sections 12, 13, 15(d), and 23(a) of the Securities Exchange Act of 1934. The proposed amendment of Rule 2a-4 under the Investment Company Act of 1940 is adopted pursuant to Sections 22 and 38(a) of that Act.

The rules as amended are set forth below.

Rule 6-02-9 of Article 6 of Regulation S-X is amended to read as follows:

9. Federal income taxes.—Appropriate provision shall be made, on the basis of the applicable tax laws, for Federal income taxes that it is reasonably believed are, or will become, payable in respect of (a) current net income, (b) realized gain on investments and (c) unrealized appreciation on investments. The company's status as a "regulated investment company" as defined in Subtitle A, Chapter 1, Subchapter M of the Internal Revenue Code as amended shall be stated in a note referred to in the appropriate statements. Such note shall also indicate briefly the principal present assumptions on which the company has relied in making or not making provisions for such taxes. However, a company which retains realized capital gains and designates such gains as a distribution to shareholders in accordance with Section 852(b)(3)(D) of the Code shall, on the last day of its taxable year (and not earlier), make provision for taxes on such undistributed capital gains during such year.

Subparagraph (a)(4) of Rule 2a-4 under the Investment Company Act of 1940 is amended so that paragraph (a) and subparagraph (a)(4) read as follows:

(a) The current net asset value of any redeemable security issued by a registered investment company used in computing periodically the current price for the purpose of distribution, redemption, and repurchase means an amount which reflects calculations, whether or not recorded on the books of account, made substantially in accordance with the following, with estimates used where necessary or appropriate:

* * * * *

(4) Expenses, including any investment advisory fees, shall be included to date of calculation. Appropriate provision shall be made for Federal income taxes in accordance with Rule 6-02-9 of Regulation S-X.

* * * * *

The amendments to Rule 6-02-9 of Article 6 of Regulation S-X and Rule 2a-4 under the Act shall be effective so that after the date of adoption of the amendments (December 31, 1969) no further provision shall be made for taxes in the circumstances stated in the amendment to Rule 6-02-9 except on the last day of the taxable year.

By the Commission.

ORVAL L. DUBOIS
Secretary

RELEASE NO. 115
February 19, 1970

SECURITIES ACT OF 1933
Release No. 5049

Certification of Financial Statements

There have recently been filed with the Commission a number of registration statements under the Securities Act of 1933 which include accountants' opinions that are qualified as to matters of such significance to the registrant that there is serious question as to whether the certificate meets the requirements of Rule 2-02 of Regulation S-X.

The following is the pertinent part of an accountant's report as to the type of situation to which reference is made:

> "Substantial losses have been experienced during the past four years and nine months and continuation of the business is dependent upon the Company's attaining sufficiently profitable operations and/or additional capital to satisfy all of its liabilities as they become due.
> "In our opinion, subject to the Company's ability to attain profitable operations and/or to successfully obtain additional capital, the accompanying financial statements . . ."

The Commission, of course, does not expect an accountant to express any opinion as to the future earnings of the registrant. However, where, as here, the financial statements are prepared on a "going concern" basis, while at the same time the accountant's opinion is so qualified as to indicate serious doubt as to whether or not the preparation of financial statements on that basis is warranted, then a significant question arises as to whether the financial statements are certified as required by Schedule A of the Securities Act of 1933 and the rules and regulations thereunder.

Rule 2-02(c) of Regulation S-X states that "The accountant's certificate shall state clearly: (i) the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein . . ."[1] In Accounting Series Release No. 90, the Commission reached a conclusion as to certification requirements as follows:

> "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 presenta-

[1] Rule 2-02(c) was subsequently revised in Accounting Series Release No. 125 (June 23, 1972) and the quoted portion now reads: "The accountant's reports shall state clearly: (1) the opinion of the accountant in respect of the financial statements covered by the report and the accounting principles and practices reflected therein; . . ."

tion 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."

The problem is an important one. If the business will not continue and the proceeds of the present offering will simply be used to pay existing creditors, then the offering may be deceptive to the public. The Commission does not expect accountants to express opinions that are unwarranted in the circumstances. Indeed, if there is a question as to whether the business will continue, no amount of changing the accountant's certificate would appear to solve the underlying problem.

The Commission has concluded that a registration statement under the 1933 Act will be considered defective because the certificate does not meet the requirements of Rule 2-02 of Regulation S-X when the accountant qualifies his opinion because of doubt as to whether the company will continue as a going concern. The Commission does not intend to preclude companies with pressing financial problems from raising funds by public offerings of securities. It does, however, believe it clear that an accountant's report cannot meet the certification requirements of the 1933 Act unless the registrant can arrange its financial affairs so that the immediate threat to continuation as a going business is removed. The independent accountant must be satisfied that it is appropriate to use conventional principles and practices for stating the accounts on a going concern basis before a registration statement under the 1933 Act can be declared effective.

RELEASE NO. 116
April 13, 1970

INVESTMENT COMPANY ACT OF 1940
Release No. 6026

Disclosure Concerning "Restricted Securities"

On October 21, 1969, the Commission issued a statement (Investment Company Act Release No. 5847; Accounting Series Release No. 113) which discusses the problems created by purchasing and holding restricted securities by such companies. One section of this release deals with *The Problem of Disclosure* and enumerates specific information regarding these securities which should be included in the financial statements.[1]

Although the release refers only to disclosures to be made in a prospectus, the principle set forth in the release is also applicable to lists of portfolio securities contained in registration statements filed pursuant to Section 8(b) of the Investment Company Act of 1940 ("Act"), reports filed with the Commission and reports mailed to shareholders pursuant to Section 30 of the Act, sales literature distributed to existing and prospective investors under Section 24(b) of the Act, and in proxy statements filed pursuant to Section 20 of the Act. Consequently, the disclo-

[1] The pertinent language of that Release is:
"It is also clear that an investment company which has a policy of acquiring restricted securities is responsible for full and adequate disclosure with respect to all matters relating to the valuation of such securities. Specifically, there should be included, in a note to the financial statements, (1) identification of any restricted securities and the date of acquisition, (2) disclosure of the methods used in valuing such securities both at the date of acquisition and the date of the financial statements, (3) disclosure of the cost of such securities and the market quotation for unrestricted securities of the same class both on the day the purchase price was agreed to (the so-called "handshake date"), and on the day the investment company first obtained an enforceable right to acquire such securities, and (4) a statement as to whether the issuer or the registrant will bear costs, including those involved in registration under the Securities Act, in connection with the disposition of such securities."

sure requirements set forth in its release of October 21, 1969 will be applied by the Commission to lists of portfolio securities set forth not only in registration statements, but also in reports to the Commission and to shareholders, in sales literature and in proxy statements. Registered investment companies should act accordingly.

RELEASE NO. 117
October 14, 1970

SECURITIES ACT OF 1933
Release No. 5090

SECURITIES EXCHANGE ACT OF 1934
Release No. 8997

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 16857

Adoption of Article 11A of Regulation S-X

The Securities and Exchange Commission today adopted an amendment to Regulation S-X consisting of a new section designated Article 11A to govern the content of statements of source and application of funds, for which a requirement has recently been adopted in certain registration and reporting forms under the Securities Act of 1933 and the Securities Exchange Act of 1934.

The adoption of a requirement for certified statements of source and application of funds in the registration and reporting forms was an implementation of a recommendation contained in the Disclosure Policy Study report submitted to the Commission last year. In 1963 the Accounting Principles Board of the American Institute of Certified Public Accountants, in its Opinion No. 3, stated its belief that a statement of source and application of funds should be presented as supplemental information in financial reports, but indicated that inclusion was not mandatory and coverage of the statement in the report of the certifying accountant was optional. The opinion was endorsed by the New York Stock Exchange and by the Directors of the Financial Analysts Federation. A survey by the Institute (*Accounting Trends and Techniques*, 1969) of the 1968 annual reports of 600 companies indicated that 535 (89%) companies presented a funds statement with their financial statements and that such statements were covered in the auditor's report in 443 (83%) of the cases.

The amendment was published in preliminary draft form for public comment on September 15, 1969, in Securities Act Release No. 4998 (Securities Exchange Act Release No. 8686 and Public Utility Holding Company Act Release No. 16460). A number of helpful comments have been received and were carefully considered in the preparation of the definitive article.

This amendment is adopted pursuant to authority conferred on the Securities and Exchange Commission by the Securities Act of 1933, particularly 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; and the Public Utility Holding Company Act of 1935, particularly Sections 5(b), 14, and 20(a) thereof.

(The text of Article 11A is omitted.)

The amendment shall be effective with respect to registration statements and reports filed with the Commission after December 31, 1970.

By the Commission.

ORVAL L. DUBOIS
Secretary

RELEASE NO. 118

December 23, 1970

INVESTMENT COMPANY ACT OF 1940
Release No. 6295

SECURITIES ACT OF 1933
Release No. 5120

SECURITIES EXCHANGE ACT OF 1934
Release No. 9049

Accounting for Investment Securities by Registered Investment Companies

The Securities and Exchange Commission today announced the publication of its views relating to some of the more important questions concerning the accounting by registered investment companies for investment securities in their financial statements and in the periodic computations of net asset value for the purpose of pricing their shares. The questions relate both to the amounts at which investment securities should be carried and to the circumstances under which individual securities may be included among the assets. This release discusses certain accounting matters in order to give additional guidance to the management of investment companies, as well as certain related auditing procedures which are considered appropriate for the guidance of independent accountants. A release was issued by the Commission on October 21, 1969[1] on the specific subject of the problems relating to so-called "restricted securities," i.e., those which must be registered under Section 5 of the Securities Act of 1933 prior to public sales, and the discussion of valuation herein does not alter any of the special considerations applicable to such securities as discussed in that release.

The financial statements of registered investment companies appearing in registration statements, proxy statements, and annual reports filed with the Commission are governed by various provisions of the Investment Company Act of 1940 (the "Act"), the rules thereunder, and by Regulation S-X, Article 6 of which sets forth accounting rules applicable to such companies. While Regulation S-X does not by its terms apply to periodic reports to stockholders, Section 30(d) of the Act provides that such reports "shall not be misleading in any material respect in the light of the reports" (including annual reports) required to be filed under Section 30(a) and (b). To the extent that any provisions in an investment company's articles of incorporation, trust indenture or other governing legal instruments specify accounting procedures inconsistent with those required by Regulation S-X, the latter must be followed in accordance with Rule 6-02-1 thereof.

Inclusion of Securities in the Portfolio

The statement of assets and liabilities of a registered investment company comprises, for the most part, not only investments in securities which are held by a custodian or are on hand, but also frequently includes securities as to which contracts to purchase have been entered into but which have not been received. Securities held by a custodian or are on hand, but also frequently includes securities as to which contracts to purchase have been entered into but which have not been received. Securities held by a custodian or on hand that have been contracted to be sold are excluded from the investments in such statement. In the ordinary transaction through a broker, recording the transaction on the date the broker advises the investment company that the securities have been purchased or sold (the "trade date"), rather than when delivery is made or due (the "settlement date"), is the established and accept-

[1] Investment Company Act Release No. 5847; Accounting Series Release No. 113. See also a supplementary release issued on April 13, 1970, Investment Company Act Release No. 6026; Accounting Series Release No. 116.

Note. See letter to the American Institute of Certified Public Accountants, p. 217, of this publication.

able practice in investment company accounting.

In the case of purchases or sales of securities other than in the usual brokerage transactions, the date on which the investment company obtains an enforceable right to demand the securities or the payment therefore—the date the transaction should be recorded—is sometimes difficult to determine. The considerations involved in determining such transaction date are similar to those discussed in the aforementioned release No. 113 on restricted securities. When a question arises as to the date an enforceable right is obtained by the investment company, an opinion of legal counsel as to when the right occurred should normally be obtained by the company's management and made available to the independent accountant. Such an opinion should be in writing, and a copy should be included in the accountant's working papers.

Where the propriety or validity of an investment in a security by an investment company is questionable because of particular provisions of the Act, or state law, or the company's investment policy or other representations as stated in its filings with the Commission, or legal obligations in respect of a contract or transaction, a written opinion of legal counsel should also be obtained by the company's management, made available to the independent accountant, and a copy included in the working papers. If the questions of propriety or validity are not satisfactorily resolved, the circumstances of the investment should be disclosed in the financial statements or notes thereto.

Securities held by the company or its custodian should be substantiated by the company's independent accountant in the course of an audit by inspection of such securities or by obtaining confirmation from a custodian which maintains the securities in custody pursuant to clause (1) of Section 17(f) of the Act. When securities contracted to be purchased but not yet received are included in the statement of assets and liabilities, confirmation of the contract to purchase should be obtained from the bank, broker, or other person responsible for the delivery of such securities. Where satisfactory confirmation has been received, audit procedures normally need not be extended to obtain evidence of subsequent receipt of the securities by the company or its custodian unless additional substantiation is considered necessary by the independent accountant under the circumstances. Where satisfactory confirmation has not been received, subsequent receipt of such securities should be substantiated by other appropriate procedures.

In accordance with Section 30(e) of the Act, the certificate of the company's independent accountant should include a brief statement concerning the substantiation of securities owned. Except for securities contracted to be purchased but not received, the certificate should state that the securities were either inspected by the independent accountant or, where the company's securities were maintained in custody pursuant to clause (1) of Section 17(f) of the Act, were confirmed to him by the custodian. In the case of securities contracted to be purchased but not received by the company or its custodian, reference should be made to confirmation by banks, brokers, or others or to alternative procedures, as appropriate in the circumstances.

Valuation of Securities

Under Rule 6-02-6 of Regulation S-X, the statements of assets and liabilities of open-end investment companies must reflect all assets at value, showing cost parenthetically, while closed-end companies may elect to use either this basis or to reflect all assets at cost, showing value parenthetically.

"Value" is defined in Section 2(a)(39)[2] of the Act. For purposes of determining the amounts at which securities and other assets are carried in the statements of assets and liabilities included in annual and other reports and in registration statements filed by investment companies, "value" is defined in pertinent part as: "(i) with respect to securities for which market quotations are readily available, the market value of such securi-

[2] Section 2(a) (39) was redesignated 2(a) (41), effective December 14, 1970, Public Law 91-547, sections 2(a)(2), 84 Stat. 1413.

ties; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors. . ." This definition is also used in Rule 2a-4 under the Act as the required basis for computing periodically the current net asset value of redeemable securities of investment companies for the purpose of pricing their shares.

In some circumstances value can be determined fairly in more than one way. Hence, the standards set forth below should be considered as guidelines, one or more of which may be appropriate in the circumstances of a particular case. These standards should be followed, and a company's stated valuation policies should be consistent with them. Any variation from the standards should be disclosed in the financial statements or notes thereto even though the variation is in accordance with the company's stated valuation policy. In addition, any deviation from a stated valuation policy, whether or not in conformity with the standards, should be disclosed in the financial statements or notes thereto.

Securities Listed or Traded on a National Securities Exchange

Ordinarily, little difficulty should be experienced in valuing securities listed or traded on one or more national securities exchanges, since quotations of completed transactions are published daily. If a security was traded on the valuation date, the last quoted sale price generally is used. In the case of securities listed on more than one national securities exchange the last quoted sale, up to the time of valuation, on the exchange on which the security is principally traded should be used or, if there were no sales on that exchange on the valuation date, the last quoted sale, up to the time of valuation, on the other exchanges should be used. With respect to the time of valuation Rule 22c-1 under the Act requires that current net asset value shall be computed not less frequently than once daily as of the time of the close of trading on the New York Stock Exchange.

If there was no sale on the valuation date but published closing bid and asked prices are available, the valuation in such circumstances should be within the range of these quoted prices. Some companies as a matter of general policy use the bid price, others use the mean of the bid and asked prices, and still others use a valuation within the range considered best to represent value in the circumstances; each of these policies is acceptable if consistently applied. Normally, it is not acceptable to use the asked price alone. Where, on the valuation date, only a bid price or an asked price is quoted or the spread between bid and asked prices is substantial, quotations for several days should be reviewed. If sales have been infrequent or there is a thin market in the security, further consideration should be given to whether "market quotations are readily available." If it is decided that they are not readily available, the alternative method of valuation prescribed by Section 2(a)(39)—"fair value as determined in good faith by the board of directors"—should be used.

Over-the-Counter Securities

Quotations are available from various sources for most unlisted securities traded regularly in the over-the-counter market. These sources include tabulations in the financial press, publications of the National Quotation Bureau and the "Blue List" of municipal bond offerings, several financial reporting services, and individual broker-dealers. These quotations generally are in the form of inter-dealer bid and asked prices. Because of the availability of multiple sources, a company frequently has a greater number of options open to it in valuing securities traded in the over-the-counter market than it does in valuing listed securities. A company may adopt a policy of using a mean of the bid prices, or of the bid and asked prices, or of the prices of a representative selection of broker-dealers quoting on a particular security; or it may use a valuation within the range of bid and asked prices considered best to represent value in the circumstances. Any of these policies is acceptable if consistently applied. Normally, the use of asked prices alone is not acceptable.

Ordinarily, quotations for a security should be obtained from more than one broker-dealer, particularly if quotations are available only from broker-dealers not known to be established market-makers for that security, and quotations for several days should be reviewed. If the validity of the quotations appears to be questionable, or if the number of quotations is such as to indicate that there is a thin market in the security, further consideration should be given to whether "market quotations are readily available." If it is decided that they are not readily available, the security should be considered one required to be valued at "fair value as determined in good faith by the board of directors."

Securities Valued "in Good Faith"

To comply with Section 2(a)(39) of the Act and Rule 2a-4 under the Act, it is incumbent upon the Board of Directors to satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered and to determine the method of arriving at the fair value of each such security. To the extent considered necessary, the board may appoint persons to assist them in the determination of such value, and to make the actual calculations pursuant to the board's direction. The board must also, consistent with this responsibility, continuously review the appropriateness of the method used in valuing each issue of security in the company's portfolio. The directors must recognize their responsibilities in this matter and whenever technical assistance is requested from individuals who are not directors, the findings of such individuals must be carefully reviewed by the directors in order to satisfy themselves that the resulting valuations are fair.

No single standard for determining "fair value ... in good faith" can be laid down, since fair value depends upon the circumstances of each individual case. As a general principle, the current "fair value" of an issue of securities being valued by the Board of Directors would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale. Methods which are in accord with this principle may, for example, be based on a multiple of earnings, or a discount from market of a similar freely traded security, or yield to maturity with respect to debt issues, or a combination of these and other methods. Some of the general factors which the directors should consider in determining a valuation method for an individual issue of securities include: 1) the fundamental analytical data relating to the investment, 2) the nature and duration of restrictions on disposition of the securities, and 3) an evaluation of the forces which influence the market in which these securities are purchased and sold. Among the more specific factors which are to be considered are: type of security, financial statements, cost at date of purchase, size of holding, discount from market value of unrestricted securities of the same class at time of purchase, special reports prepared by analysts, information as to any transactions or offers with respect to the security, existence of merger proposals or tender offers affecting the securities, price and extent of public trading in similar securities of the issuer or comparable companies, and other relevant matters.

This release does not purport to delineate all factors which may be considered. The directors should take into consideration all indications of value available to them in determining the "fair value" assigned to a particular security.[3] The information so considered together with, to the extent practicable, judgment factors considered by the board of directors in reaching its decisions should be documented in the minutes of the directors' meeting and the supporting data retained for the inspection of the company's independent accountant.

Auditing Security Valuations

In the case of securities for which market quotations are readily available, the inde-

[3] With regard to restricted securities, consideration should be given to the discussion in the release on this subject (see Note 1 *supra*).

pendent accountant should independently verify all the quotations used by the company at the balance sheet date and satisfy himself that such quotations may properly be used under the standards stated above.

In the case of securities carried at "fair value" as determined by the Board of Directors in "good faith," the accountant does not function as an appraiser and is not expected to substitute his judgment for that of the company's directors; rather, he should review all information considered by the board or by analysts reporting to it, read relevant minutes of directors' meetings, and ascertain the procedures followed by the directors. If the accountant is unable to express an unqualified opinion because of the uncertainty inherent in the valuations of the securities based on the directors' subjective judgment, he should nevertheless make appropriate mention in his certificate whether in the circumstances the procedures appear to be reasonable and the underlying documentation appropriate.

When considering values assigned to securities by the company, the independent accountant should consider any investment limitations or conditions on the acquisition or holding of such securities which may be imposed on the company by the Act, by its certificate or by-laws, by contract, or by its filings with the Commission. If such restrictions are met by a narrow margin, the independent accountant may need to exercise extra care in satisfying himself that the evidence indicates that the security valuation determinations were not biased to meet those restrictions.

Investments in Affiliates or Affiliated Persons

Various rules of Regulation S-X require that the financial statements of an investment company state separately investments in, investment income from, gain or loss on sales of securities of, and management or other service fees payable to, (a) controlled companies and (b) other "affiliates." As stated in Rule 6-02-4 of Regulation S-X, the term "affiliate" means an affiliated person as defined in Section 2(a)(3) of the Act, and the term "control" has the meaning given in Section 2(a)(9) of the Act. The term "affiliated person" is defined in Section 2(a)(3) of the Act in such a manner as to encompass such control relationships and also the direct or indirect ownership of five percent or more of the outstanding voting securities of an issuer. An affiliated person as there defined also includes any officer, director, partner, co-partner, or employee or, with respect to an investment company, any investment adviser or member of an advisory board thereof.

In ascertaining the existence of any such affiliations, the independent accountant should consider the facts obtained during the course of an audit and also make inquiries of the company's management; and his working papers should include written representations from the management as evidence of such inquiries. The representations should be in the form of a statement that the company, except to the extent indicated, (i) does not own any securities either of persons who are directly affiliated, or, to the best information and belief of management, of persons who are indirectly affiliated, (ii) has not received income from or realized gain or loss on sales of investments in or indebtedness of such persons, (iii) has not incurred expenses for management or other service fees payable to such persons, and (iv) has not otherwise engaged in transactions with such persons. Where there is a question as to the existence of an affiliation, a written opinion of legal counsel should be obtained by the company's management, made available to the independent accountant, and a copy included in the working papers. Regulation S-X requires disclosure in the financial statements or notes thereto of details of such investments and transactions.

By the Commission.

ORVAL L. DUBOIS
Secretary

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
December 16, 1970

MR. ROBERT M. MAYNARD, *Chairman,*
Committee on Investment Companies
American Institute of Certified Public Accountants
666 Fifth Avenue
New York, NY 10019

DEAR MR. MAYNARD:

I want to thank you and your committee for the assistance you have given us in developing a much needed Accounting Series Release on Accounting for Investment Securities by Registered Investment Companies which the Commission has approved for publication.

The Commission has considered your committee's suggestions with particular reference to the circumstances in which a "subject to" opinion would be appropriate. I am authorized to advise you that the "subject to" form of qualified opinion may be used when an investment company's portfolio includes *a significant amount* represented by securities for which market quotations are not readily available *and* when the auditor is satisfied that the procedures followed and the information obtained are adequate to enable the board of directors to value the securities but is unable to form an opinion as to the fairness of the specific values determined in good faith by the board of directors. As developed in our conversations, an opinion in the following form, introduced by the standard scope paragraph, in the interests of uniformity of language should be used:

> As discussed more fully in Note 1 to the financial statements, securities amounting to $____ (_% of net assets) have been valued at fair value as determined by the Board of Directors. We have reviewed the procedures applied by the directors in valuing such securities and have inspected underlying documentation; while in the circumstances the procedures appear to be reasonable and the documentation appropriate, determination of fair values involves subjective judgment which is not susceptible to substantiation by auditing procedures.
>
> In our opinion, subject to the effect on the financial statements of the valuation of securities determined by the Board of Directors as described in the preceding paragraph, the (financial statements) present fairly . . .

Sincerely,

ANDREW BARR,
Chief Accountant

RELEASE NO. 119
June 15, 1971

SECURITIES ACT OF 1933
Release No. 5158

SECURITIES EXCHANGE ACT OF 1934
Release No. 9210

Computation of Ratio of Earnings to Fixed Charges

Certain registration forms under the Securities Act of 1933 require, where debt securities are to be registered, a statement of the ratio of earnings to fixed charges. Certain registration and report forms under the Securities Exchange Act of 1934 permit the showing of such a ratio. There have recently been filed with the Commission a number of registration statements wherein the registrants, in computing the ratio of earnings to fixed charges, have deducted from fixed charges amounts comprising (1) interest in-

come or investment income earned on funds in excess of the requirements for working capital and (2) gains on retirement of debt at less than its principal amount. In some cases registrants have, in computing the pro forma ratio, imputed interest or investment income on amounts of funds to be obtained from the registered offering which is in excess of the immediate requirements for debt retirement or capital expenditures and have deducted such imputed income from the pro forma fixed charges in computing the pro forma ratio of earnings to fixed charges.

The propriety of reducing fixed charges by amounts representing interest or investment income or gains on retirement of debt has been considered in the light of the purposes for which ratios of earnings to fixed charges are used and the Commission has determined that the reduction of fixed charges by the amount of either actual or imputed interest or investment income or debt retirement gains for the purpose of computing fixed charge ratios results in incorrect ratios and is therefore inappropriate. Accordingly, such reductions will no longer be deemed acceptable in registration statements or reports filed with the Commission.

By the Commission.

THEODORE L. HUMES
Associate Secretary

RELEASE NO. 120
July 15, 1971

INVESTMENT COMPANY ACT OF 1940
Release No. 6620

SECURITIES EXCHANGE ACT OF 1934
Release No. 9250

Notice of Revision of Annual Report Form N-1R for Management Investment Companies and Withdrawal of Proposal to Amend Rule 30a-1

NOTICE IS HEREBY GIVEN that the Securities and Exchange Commission has adopted certain revisions of Form N-1R for annual reports of most registered management investment companies and has withdrawn its proposal to amend Rule 30a-1. Notices of the proposed revisions were published in Investment Company Act Release Nos. 6284 on December 16, 1970, and 6349 on February 16, 1971, in which interested persons were invited to submit written statements of their views and comments.

The revisions of Form N-1R require more explicit information with respect to the registration of investment company shares; the processing of orders for sales, redemptions and repurchases of such shares; and investment company portfolio transactions generally and in "restricted securities." Information relating to the status of shareholder accounts and the processing of shareholder inquiries is also required. The Opinion of the Independent Public Accountant filed with the annual report on Form N-1R is required to include comments upon any material inadequacies in the accounting system and the system of internal accounting control of the investment company and any corrective action taken or proposed.

Revisions of Form N-1R

Form N-1R, a comprehensive form for annual reports filed by management investment companies, was adopted January 25, 1965 (Investment Company Act Release No. 4151). It was designed to assist the Commission materially in its inspection program and to achieve a substantial degree of self-inspection by laying before persons responsible for the management and operations of an investment company information which would assist them in determining more readily whether the investment company is in fact complying with the statutory standards and requirements of the Act and rules thereunder.

When Form N-1R was adopted, the Commission recognized that it might require further revision and supplementation in the future. It therefore directed its Division of Corporate Regulation, in light of experience with the revised form, to bring to its attention any special problems encountered in the reports filed on this form. The Division recommended that those items of the form designed to provide information about the issuance and redemption of investment company shares, *Item 1.07, Issuance and Redemption of Securities* (Sections 22(g) and 23); *Item 2.23, Procedures Followed upon Receipt of Orders for Purchase, Repurchase, or Redemption of Registrant's Shares; Item 2.24, Time Lapse between Sale of Shares of, and Receipt of Proceeds by, Registrant; Item 2.25, Suspension or Postponement of Right of Redemption (Section 22(e));* and the item relating to "restricted securities," *Item 1.27, Holdings of "Restricted Securities" Other Than Straight Debt Securities;* be revised as indicated below to provide more specific information and better serve the purposes for which Form N-1R was designed. The Division also recommended that three new items be added, *Item 2.30, Portfolio Transactions Not Settled by Specified Settlement Dates; Item 2.31, Correspondence Received by Registrant Relating to Shareholder Accounts;* and *Item 2.32, Confirmations and Statements of Shareholders' Accounts;* to assist the Commission more effectively in its inspection program and to aid investment company management in preventing and detecting potential back-office problems.

The above revisions and additional items of Form N-1R were proposed by the Commission in its Notice of December 16, 1970. In addition, the Commission's Notice of February 16, 1971 proposed the use in Item 1.27 of the EDP attachments to Form N-1R (in addition to the use in certain other Commission reporting forms) of securities identification numbers assigned by the system developed under the sponsorship of the Committee on Uniform Security Identification Procedures (CUSIP) of the American Bankers Association.

The Commission has considered the written comments received on the proposed revisions of Form N-1R and has adopted a number of the comments which suggested changes in the revisions of the form as they were proposed. It has also withdrawn the proposed amendment to Rule 30a-1 which would have reduced the time for filing annual reports on Form N-1R from 120 to 90 days.

(The text of the amended items and related instructions is omitted.)

The Commission, acting pursuant to Sections 30, 31, 38(a) and 45(a) of the Investment Company Act of 1940 and Sections 13, 15(d), 23(a) and 24 of the Securities exchange Act of 1934, and deeming it necessary to the functions vested in it, and necessary and appropriate in the public interest and for the protection of investors, hereby adopts the revisions of Form N-1R, including the EDP attachments, effective for all fiscal years ending on or after December 31, 1971.

By the Commission.

THEODORE L. HUMES
Associate Secretary

RELEASE NO. 121

July 19, 1971

SECURITIES ACT OF 1933
Release No. 5172

SECURITIES EXCHANGE ACT OF 1934
Release No. 9253

Adoption of Amendments to Regulation S-X and to Forms 10 and 10-K to Revise the Exemption from Certification of Financial Statements of Banks Filed Under the Securities Act of 1933 and the Securities Exchange Act of 1934.

The Securities and Exchange Commission today adopted amendments of Article 9 of Regulation S-X and Instructions 13 and 7 of the Instructions as to Financial Statements of Forms 10 and 10-K, respectively, which revise the exemption from certification of financial statements of banks filed under the Securities Act of 1933 and the Securities Exchange Act of 1934.

Proposed amendments of the rules and forms to delete the exemption from certification of financial statements of banks and life insurance companies were issued for public comment on May 17, 1971 in Securities Act Release No. 5149 (Securities Exchange Act Release No. 9175). Letters of comment were received which have been given careful consideration in determining the extent of the definitive amendments.

The Commission has determined to adopt the amendments deleting the exemption from certification of financial statements of banks. However, such amendments do not apply to financial statements for periods ending on or before November 30, 1971, included in registration statements and reports filed with the Commission so that a reasonable period of time will be provided for affected registrants to plan and arrange for appropriate audit work and because of the difficulties that may be encountered by registrants if retroactive independent audits for periods ending prior to the effective date were required.

With respect to life insurance companies, the exemption from certification of financial statements for such companies filed under the Securities Exchange Act of 1934 is retained at this time. This will permit the accounting profession in collaboration with the life insurance industry to complete work now underway to develop and promulgate accounting guidelines for life insurance companies which will enable the financial statements of such companies to be certified in accordance with generally accepted accounting principles.

These amendments are adopted pursuant to authority conferred on the Securities and Exchange Commission by the Securities Act of 1933, particularly Sections 6, 7, 8, 10 and 19(a) thereof and the Securities Exchange Act of 1934, particularly Sections 12, 13, 15(d) and 23(a) thereof.

The amendments are set forth below.

I. Paragraph (a) of Rule 9-05 of Regulation S-X has been amended to read as follows:

"(a) Statements of banks need not be certified for periods ending on or before November 30, 1971."

II. Instructions 13 and 7 of Instructions as to Financial Statements in Forms 10 and 10-K, respectively, have been amended to read as follows:

Statements of Banks and Life Insurance Companies

Notwithstanding the requirements of the foregoing instructions, financial statements filed for banks for periods ending on or before November 30, 1971 and for life insurance companies need not be certified.

* * * * *

The foregoing amendments shall be effective July 19, 1971.

By the Commission.

THEODORE L. HUMES
Associate Secretary

RELEASE NO. 122
August 10, 1971

SECURITIES ACT OF 1933
Release No. 5176

SECURITIES EXCHANGE ACT OF 1934
Release No. 9279

Coverage of Fixed Charges

Certain registration forms under the Securities Act of 1933 require, where debt securities are to be registered, a statement of the ratio of earnings to fixed charges. Certain registration and report forms under the Securities Exchange Act of 1934 permit the showing of such ratio. Registration statements have been filed recently with the Commission wherein the ratio of earnings to fixed charges was computed on the basis of the revenues and expenses set forth in financial statements which did not reflect the revenues and expenses of a substantial portion of the enterprise carried on by the registrant. For example, some issuers operate large affiliated credit companies or supplier companies which themselves are obligated for substantial amounts of fixed charges by reason of debt, leases or other contractual obligations. In addition, the registrant may have guaranteed the debt of a supplier company which is not a subsidiary of the registrant or may have entered into contracts with such supplier which provide for payments designed to service debt of the supplier. The fixed charges of such related companies are frequently not taken into account in computing the ratio of earnings to fixed charges for the registrant (or registrant and consolidated subsidiaries) and, therefore, such ratio standing by itself may be misleading where consideration of the revenues and expenses of the total enterprise would produce a materially different result. It is the position of the Commission that, in such instances, the ratio of earnings to fixed charges for the registrant must be accompanied by effective disclosure of the significance of fixed charges of other companies included in the enterprise whether or not the revenues and expenses of such companies are set forth in the financial statements of the registrant. Such disclosure usually should be accomplished by presenting the ratio of earnings to fixed charges for the total enterprise in equivalent prominence with the ratio for the registrant or registrant and consolidated subsidiaries.

By the Commission.

THEODORE L. HUMES
Associate Secretary

RELEASE NO. 123
March 23, 1972

SECURITIES ACT OF 1933
Release No. 5237

SECURITIES EXCHANGE ACT OF 1934
Release No. 9548

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 17514

INVESTMENT COMPANY ACT OF 1940
Release No. 7091

Standing Audit Committees Composed of Outside Directors

As far back as 1917 it was urged that auditors in the United States should be appointed or selected by the stockholders in accordance with the practice in Great Brit-

ain and in Canada, and that state laws or company by-laws "should contain a provision for an independent report on the affairs of the company by an auditor appointed by the stockholders."[1]

Following the McKesson-Robbins investigation, in 1940 the Commission advocated the adoption of a program for: (1) current election of auditors at the annual meeting of stockholders; (2) nomination of auditors and arranging the details of the audit by a committee of nonofficer members of the board of directors; (3) addressing of the auditors' certificate, report or opinion to the stockholders; (4) mandatory attendance by auditors at the annual meetings of stockholders at which the audit report is presented; and (5) mandatory submission by auditors of a report on the amount of work done and of the reasons for noncompletion in situations where audit engagements are not completed. The stress of the program was on the responsibility of auditors to public investors.[2]

More recently others have supported these suggestions. In 1967 the executive committee of the American Institute of Certified Public Accountants recommended that standing audit committees of outside directors should nominate auditors for the annual audits of publicly-owned companies and should discuss the audit work with the auditors appointed to perform the audit. The Institute considered that such standing audit committees "... can be a constructive force in the overall review of internal controls and financial structure, and give added assurance to stockholders as to the objectivity of corporate financial statements."[3]

A 1970 study has concluded that "[t]he potential for usefulness of corporate audit committees, ... sufficiently exceeds the possibilities for disturbance that we strongly recommend that all companies with significant nonmanagement shareholder interests consider carefully the desirability of establishing an audit committee. . . ."[4]

The Commission has a statutory duty to satisfy itself that the consolidated financial statements filed with it by publicly-held companies of increasingly sophisticated and interlocking affiliations satisfy the requirements of Rules 2-02(b) and (c) of Regulation S-X and/or Instruction 5 to Item 6 of Form S-1, as appropriate. To this end, the Commission, in the light of the foregoing historical recital, endorses the establishment by all publicly-held companies of audit committees composed of outside directors and urges the business and financial communities and all shareholders of such publicly-held companies to lend their full and continuing support to the effective implementation of the above-cited recommendations in order to assist in affording the greatest possible protection to investors who rely upon such financial statements.

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[1] John Thomas Madden, *Accounting Practice and Auditing:* Modern Business Texts, Vol. 21 (New York: Alexander Hamilton Institute, 1917, pp. 248-9).

[2] Accounting Series Release No. 19, December 5, 1940.

[3] "AICPA Executive Committee Statement on Audit Committees of Boards of Directors," *Journal of Accountancy*, Vol. 124 (September 1967), p. 10.

[4] R. K. Mautz and F. L. Neumann, *Corporate Audit Committees* (Urbana, Ill.: Bureau of Economic and Business Research, University of Illinois, 1970), p. 96.

RELEASE NO. 124

June 1, 1972

SECURITIES ACT OF 1933
Release No. 5255

SECURITIES EXCHANGE ACT OF 1934
Release No. 9618

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 17583

INVESTMENT COMPANY ACT OF 1940
Release No. 7204

Pro Rata Stock Distributions to Shareholders

Several instances have come to the attention of the Commission in which registrants have made pro rata stock distributions which were misleading. These situations arise particularly when a registrant makes distributions at a time when its retained earnings or its current earnings are substantially less than the fair value of the shares distributed. Under present generally accepted accounting rules, if the ratio of distribution is less than 25 percent of shares of the same class outstanding, the fair value of the shares issued must be transferred from retained earnings to other capital accounts. Failure to make this transfer in connection with a distribution or making a distribution in the absence of retained or current earnings is evidence of a misleading practice. Distributions of over 25 percent (which do not normally call for transfers of fair value) may also lend themselves to such an interpretation if they appear to be part of a program of recurring distributions designed to mislead shareholders.

It has long been recognized that no income accrues to the shareholder as a result of such stock distributions or dividends, nor is there any change in either the corporate assets or the shareholders' interests therein. However, it is also recognized that many recipients of such stock distributions, which are called or otherwise characterized as dividends, consider them to be distributions of corporate earnings equivalent to the fair value of the additional shares received. In recognition of these circumstances, the American Institute of Certified Public Accountants has specified in Accounting Research Bulletin No. 43, Chapter 7, paragraph 10, that "... the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued. Unless this is done, the amount of earnings which the shareholder may believe to have been distributed will be left, except to the extent otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions." Both the New York and American Stock Exchanges require adherence to this policy by their listed companies.[1]

The Commission also considers that if such stock distributions are not accounted for in this manner the shareholders may be misled. In a recent stop order proceeding[2] the Commission found that a registration statement was materially misleading because a series of four stock distributions made between 1966 and 1968 "... were 'part of a frequent recurrence of issuances of shares' ... [and] ... under generally accepted accounting principles they should have been accounted for as stock dividends."

If, in addition to failing to account for the distribution properly, the registrant does not have sufficient retained earnings or current income to cover the appropriate transfer to permanent capital, a question immediately arises whether these factors may be part of a

[1] See New York Stock Exchange Manual, page A-235, and American Stock Exchange Guide, ¶10,046.

[2] *Monmouth Capital Corporation*, Securities Act Release No. 5169 (July 14, 1971).

manipulative or fraudulent scheme, and as such are proscribed under Rule 10b-5 of the Securities Exchange Act of 1934. The Commission has stated in published opinions,[3] in situations where companies did not have retained or current earnings, that the declaration of a dividend not warranted by the business condition of a company is characteristic of a manipulative scheme.

The Commission emphasizes that it will deem the types of transactions noted above to be misleading if the accounting is improper or disclosure is inadequate, and if there is a question of whether the condition of the business warrants the distribution, a further investigation will be considered to determine whether such distribution may be part of a manipulative or fraudulent scheme.

By the Commission.

RONALD F. HUNT
Secretary

[3] *Gob Shops of America, Inc.*, 39 S.E.C. 92 (1959); *Mac Robbins & Co., Inc.*, 41 S.E.C. 116 (1962).

RELEASE NO. 125
June 23, 1972

SECURITIES ACT OF 1933
Release No. 5261

SECURITIES EXCHANGE ACT OF 1934
Release No. 9648

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 17617

INVESTMENT COMPANY ACT OF 1940
Release No. 7236

Notice of Adoption of Amendments to Regulation S-X

Proposals to amend Articles 1, 2, 3, 4, 5, 9, 11 and Rules 12-01 to 12-16 (exclusive of 12-06A), and to omit Rules 12-17 and 12-32 of Regulation S-X were issued for public comment on August 20, 1971 in Securities Act Release No. 5177 (Securities Exchange Act Release No. 9264, Public Utility Holding Company Act Release No. 17215 and Investment Company Act Release No. 6645).

The letters of comment which were received have been given careful consideration in determining the definitive amendments of the above articles and rules. Amendments to Article 9 and Rule 12-32 have been deferred temporarily. Rule 12-17 has been retained for use in other articles of the regulation not affected by these amendments. Many changes of an editorial or clarifying nature have been made. Parts of the index of the regulation and certain rules in Articles 7 and 7A have been revised to reflect changes in rule numbers and caption headings. Other more substantive changes have been made in rules discussed below. The Commission also plans to issue in the near future a proposal to revise the instructions to the financial statements and summaries of operations in various filing forms to reflect the changes in terminology and caption headings adopted in Regulation S-X and to clarify and modify the instructions in some respects.

Rule 1-01. Application of Regulation S-X. Additional cross-referencing to pertinent Accounting Series Releases has been made at various points in the revised articles and rules as an aid to utilization of the releases as part of Regulation S-X. A study of the releases is being made to provide a codification and to determine whether certain of the releases should be rescinded.

Rule 1-02. Significant Subsidiary. A change has been made in the tests in this definition to base them on the parent's and the parent's other subsidiaries' proportionate share of revenues and assets of a subsidiary rather than on the total of such revenues and assets.

Rule 2-02. Accountants' Reports, paragraph

(c), Opinion to be expressed. More general wording was adopted in part (1) regarding the financial statements and accounting principles reflected therein in lieu of parts (1) and (2) of the proposal to avoid improper interpretations of what is required by the rule. Part (4) of the proposal was omitted because the requirement is no longer considered necessary.

Rule 2-06 (proposed). Examination of Policy Reserves of Life Insurance Companies by an Actuary. Adoption of the proposed rule has been deferred pending completion of a study by the American Institute of Certified Public Accountants regarding accountants' responsibility in connection with such examinations.

Rule 3-08. Summary of Accounting Principles and Practices. The original permissive basis for the presentation of a single statement regarding information on accounting principles and practices reflected in financial statements, as specified under other rules of Article 3, has been restored in view of the fact that the Accounting Principles Board of the American Institute of Certified Public Accountants has recently issued an opinion on "Disclosure of Accounting Policies."

Rule 3-09. Translation of Items in Foreign Currencies (as proposed). Paragraph (a) of the proposal was combined with Rule 3-16(b) to eliminate some duplication and to place it more logically under the requirements for notes to financial statements, and paragraph (b) which dealt with bases of translation was omitted pending completion of studies by the American Institute of Certified Public Accountants on translation of foreign currencies and intercorporate investments.

Rule 3-16(g). Pension and retirement plans. The original rule was revised to require disclosures specified in the Accounting Principles Board Opinion on "Accounting for the Cost of Pension Plans" in addition to the disclosures originally required, including the amount of unfunded past service cost.

Rule 3-16(i). Commitments and contingent liabilities. Part (2) of this rule has been changed to restrict the requirements for disclosure to noncancelable leases which have not been capitalized.

Rule 3-16(o). Income tax expense. This rule was adapted from instructions proposed for Rule 5-03-15 and placed with the requirements for notes to the financial statements to provide more flexibility for presentation of the data in the body of a financial statement or in a footnote. The instruction is intended to insure that the components of income tax expense, including taxes currently payable, are adequately disclosed.

Rule 3-16(p). Warrants or rights outstanding. This rule conforms to the present practice of requiring the data, which is specified in the schedule under Rule 12-15, to be presented in the notes to the financial statements for more informative disclosure.

Rule 4-02. Consolidated Financial Statements of the Registrant and Subsidiaries. Additional instructions were included in paragraphs (b) and (c) to clarify the rule, and the disclosure requirement specified under paragraph (b)(4) of the proposed rule was included with other disclosure requirements in paragraph (b) of Rule 4-04.

Rule 4-05. Reconciliation of Investment of a Person in Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons Accounted for by the Equity Method, and Equity of Such Person in Their Net Assets. Part (a) of the proposed rule has been omitted since, with the advent of the equity method of accounting, the disclosure specified therein is not meaningful. The second paragraph of part (b) of the proposed rule has been omitted since substantially the same information will be obtained under a new caption in the income statement.

Rule 4-07. Consolidation of Financial Statements of a Registrant and Its Subsidiaries Engaged in Diverse Financial Activities. The rule has been revised to clarify the conditions under which consolidated statements are permissible [paragraph (a)] and are not permissible [paragraph (b)].

Rule 5-02-20. Deferred research and development expenses, preoperating expenses and similar deferrals. An instruction was added to obtain disclosure in the notes to financial statements of significant data which would otherwise be disclosed under the schedule requirements adopted in Rule 12-08 for these types of expenses. (See comment under Rule 5-04, Schedule VII.)

Rule 5-02-39. Other stockholders' equity.

The caption of this rule has been changed to provide a clearer distinction between retained earnings and other types of additional capital. The proposed requirement in paragraph (a) for disclosure regarding retained earnings capitalized has been omitted as unnecessary in light of requirements for analyses of the various equity accounts on a continuing basis. The change in terminology has also been reflected in Article 11.

Rule 5-03-17. Equity in earnings of unconsolidated subsidiaries and 50 percent or less owned persons. An additional instruction has been included to recognize that in some circumstances this item may be presented in a different position and in a different manner.

Rule 5-03-20. Cumulative effects of changes in accounting principles. This new caption was adopted to provide for the presentation of cumulative effects of changes in accounting principles in the income statement in the circumstances specified in Accounting Principles Board Opinion No. 20 of the American Institute of Certified Public Accountants.

Rule 5-04, Schedule VII. The instructions and the schedule prescribed in Rule 12-08 have been revised to require inclusion of data in support of balance sheet caption 20, Deferred research and development expenses, preoperating expenses and similar deferrals, comparable to the data presently required to be reported in the schedule in support of balance sheet caption 16, Intangible assets. This addition to the schedule provides for more complete disclosure regarding the caption 20 items than was originally proposed under Rule 12-16 for research and development costs. This is considered desirable in light of the importance of expenditures on these types of activities to the current and future welfare of a company.

Rule 5-04, Schedules XVII and XVIII. The instructions have been changed to relate to new schedules adopted as Rules 12-42 and 12-43 to replace Rules 12-37 and 12-38 which had been adapted in Form S-11 from another use for reporting by certain real estate companies on real estate held for investment and mortgage loans on real estate. The new schedules reflect the current structure of the real estate industry and will enable the companies to provide better disclosure regarding these important assets. The Instructions as to Financial Statements of Form S-11 will be amended in the near future to conform those instructions to these changes.

Rule 12-16. Supplementary Income Statement Information. In order to simplify and reduce the overall requirements of the schedule, the requirement for disclosure of charges to other than income accounts for all items listed and the item *Management and service contract fees* have been omitted; the two elements of the item *Rents and royalties* have been listed separately; and a restricting definition for the item *Advertising costs* has been included.

The amendments to Regulation S-X are adopted pursuant to authority conferred on the Securities and Exchange Commission by the Securities Act of 1933, particularly 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 text of the amendments revising Articles 1, 2, 3, 4, 5, 11 and Rules 12-01 to 12-16 (exclusive of 12-06A) and rescinding Rule 12-17, all of Regulation S-X, is omitted.)

These amendments shall be effective with respect to financial statements for periods ending on or after December 31, 1972, except that the inclusion of professional employees in the definition of "member" in Rule 2-01(b) is effective commencing January 1, 1973, in registration statements and reports filed with the Commission.

By the Commission.

RONALD F. HUNT
Secretary

RELEASE NO. 126

July 5, 1972

SECURITIES ACT OF 1933
Release No. 5270

SECURITIES EXCHANGE ACT OF 1934
Release No. 9662

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 17636

INVESTMENT COMPANY ACT OF 1940
Release No. 7264

Independence of Accountants; Guidelines and Examples of Situations Involving the Independence of Accountants

The Securities and Exchange Commission today announced the publication of an additional release in its Accounting Series on the subject of the independence of the certifying accountant. The primary purpose of this release is to set forth presently existing guidelines employed by the Commission in resolving the various independence questions that come before it. This release, therefore, is not intended to supersede Accounting Series Release No. 47 issued on January 25, 1944, or No. 81 issued on December 11, 1958, but should be read as complementing and implementing further the policy developed in those prior releases. However, to the extent that any inconsistency exists between these prior releases and the release presented herein, the latter should be regarded as indicative of the Commission's current position.

The Commission's authority and responsibility for determining that accountants are independent are found in the statutory language of the acts it administers. These acts, and the rules adopted pursuant to them, principally provide for the adequate and accurate disclosure of all material facts to the public. The concept of independence, as it relates to the accountant, is fundamental to this purpose because it implies an objective analysis of the situation by a disinterested third party. In order to assure public confidence in the objective reporting of these material facts, certain rules, particularly Rule 2(e)[1] of the Commission's Rules of Practice and Rule 2-01[2] of Regulation S-X, were adopted. Under Rule 2(e) "the 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 (i) not to possess the requisite qualifications to represent others, or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the federal securities laws, or the rules and regulations thereunder."[3] Contrasted with Rule 2(e), under which the Commission may impose sanctions once the issue of lack of independence or other improper professional conduct has been determined, is Rule 2-01 of Regulation S-X which deals with the qualifications of accountants and broadly illustrates how the qualification of independence can be impaired. Audited financial statements which are used in connection with an offering of securities within the Commission's jurisdiction, including those offerings which are exempted from certification under the Securities Act of 1933, must be audited by an accountant who satisfies the independence requirements of this rule.

In Rule 2-01(b) the use of the introductory words "[f]or example" implies that situations involving possible loss of independence include, but are not limited to, the relationships set forth therein. Rule 2-01(b) as amended states that "... an accountant will be considered not independent with respect

[1] 17 CFR 201.2(e).
[2] 17 CFR 210.2-01.

[3] 17 CFR 201.2(e)(1).

to any person or any of its parents, its subsidiaries, or other affiliates (1) in which, during the period of his professional engagement or at the date of his report, he or his firm or a member[4] thereof, had, or was committed to acquire, any direct financial interest or any material indirect financial interest; or (2) with which, during the period of his professional engagement, at the date of his report or during the period covered by the financial statements, he or his firm or a member thereof, was connected as a promoter, underwriter, voting trustee, director, officer, or employee."[5] The Accounting Series Releases issued on the subject of independence attempt to clarify the intent of Rule 2-01 by applying these abstract principles to concrete factual situations.

The critical distinction which must be recognized at the outset is that the concept of independence is more easily defined than applied. As a result, the guidelines and illustrations presented in these releases cannot be, nor are they intended to be, definitive answers on any aspect of this subject. Rather, they are designed to apprise the practitioner of typical situations which have involved loss of independence, whether in appearance or in fact, and by so doing to place him on notice of these and similar potential threats to his independence.

An important consideration in determining whether an accountant is independent is the relationship between the company, its stockholders and the accountants. Ratification of accountants by stockholder vote and attendance of accountants at the company's annual meeting to answer stockholder questions are desirable actions to strengthen the accountant's independent position. The existence of an audit committee of the board of directors, particularly if composed of outside directors, should also strengthen such independence.[6]

[4] For the purposes of Rule 2-01 [17 CFR 210.2-01(b)] the term "member" means "all partners in the firm and all professional employees participating in the audit or located in an office of the firm participating in a significant portion of the audit."

[5] 17 CFR 210.2-01(b).

[6] Securities Act Release No. 5237 (March 23, 1972); Accounting Series Release No. 123.

In Accounting Series Release No. 81 it was said that the growth of the accounting profession and the number of inquiries received from public accountants necessitated the publication of rulings in this category. We find ourselves today in a similar situation. Since the publication of Accounting Series Release No. 81 in 1958 technological advances have been considerable and have resulted in not only faster and more efficient means of rendering the customary services to clients but also in an expanded range of possible services which could be rendered. Consequently, although the principles affecting the determination of independence have remained unchanged, the application of these principles has been complicated by the difficulty in properly delineating the permissible scope of these expanded services. The Ethics Division of the American Institute of Certified Public Accountants has also recognized the need for further guidelines in this area. In April 1971 it issued Ethics Opinion No. 22, which deals with the "impact of data processing services on audit independence." This opinion supports the Commission's philosophy that "the fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among investors rests upon management."[7] It also recognizes that when "securities issued by the client are offered to the public and become subject to regulation by the Securities and Exchange Commission or other federal or state regulatory bodies, the matter of appearance, in addition to independence in fact, becomes more significant."[8]

A part of the rationale which underlies any rule on independence is that managerial and decision-making functions are the responsibility of the client and not of the independent accountant. It is felt that if the independent accountant were to perform functions of this nature, he would develop, or appear to develop, a mutuality of interest with his client which would differ only in degree, but not in

[7] *Interstate Hosiery Mills, Inc.*, 4 S.E.C. 706, 721 (1939).

[8] Ethics Opinion No. 22: "Impact of Data Processing Services on Audit Independence," American Institute of Certified Public Accountants (April 1971).

kind, from that of an employee. And where this relationship appears to exist, it may be logically inferred that the accountant's professional judgment toward the particular client might be prejudiced in that he would, in effect, be auditing the results of his own work, thereby destroying the objectivity sought by shareholders. Consequently, the performance of such functions is fundamentally inconsistent with an impartial examination. However, it is the role of the accountant to advise management and to offer professional advice on their problems. Therefore, the problem posed by this dilemma is to ascertain the point where advice ends and managerial responsibility begins.

In this context, managerial responsibility begins when the accountant becomes, or appears to become, so identified with the client's management as to be indistinguishable from it. In making a determination of whether this degree of identification has been reached, the basic consideration is whether, to a third party, the client appears to be totally dependent upon the accountant's skill and judgment in its financial operations or to be reliant only to the extent of the customary type of consultation or advice. A particularly difficult situation arises when a small client for whom accounting services were performed desires to go public to meet the needs of its expanding business. If any of these services involved managerial functions or the maintenance of basic accounting records, the accountant may find himself unqualified to render an independent opinion on the financial statement for any period in which these services were performed. The financial statements are the responsibility of the client and all decisions with respect to them must ultimately be assumed by the client. Consequently, it is essential that the company and its accountant allow for an adequate transitional period to avoid this problem.

The Commission has said that the question of independence is one of fact, to be determined in the light of all the pertinent circumstances in a particular case.[9] No set of rules or compilation of representative situations can embrace all the circumstances which could affect such a determination. But what they can do, and what they are intended to do, is act as a general notification which simultaneously educates the practitioner and places on him the responsibility for recognizing these general areas of potential loss of independence. The Commission is aware of the fact that situations arise which require judgment in determining whether the Commission's standards of independence have been met and that a company or its accountants may wish assurance that no question as to independence will be raised if the company files financial statements with the Commission. Where this is the case, the Commission urges the parties concerned to bring the problem to its attention so that a timely and informed decision on the matter may be made.

EDP AND BOOKKEEPING SERVICES

The Commission is of the opinion that an accountant cannot objectively audit books and records which he has maintained for a client. The performance of these services, whether accomplished manually or by means of computers and other mechanized instruments, ultimately places the accountant in the position of evaluating and attesting to his own recordkeeping. In some cases the amount of recordkeeping by the accountant may be limited and a strict application of the recordkeeping prohibition may cause an unreasonable hardship on companies going public for the first time. When no question relating to recordkeeping exists in the latest full year certified, the Commission may, in some cases, not raise a question as to independence in the earlier periods.

a. Systems design is a proper function for the qualified public accountant. Computer programming is an aspect of systems design and does not constitute a bookkeeping service.
b. Where source data is provided by the client and the accountant's work is limited to processing and production of listings and reports, independence will be

[9] Accounting Series Release No. 47, January 25, 1944.

adversely affected if the listings and reports become part of the basic accounting records on which, at least in part, the accountant would base his opinion. In this situation the accountant, by preparing basic accounting records, has placed himself in a position where he would be reviewing his own recordkeeping and could therefore appear to a reasonable third party to lack the objectivity and impartiality with respect to that client which an independent audit requires. On the other hand, if the processing results in the production of statistical summaries and analyses which do not become part of the basic accounting records, independence would not be adversely affected because the accountant, in the course of his audit, would not be put in the position, actual or apparent, of evaluating and attesting to the accuracy of his own recordkeeping.

Examples based upon situations brought to the attention of the staff are set forth below:

1. Accounting firm provided services to the client which included writing up the books, making adjusting entries, and preparing financial statements. Audited statements prepared under these circumstances are acceptable to the State Attorney General under that state's financing act. *Conclusion*, independence is adversely affected since the aggregate of these activities appears to place the basic responsibility for the accounting records and financial statements with the same accounting firm which is expected to perform an objective audit.

2. Accounting firm, through the use of their data processing equipment, maintained the sales, purchase, cash receipts and disbursements, and general journals for five of the client's subsidiaries. In addition, they posted the general ledger, coded and reclassified voucher checks, and reconciled certain accounts. The financial statements for the most recent year are to be audited by another accounting firm and those of the prior year by the subject accounting firm. *Conclusion*, the extent of the services performed is such as to cause the subject firm to be not independent either with regard to the parent or its subsidiaries.

3. In order to keep certain information confidential the client has asked the accounting firm to perform the following work:

(1) Preparation of executive payroll.
(2) Maintenance of selected general ledger accounts in a private ledger.

Conclusion, the performance of the foregoing work would adversely affect independence.

4. Client personnel will prepare from the books of original entry printed tapes that can be read on an optical scanner and will send the tapes to the accountant's office. The accountants will forward the tapes to a service bureau. The accountants will receive the print-outs of the financial statements and general ledgers and will send them to the client. The accountants will not edit input data prior to transmission to the service bureau. *Conclusion*, independence would be adversely affected. Although the function of the accountant appears totally mechanical, the service bureau appears to be acting as an agent of the accountant and this relationship should be changed so that the printed tapes will be transmitted directly to the service bureau by the client and the resulting print-out returned directly to the client.

5. Bookkeeping department of public accounting firm has kept and posted the client's general ledger from the start of the client's business. All other bookkeeping work has been done by the client's employees. *Conclusion*, since the accounting firm had control of the general ledger for the life of the company, their independence is adversely affected. However, another public accounting firm, if engaged to audit the company, could reduce its work by reference to the work papers and schedules of the present accountants but only to the extent that they could be accepted as the work of the client's bookkeeping staff.

6. Public accounting firm recorded the client's books of original entry, posted the general ledger, and determined the account classification of expenditures. The client was in the preoperating stage when this work was done and consequently had no need for a full-time bookkeeper. A controller has re-

cently been hired by the client. *Conclusion,* accounting firm could not be considered independent for the purpose of auditing financial statements to be filed with the Commission. The maintenance of records in the absence of qualified personnel, as in this case, would not be considered an emergency situation which would permit such services.

7. Accounting firm proposed, by use of its computer, to perform certain data processing activities in connection with the client's stockholder ledger. Programming, keypunching and computer processing would be performed by personnel of the data processing department who are separate from the audit staff. The work proposed would consist of a complete restatement of the stockholder's ledger and its subsequent maintenance and updating to reflect future transactions. In the course of restating the ledger accounts certain audit procedures would be applied which would lead to the correction of errors in the restated accounts. *Conclusion,* these services would adversely affect independence. The accountant has assumed the responsibility for maintaining the client's stock records.

8. Accounting firm did certain computer servicing work for a client during the period to be covered by their opinion. The client is not using the computer services of the accounting firm for the current fiscal year but still employs this firm as its accountants. The client's personnel had complete control over the preparation and coding of the vouchers. These vouchers were sent to the accounting firm but were not accompanied by the source data. These vouchers were fed into the computer and voucher registers and general journals were printed. All corrections were made by the client. The accountants performed only those services necessary to prepare the data for the computer. *Conclusion,* no question of independence will be raised because these services have been discontinued prior to the current fiscal year and appear to have been mechanical in nature involving neither the exercise of judgment nor the making of any decisions by the accounting firm, and the processing was subject to controls of the client.

FINANCIAL INTEREST

Rule 2-01(b) states that an accountant will be considered not independent if "he or his firm or a member thereof had, or was committed to acquire, any direct financial interest or any material indirect financial interest" in a client. For purposes of interpreting this section, any financial interest in a client owned by the accountant, or by the accountant's spouse is considered to be a direct interest. Also, any financial interest in a client by someone other than the accountant may be treated as a direct financial interest of the accountant himself if, under the circumstances, it appears that the holder is subject to the accountant's supervision or control. On the other hand, if the interest is considered indirect, it is necessary to determine whether or not it is also material. And, in this context, the determination is primarily made with reference to the net worth of the accountant, his firm, and the net worth of his client.

9. Corporation A is acquiring Corporation B in a merger to be accounted for as a pooling of interests and proposes to pay the accountant for Corporation B for his audit services with stock of Corporation A. The accountant for Corporation B will not audit future reports of the acquiring company. *Conclusion,* independence would be adversely affected because of the receipt of stock.

10. Accounting Firm A is considering a merger with Firm B, one of whose partners owns stock in a client of Firm A. The partner proposed to put the stock in an irrevocable trust for the benefit of his children and controlled by two unassociated trustees. *Conclusion,* independence would be adversely affected if the shares were not sold. Putting the shares in an irrevocable trust would not be sufficient.

11. A partner in the accounting firm, whose proposed client was a wholly owned subsidiary of the registrant, owned one percent of the stock of the parent company. *Conclusion,* not independent.

12. A partner in an accounting firm owns stock in a company which has recently asked his firm to perform the audit for the current

year. The partner would sell his stock prior to accepting the engagement. *Conclusion*, no question of independence would be raised.

13. Accounting firm received a five percent, ten-year debenture of the client in settlement of accounting fees pursuant to a plan of reorganization approved by the U. S. District Court. The firm intends to sell the debenture as soon as possible after issuance, providing any reasonable market exists. *Conclusion*, if securities taken in reorganization are disposed of promptly, no question as to independence will be raised. Although this is not an equity security, the debentures should be disposed of promptly.

14. A partner in an accounting firm is a member of an investment club. The club owns stock in a company which is a client of the accounting firm. Neither the number nor the value of the shares purchased is material to the club or the company. *Conclusion*, the firm's independence would be adversely affected as a result of the partner's interest in the investment club. In this regard, an investment club does not stand on the same footing as a mutual fund because the former is comprised of relatively few members and each member plays an active part in the selection of investments.

Accountant as Creditor of Client

When the fees for an audit or other professional service remain unpaid over an extended period of time and become material in relation to the current audit fee, it may raise questions concerning the accountant's independence because he appears to have a financial interest in his client. While no precise rules can be set forth, normally the fees for the prior year's audit should be paid prior to the commencement of the current engagement. When such unpaid fees become material the accountant cannot be considered independent because he may appear to have a direct interest in the results of operations of the company for the period to be audited.

15. Recent operations of a client company have not been profitable and in order to improve its current working capital ratio it has invited unsecured creditors to extend their settlement dates and subordinate their interests in exchange for receiving the first proceeds from a proposed offering. The accounting firm's fee was one of the debts to be subordinated. *Conclusion*, if the accounting firm subordinates the amount due them its independence would be adversely affected.

16. Pursuant to a plan of recapitalization, the existing debt of the company was to be exchanged for five-year promissory notes. The accounting firm was to receive these promissory notes in payment of its audit fee. *Conclusion*, accountant should dispose of such notes as promptly as possible and, if material, before undertaking any additional auditing work for this company.

FAMILY RELATIONSHIPS

As a general rule, an accountant cannot be considered independent where the family relationship existing between the accountant or member of his firm and the client is such that, because of the strong bond which customarily exists in such a relationship, an outside party could reasonably question the accountant's impartial examination. In this context and in the absence of any other factors, the presumption of impairment to independence is greater in husband-wife or father-son relationships than in that of, for example, an uncle-nephew. In other words, the presumption is directly related to the presumed strength of the family bond. But, in resolving cases of this nature, attention is directed not only to the nature of the family relationship involved but also to such other factors, particularly the positions occupied by the parties in their respective employment, as may make the related parties appear to have the opportunity to mold the shape of the financial statements.

17. A is the controller of Company Z. He is not an elected officer nor does he have any stock holdings in Company Z. A's brother, B, is a partner in the public accounting firm that audits Company Z's books. However, B is not the partner in charge of this client. *Conclusion*, the accountant could not be considered independent because of this relationship.

18. Partner in a national public accounting firm has a brother-in-law who is sales vice

president for a recently acquired client company. The brother-in-law is not directly involved in the financial affairs of the company and the partner would not be connected with the audit in any way. *Conclusion*, no question of independence would be raised because of this relationship.

19. An accountant has a sister-in-law whose husband is a 40 percent stockholder of a client company. There is no other business connection between the company, the stockholder, the accountant or his wife. *Conclusion*, independence is adversely affected because of the family relationship between the accountant and a major stockholder in a client company.

20. An attorney's father and brother are partners in an accounting firm. The law firm in which the attorney is a partner acts as counsel for several companies which are also clients of the accounting firm. As partial compensation for legal services, the law firm receives securities from the client. The attorney does not live in the same home or dwelling as either the father or brother and does not have any financial interest in their accounting firm. Nor do the accountants have any interests in the law firm. *Conclusion*, no question of independence will be raised.

21. The father of a partner in a public accounting firm was the chairman of the board and chief executive officer of a client company. The accounting firm had approximately 400 general partners and had offices throughout the U. S. The client was a large and diverse company with many consolidated subsidiaries. The partner's office was located over 500 miles from the client's home office and the partner was totally isolated from the audit engagement. This situation and the independence issue involved were presented to and reviewed by the company's board of directors. This body, which performs the functions typically delegated to an audit committee of directors, decided that if the son would not be involved in the audit in any way his association with the accounting firm would not be incompatible with the independent relationship. *Conclusion*, no question of independence was raised under these circumstances.

22. A client of the accounting firm acquired a 20 percent interest in a publicly held company and consequently could elect two members of the board of directors. One of the individuals they proposed to elect is the brother of a partner in the accounting firm as well as a senior partner in the law firm which acts as general counsel for the client. The offices of the law firm and accounting firm are located in the same city and, in addition, both brothers, their affiliations and relationships are well known in the community. *Conclusion*, independence would be adversely affected.

BUSINESS RELATIONSHIPS WITH CLIENT

Direct and material indirect business relationships, other than as a consumer in the normal course of business, with a client or with persons associated with the client in a decision-making capacity, such as officers, directors or substantial stockholders, will adversely affect the accountant's independence with respect to that client. Such a mutuality or identity of interests with the client would cause the accountant to lose the appearance of objectivity and impartiality in the performance of his audit because the advancement of his interest would, to some extent, be dependent upon the client. In addition to the relationships specifically prohibited by Rule 2-01(b), joint business ventures, limited partnership agreements, investments in supplier or customer companies, leasing interests, except for immaterial landlord-tenant relationships, and sales by the accountant of items other than professional services are examples of other connections which are also included within this classification.

23. Accounting firm will process the client's data on the firm's computer if the client's computer becomes inoperable. *Conclusion*, accountant's independence is not adversely affected if he assisted a client by maintaining books and records for a short period because of an emergency. The inoperability of the client's computer may be considered such an emergency.

24. Accounting firm plans to rent block time on its computer to a client if the client's

computer becomes overburdened. *Conclusion*, renting excess computer time to a client, except in emergency or temporary situations, is a business transaction with a client beyond the customary professional relationship and would therefore adversely affect independence.

25. An individual owns 100 percent of the stock of a corporation which acts as the general partner in the limited partnership A and 51 percent of the stock of another corporation which acts as general partner for limited partnership B. The accounting firm, which has a one percent interest in partnership B, has been asked to audit partnership A. *Conclusion*, independence as to partnership A is adversely affected because partnership B, in which the accounting firm has an interest, was promoted under the same sponsorship as A. However, if the one percent interest is disposed of, no question will be raised.

26. Client of an accounting firm is engaged in the business of selling franchises. Two partners of this firm have invested approximately five percent of their personal fortunes to buy one half of the stock of a corporation which holds a franchise granted by this client. Except for the payment of a percentage of sales to the franchisor, the franchisee operates independently. *Conclusion*, the firm cannot be considered independent because the partners have a material investment in the franchise which has a close identity in fact and in appearance with the client.

27. A retired partner of an accounting firm plans to accept election as a director of one of the firm's clients. Under the terms of the partnership agreement this partner will continue to share in the earnings of the firm at a reducing rate but would be precluded from participating in the fees from this client if he were to become associated with it either as an employee, officer, director, or shareholder. *Conclusion*, when a retired partner of an accounting firm accepts a position with a client of that firm, all active connections with the firm must be severed if the firm is to remain independent. If this partner is still receiving retirement benefits from the firm, this severance requirement can be met only if the benefits flow from a fixed settlement payable in predetermined annual amounts.

28. Partner in accounting firm is also a financial vice president and stockholder of a real estate investment trust. In addition, he is a limited partner in a company which manages the trust. A client of his firm has asked him to help them get a loan from the investment trust. *Conclusion*, independence for future periods would be adversely affected if the company were to obtain the loan from the real estate investment trust. However, no question would be raised as to periods prior to the commencement of negotiations for the loan.

29. An accounting firm's client, a realtor corporation, is the general partner and ten percent owner in a limited partnership which owns unimproved land for appreciation. The accounting firm also owns a five percent interest in this limited partnership and a partner in the firm has a two percent interest. *Conclusion*, independence is adversely affected because of this joint investment with the client.

30. Partners in the accounting firm have a common investment with stockholders of a prospective client. These partners own approximately 11 percent of Company A and the other investors, who own approximately 78.5 percent of Company A, also own 22 percent of the prospective client. *Conclusion*, independence is adversely affected because the common investment which the partners of the firm have with the substantial minority shareholders of the prospective client is such a circumstance as could lead a third party to question the firm's objectivity.

31. A partner in an accounting firm manages a building owned by an audit client. *Conclusion*, independence is adversely affected.

32. An employee of an accounting firm was asked by an audit client to assume part-time management functions for the client. These services would be provided with the full knowledge and consent of the accounting firm and the employee would be paid a monthly retainer directly by the client. *Conclusion*, this would create an inappropriate relationship and would adversely affect independence.

33. A broker-dealer, an audit client, planned to manage a discretionary account for principals of the accounting firm. The account would be opened as a margin account with a different broker who is not a client. The client, however, would have discretionary authority to execute transactions for the account. No investment in this account could exceed $25,000 nor would it represent a material portion of any of the participants' net worth. *Conclusion,* independence is adversely affected in those cases where the broker has extended credit to his accountant or where the accountant has given his client-broker discretionary authority to execute transactions for his account. However, no objection will be raised where an accountant executes his securities transactions in a regular cash account with a broker who is also his audit client if neither cash nor securities are left with the broker beyond a normal settlement period.

34. An accounting firm planned to construct office buildings in which it would occupy a relatively small portion of the space and would rent the remainder to other tenants, some of whom might be clients of the firm. *Conclusion,* the activity of owning and managing real property is more in the nature of a commercial business activity than of a professional service. Rental of a material amount of space to a client would raise a question of independence since the accounting firm would appear to have a material business relationship with the client. Some reasonable tests which would be applied in determining what constitutes a rental of material amount might be the relationship of a single lease to the fees earned in the office located in the building concerned, total lease rentals from all clients to the firm's total fees, and lease rentals from a particular client to the auditing fee paid by that client for the same period.

35. An accounting firm has its office in a building which is owned by a client. The accounting firm, which occupied approximately 25 percent of the available office space in the building, was the only tenant other than the client. *Conclusion,* the fact that the accounting firm was the only other tenant in the client's building and leased a substantial portion of the available office space are circumstances that would lead a reasonable third party to question the firm's objectivity. Therefore, independence is adversely affected.

OCCUPATIONS WITH CONFLICTING INTERESTS

Certain concurrent occupations of certified public accountants engaged in the practice of public accounting involve relationships with clients which may jeopardize the certified public accountant's objectivity and, therefore, his independence. In general, this situation arises because the relationships and activities customarily associated with this occupation are not compatible with the auditor's appearance of complete objectivity or because the primary objectives of such occupations are fundamentally different from those of a public accountant. Acting as counsel or as a broker-dealer, or actively engaging in direct competition in a commercial enterprise are examples of occupations so classified and the following discussion relating thereto is intended to be illustrative only. The principles involved are equally applicable to any other undertaking which is similarly referable to them.

Accountant—Attorney

A legal counsel enters into a personal relationship with a client and is primarily concerned with the personal rights and interests of such client. An independent accountant is precluded from such a relationship under the securities acts because the role is inconsistent with the appearance of independence required of accountants in reporting to public investors.

36. A partner in an accounting firm also acted as legal counsel for an audit client. He received fees for such legal services and, through the accounting partnership, for accounting services rendered concurrently. *Conclusion,* independence is adversely affected.

Accountant—Broker-Dealer

Concurrent engagement as a broker-dealer

is incompatible with the practice of public accounting. The functions customarily performed in such employment include the recommendation of securities, the solicitation of customers and the execution of orders, any one of which could involve securities transactions of clients either as issuer or investor and provide third parties with sufficient reason to question the accountant's ability to be impartial and objective.

37. A practicing accountant is also a broker-dealer and, functioning as a broker-dealer, makes a market in the stock of an audit client. *Conclusion*, accountant is not independent.

38. A partner in an accounting firm is also a principal for broker-dealer A. The accounting firm has been engaged to perform the audit for broker-dealer B. Firm A, which is primarily involved in mutual fund sales, clears some transactions through Firm B. *Conclusion*, the accounting firm is not independent.

Accountant—Commercial Competitor

Occasionally accountants engage in a commercial business concurrently with the practice of public accounting. Where such commercial business is directly competitive with that of a client, there would appear to third parties to be a conflict of interests which might influence the firm's objectivity since the public accounting firm would have access to the records, policies and practices of a business competitor of that firm.

39. Four partners in an accounting firm were among the six founders of a company which was engaged in the same type of business and was directly competitive with an audit client. In addition to owning stock, they also served as directors and officers of this company. The accountants informed the president of the client-company of their investment in a business competitor but he did not object to the business venture and permitted them to continue as auditors. Both companies were located in the same geographical area. *Conclusion*, the accountants were not independent.

APPENDIX

Principal References Concerning the Practice of Accountants Before the Commission

OPINIONS AND ORDERS OF THE COMMISSION

Cornucopia Gold Mines, 1 S.E.C. (1936)
American Terminals and Transit Company, 1 S.E.C. 701 (1936)
National Boston Montana Mines Corporation, 2 S.E.C. 226 (1937)
Richard Ramore Gold Mines, Ltd., 2 S.E.C. 377 (1937)
Metropolitan Personal Loan Company, 2 S.E.C. 803 (1937)
Interstate Hosiery Mills, Inc., 4 S.E.C. 706 (1939)
margin
A. Hollander & Son, Inc., 8 S.E.C. 586 (1941)
Abraham H. Puder and Puder and Puder, Securities Exchange Act of 1934 Release No. 3073 (1941)
Southeastern Industrial Loan Company, 10 S.E.C. 617 (1941)
Kenneth N. Logan, 10 S.E.C. 982 (1942) (Accounting Series Release No. 28)
Associated Gas and Electric Company, 11 S.E.C. 975 (1942)
C. Cecil Bryant, 15 S.E.C. 400 (1944) (Accounting Series Release No. 48)
Red Bank Oil Company, 21 S.E.C. 695 (1946)
Drayer-Hanson, Incorporated, 27 S.E.C. 838 (1948)
Cristina Copper Mines, Inc., 33 S.E.C. 397 (1952)
Coastal Finance Corporation, 37 S.E.C. 699 (1957)
Sports Arenas (Delaware) Inc., 39 S.E.C. 463 (1959)
American Finance Company, 40 S.E.C. 1043 (1962)
Advanced Research Associates, Inc., 41 S.E.C. 579 (1963)
South Bay Industries, Inc., Securities Act of 1933 Release No. 4702 (1964)
Idaho Acceptance Corp., Securities Exchange Act of 1934 Release No. 7383 (1964)
Dixie Land and Timber Corporation, Securities Act of 1933 Release No. 4841 (1966) [For details see initial decision of Hearing Examiner, Administrative Proceeding File No. 3-215.]

ACCOUNTING SERIES RELEASES

No. 2 (1937) Independence of accountants—Relationship to registrant
No. 19 (1940) McKesson & Robbins, Inc.
No. 22 (1941) Independence of accountants—Indemnification by registrant
No. 28 (1942) Kenneth N. Logan, 10 S.E.C. 982
No. 47 (1944) Independence of certifying accountants—Summary of past releases of the Commission and a compilation of hitherto unpublished cases or inquiries
No. 48 (1944) C. Cecil Bryant, 15 S.E.C. 400
No. 51 (1945) Disposition of Rule II(e) proceedings against certifying accountant
No. 59 (1947) Williams and Kingsolver
No. 64 (1948) Drayer-Hanson, Incorporated, 27 S.E.C. 838
No. 67 (1949) Barrow, Wade, Guthrie & Co., Henry H. Dalton and Everett L. Mangam
No. 68 (1949) F. G. Masquelette & Co., and J. E. Cassel
No. 73 (1952) Haskins & Sells and Andrew Stewart
No. 77 (1954) Disposition of Rule II(e) proceedings against certifying accountant
No. 78 (1957) Touche, Niven, Bailey & Smart, et al., 37 S.E.C. 629
No. 81 (1958) Independence of Certifying accountants—Compilation of representative administrative rulings in cases involving the independence of accountants.
No. 82 (1959) Bollt and Shapiro, 38 S.E.C. 815
No. 88 (1961) Myron Swartz, 41 S.E.C. 53
No. 91 (1962) Arthur Levison and Levison and Company, 41 S.E.C. 150
No. 92 (1962) Morton I. Myers, 41 S.E.C. 156
No. 97 (1963) Harmon R. Stone
No. 105 (1966) Homer E. Kerlin
No. 108 (1967) Nicholas J. Raftery [Misspelled in release]
No. 110 (1968) Meyer Weiner
No. 112 (1968) Independence of accountants examining a nonmaterial segment of an international business

CHANGES IN THE INDEPENDENCE RULE

Article 14, Rules and Regulations under the Securities Act of 1933,[1] Federal Trade Commission, July 6, 1933
Article 41, Rules, Regulations and Opinions under the Securities Act of 1933 as Amended, April 29, 1935
Rule 650, General Rules and Regulations under the Securities Act of 1933, January 21, 1936
Rule 2-01, Regulation S-X, Adopted February 21, 1940, Accounting Series Release No. 12
Amendments of Rule 2-01:
Accounting Series Release No. 37, November 7, 1942
Accounting Series Release No. 44, May 24, 1943
Accounting Series Release No. 70, December 20, 1950
Accounting Series Release No. 79, April 8, 1958
Accounting Series Release No. 125, June 23, 1972

[1] The Securities and Exchange Commission was established under provisions of the Securities Exchange Act of 1934 and was authorized to continue in effect until modified all rules and regulations issued by the Federal Trade Commission under the Securities Act of 1933.

RELEASE NO. 127
September 11, 1972

Notice that initial decision has become final in the Matter of Martin L. Sanchez. (Rules of Practice—Rule 2(e))

In these proceedings pursuant to Rule 2(e)(3) of the Commission's Rules of Practice, no petition for review of the hearing examiner's initial decision with respect to Martin L. Sanchez has been filed. The examiner found that Sanchez was permanently enjoined by a court of competent jurisdiction from further violations of certain provisions of the securities laws, and he ordered that Sanchez be permanently disqualified from appearing or practicing before the Commission. The time for filing any such petition has expired, and the Commission has not determined to review the matter on its own initiative.

Accordingly, notice is hereby given, pursuant to Rule 17(f) of the Commission's Rules of Practice, that the hearing examiner's initial decision with respect to Martin L. Sanchez has become the final decision of the Commission. The examiner's order disqualifying Sanchez from appearing or practicing before the Commission is hereby declared effective.

RONALD F. HUNT,
Secretary

RELEASE NO. 128
September 20, 1972

SECURITIES ACT OF 1933
Release No. 5301

SECURITIES EXCHANGE ACT OF 1934
Release No. 9776

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 17698

INVESTMENT COMPANY ACT OF 1940
Release No. 7360

Notice of Adoption of Revision of Article 9 of Regulation S-X

The Commission today adopted a general revision of Article 9 of Regulation S-X pertaining to the form and content of financial statements of bank holding companies and banks. The revision was issued for public comment on August 20, 1971[1] as part of a general revision of Regulation S-X but, because a number of unexpected problems arose, its adoption was deferred when other portions of the proposed revision were adopted on June 23, 1972.[2]

Letters commenting on the proposal were given careful consideration in determining the final form of the revision of Article 9. The more significant changes from the existing Article 9 are discussed below:

Rule 9-01. Application of Article 9. A requirement has been added that in preparing consolidated statements, holding companies

[1] Securities Act Release No. 5177, Securities Exchange Act Release No. 9264, Public Utility Holding Company Act Release No. 17215 and Investment Company Act Release No. 6645.

[2] Securities Act Release No. 5261, Securities Exchange Act Release No. 9648, Public Utility Holding Company Act Release No. 17617, Investment Company Act Release No. 7236 and Accounting Series Release No. 125.

shall give consideration to utilization of the form and content of financial statements prescribed for banks.

Rule 9-02. Balance Sheets of Bank Holding Companies. The former special requirements for holding company balance sheets pertaining to disclosure of balances with affiliated banks have been eliminated.

Rule 9-03. Income Statements of Bank Holding Companies. This rule was revised to provide for use of the equity method of reflecting income of subsidiaries and for separate reporting of income from operations, securities gains and losses and extraordinary items.

Rule 9-04. What Schedules Are To Be Filed for Bank Holding Companies. The requirement for filing the schedule of investments in securities of affiliate banks, Rule 12-32, has been deleted.

Rule 9-05. Financial Statements and Schedules of Banks. This rule has been revised to require that statements of banks shall generally follow the form and content prescribed in Regulation F of the Board of Governors of the Federal Reserve System. These statements shall be supplemented by a statement of source and application of funds, information as to market value of investment securities, a schedule of amounts receivable from directors, officers and certain other persons, and a schedule of supplementary income statement information. Requirements for filing schedules have been provided.

The amendments to Regulation S-X are adopted pursuant to authority conferred on the Securities and Exchange Commission by the Securities Act of 1933, particularly 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 text of the amendments revising Article 9 of Regulation S-X is omitted.)

Rule 12-32 of Regulation S-X is hereby deleted.

The amendments shall be effective with respect to financial statements for periods ending on or after December 31, 1972.

By the Commission.

RONALD F. HUNT
Secretary

RELEASE NO. 129
September 26, 1972

Order accepting resignation from Commission practice in the Matter of Barry L. Kessler. (Rules of Practice—Rule 2(e))

On April 6, 1972, the Commission instituted an injunctive action in the United States District Court for the Northeastern District of Ohio alleging, among other things, that Barry L. Kessler, an accountant, violated antifraud provisions of the Securities Exchange Act of 1934 by recommending to his clients and others the purchase of orange grove investment contracts of American Agronomics Corporation ("Agronomics") without disclosing that he was paid a substantial fee for each sale consummated.[1] Without admitting or denying the allegations in the Commission's complaint, Kessler consented to entry of a permanent injunction in that action enjoining him from fraudulent conduct in connection with the purchase and sale of securities of Agronomics or any other issuer.[2]

Having been advised that the Commission was contemplating the institution of administrative proceedings pursuant to Rule 2(e) of its Rules of Practice, based on the allegations in the injunctive action, to determine

[1] *S.E.C. v. American Agronomics Corp., et al.,* Civil Action No. C72-331.

[2] The injunction was entered on September 14, 1972.

whether he should be temporarily or permanently denied the privilege of appearing or practicing before it as an accountant, Kessler agreed to resign from Commission practice on condition that no administrative action be brought against him. He further agreed that if he subsequently applies for readmission to such practice, the allegations in the injunctive action shall, for purposes of any such application only, be deemed proven.

After due consideration, and upon the recommendation of its staff, the Commission determined to accept Kessler's resignation from Commission practice.

Accordingly, IT IS ORDERED that the resignation of Barry L. Kessler from appearing or practicing before the Commission be, and it hereby is, accepted, and he shall no longer have the privilege of so appearing or practicing.

For the Commission, by the Office of Opinions and Review, pursuant to delegated authority.

RONALD F. HUNT
Secretary

RELEASE NO. 130
September 29, 1972

SECURITIES ACT OF 1933
Release No. 5312

SECURITIES EXCHANGE ACT OF 1934
Release No. 9798

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 17712

INVESTMENT COMPANY ACT OF 1940
Release No. 7395

Pooling-of-Interests Accounting

In recent months, the Commission has noted an increasing number of business combinations which appear to meet the individual requirements for pooling-of-interests accounting set forth in Accounting Principles Board Opinion No. 16 but which do not conform with the overriding thrust of that Opinion which requires that a combination represent a sharing of rights and risks among constituent stockholder groups if it is to be a pooling of interests. Paragraphs 28, 45 and 47 of that Opinion clearly provide that such a sharing of risk is an essential element in poolings, and the specific requirements set forth in paragraphs 46, 47 and 48 should certainly not be construed as a formula which, if followed with precision, may be used to overcome an essential concept which underlies the entire Opinion. Despite the clarity of the Opinion in articulating the need for a sharing of risk, a number of registrants and their auditors have proposed to account for combinations which did not meet this basic requirement as poolings.

Accordingly, the Commission has concluded that any confusion regarding this matter should be laid to rest. It is the Commission's understanding that the Accounting Principles Board has authorized its staff to issue an interpretation providing that a business combination should be accounted for as a purchase if its consummation is contingent upon the purchase by a third party of any of the common stocks to be issued. Including such a contingency in the arrangement of the combination, either explicitly or by intent, would be considered a financial arrangement which is precluded in a pooling under Opinion 16.

The Commission endorses this interpretation. Recent questions by registrants indicate that maximum prompt exposure should be given to this interpretation and to the Commission's policies for dealing with ques-

tions which arise under it both in the interim period during which the interpretation is being assimilated by the financial community and on a continuing basis thereafter.

As a matter of policy, the Commission believes that it is unwise to set forth absolute rules in such an accounting matter which will be followed regardless of all other factual situations which may surround a particular transaction. To do so would be to encourage the application of form over substance. Nevertheless, it appears reasonable for the Commission to establish guidelines which it will use in making determinations as to disposition of various individual cases brought before it and to make these guidelines known to registrants and independent public accountants.

The Commission will henceforth consider that the risk sharing required for the applicability of pooling-of-interests accounting will have occurred if no affiliate of either company in the business combination sells or in any other way reduces his risk relative to any common shares received in the business combination until such time as financial results covering at least 30 days of post merger combined operations have been published. This would include all sales whether private or public. Publication of combined financial results can take the form of a post-effective amendment, a Form 10-Q or 8-K filing, the issuance of a quarterly earnings report, or any other public issuance which includes combined sales and net income.[1]

[1] This paragraph reflects amendment in Accounting Series Release No. 135 (January 5, 1973.)

This release is not intended to restrict sale of stock at the option of the stockholders subsequent to the pooling as long as a sharing of risks for the period of time indicated above has taken place. An arrangement to register shares subsequent to the combination would therefore not bar pooling. However, an agreement which requires sale of shares after such a period would preclude pooling treatment as would any agreement to reduce the risk borne by the stockholders subsequent to the transaction.

During an interim period of 75 days while this release and interpretation are being assimilated and where transactions previously negotiated are being filed with the Commission, it seems reasonable to apply a less rigorous risk-sharing test while at the same time recognizing that in the Commission's general view a transaction in which no risk is shared is not appropriately treated as a pooling. During this interim period, therefore, the Commission will raise no questions as to the appropriateness of pooling accounting in transactions where at least 25% of the stock issued in the pooling is retained at risk by shareholders of the pooled company and where effective date of any registration statement covering sale of the stock to be sold is subsequent to the date the combination is consummated.

By the Commission.

RONALD F. HUNT
Secretary

RELEASE NO. 131

October 19, 1972

Order accepting resignation from Commission practice in the Matter of Robert Trivison. (Rules of Practice—Rule 2(e)).

Robert Trivison, an accountant, has submitted an offer to resign from practice before the Commission. Having been advised by the Commission that it was contemplating the institution of administrative proceedings pursuant to Rule 2(e) of its Rules of Practice, based on the allegations in a pending injunction action,[1] to determine whether he should be temporarily or permanently denied the privilege of appearing or practicing before it,

[1] *S.E.C.* v. *American Agronomics Corp., et al.,* Civil Action No. C72-331 (N.E.D. Ohio).

Trivison agreed to resign on condition that no administrative action be brought against him, and that, if his offer of resignation were accepted, he would, without admitting or denying the allegations in the injunctive action, consent to a permanent injunction therein.[2]

Trivison further agreed that if he subsequently applies for readmission to Commission practice, the allegations in the injunctive action shall, for purposes of any such application only, be deemed proven. Those allegations charged that Trivison violated antifraud provisions of the Securities Exchange Act of 1934 by recommending to his clients and others the purchase of orange grove investment contracts of American Agronomics Corporation without disclosing that he was paid a substantial fee for each sale consummated.

[2] The injunction, enjoining Trivison from fraudulent conduct in connection with the purchase or sale of securities of American Agronomics Corporation or any other issuer, was entered on September 1, 1972.

After due consideration, and upon the recommendation of its staff, the Commission determined to accept Trivison's resignation from Commission practice.

Accordingly, IT IS ORDERED that the resignation of Robert Trivison from appearing or practicing before the Commission be, and it hereby is, accepted, and he shall no longer have the privilege of so appearing or practicing.

For the Commission, by the Office of Opinions and Review, pursuant to delegated authority.

RONALD F. HUNT
Secretary

RELEASE NO. 132
November 17, 1972

SECURITIES ACT OF 1933
Release No. 5333

SECURITIES EXCHANGE ACT OF 1934
Release No. 9867

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 17772

Reporting of Leases in Financial Statements of Lessees

It has recently come to the Commission's attention that some confusion exists as to the proper accounting treatment to be followed by a lessee in certain lease transactions. These are transactions in which a lessor is created with no real economic substance other than to serve a conduit by which debt financing can be obtained by the "lessee." The cases which have called this practice to our attention have been arrangements by which a nuclear fuel core is financed by a public utility, but the principle is a general one.

Lease accounting principles are presently set forth in Accounting Principles Board Opinion No. 5 issued in 1964. The thrust of this opinion provides that when a lease is equivalent to an installment purchase, it should be accounted for as a purchase. The opinion also provides that "in such cases, the substance of the arrangement, rather than its legal form, should determine the accounting treatment."

The opinion deals (in paragraph 12) with the situation in which a lessor without independent economic substance exists:

> "In cases where the lessee and the lessor are related, . . . a lease should be recorded as a purchase if a primary purpose of ownership of the property by the lessor is to lease it to the lessee and (1) the lease payments are pledged to secure the debts of the lessor or (2) the lessee is able, directly or indirectly, to control or influence significantly the actions of the lessor with

respect to the lease. The following illustrate situations in which these conditions are frequently present:

* * * * *

c. The lessor has been created, directly or indirectly, by the lessee and is substantially dependent on the lessee for its operations."

It is apparent from the overall thrust of the opinion and the frequent use of the phrase "directly or indirectly" that the relationship described between lessor and lessee need not be one of equity ownership. When a lessor is created at the direction of the lessee and exists as an economic entity because of the lease agreement entered into with the lessee, there can be no question that the lessor and the lessee "are related."

Accordingly, the Commission reaffirms that when lease transactions are entered into with lessors without material independent economic substance, the transaction should be accounted for as a purchase in accordance with the procedures described in Accounting Principles Board Opinion No. 5.

Because many questions have come up in regard to lease accounting, the Commission has urged that the new Financial Accounting Standards Board place this item high on its agenda for consideration early in 1973.

RELEASE NO. 135*

January 5, 1973

SECURITIES ACT OF 1933
Release No. 5348

SECURITIES EXCHANGE ACT OF 1934
Release No. 9927

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 17841

INVESTMENT COMPANY ACT OF 1940
Release No. 7606

Revised Guidelines for the Application of Accounting Series Release No. 130

RELEASE NO. 136*

January 11, 1973

SECURITIES ACT OF 1933
Release No. 5351

SECURITIES EXCHANGE ACT OF 1934
Release No. 9937

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 17854

INVESTMENT COMPANY ACT OF 1940
Release No. 7616

Notice of Adoption of Amendment to Regulation S-X Deferring Effective Date of Rule 5-02-1 as it Relates to Disclosure of Compensating Balances

* Text of release omitted.

RELEASE NO. 138

January 12, 1973

SECURITIES ACT OF 1933
Release No. 5354

SECURITIES EXCHANGE ACT OF 1934
Release No. 9944

Notice of Adoption of Amendments to Forms 8-K, 10-K, 12-K, S-1, S-7, S-8, S-9, S-11, 10 and 12 Requiring Increased Disclosure of Unusual Charges and Credits to Income

The Securities and Exchange Commission today adopted amendments to its registration and reporting forms to require more detailed and timely reporting, and timely review by independent accountants of extraordinary or material unusual charges and credits to income or material provisions for losses effected by registrants. Proposals to amend these forms, as well as Forms 7-Q and 10-Q, for these purposes were published for comment in Securities Act Release No. 5313 (Securities Exchange Act Release No. 9801) on October 2, 1972. Form 8-K is the form for reporting certain specified material events and transactions pursuant to Sections 13 and 15(d) of the Securities Exchange Act of 1934 (Exchange Act); Forms 10-K and 12-K are the forms for annual reports pursuant to those sections of the Exchange Act; Forms S-1, S-7, S-8, S-9, and S-11 are forms for registration of securities pursuant to the Securities Act of 1933; and Forms 10 and 12 are forms for registration of securities pursuant to the Exchange Act.

The Commission noted when it proposed amendments to these forms that it had observed an increasing number of large charges to income which often appeared without warning and were not generally understood by investors. The Commission is concerned that this trend seems to have accelerated in recent months. While many of such charges result from an identifiable event, many also appear to be made on the basis of a discretionary decision to dispose of marginal facilities or operations or to write off deferred development or excess production costs. In the latter situations, where facilities or operations gradually deteriorate or the outlook for a contract or program gradually worsens to the point where a write-off is deemed necessary, registrants have an obligation to forewarn public investors of the deteriorating conditions which unless reversed may result in a subsequent write-off. This includes an obligation to provide information regarding the magnitude of exposure to loss.

The Commission, therefore, reiterates its view that registrants should make special efforts to recognize incipient problems that might lead to such charges and to identify them clearly at the earliest possible time in financial statements and other forms of public disclosure, including public reports filed with the Commission, so that public investors may recognize the risks involved. In this connection, registrants should consider disclosure of the investment involved in divisions operating at a loss; the undepreciated cost of plant and equipment currently considered to be obsolete or of marginal utility; the extent of deferred research and development costs incurred in connection with products whose success is not reasonably assured; and other similar items where significant uncertainties exist as to realization.

The Commission has previously urged more comprehensive disclosure of progress and problems encountered in defense and other long-term contracts which may also give rise to major charges against income (Securities Act Release No. 5263 dated June 22, 1972) and has urged greater diligence in the release of quarterly and other interim reports of operations (Securities Exchange Act Release No. 9559 dated April 5, 1972).

In addition to disclosure of incipient problems, the Commission believes that substantial additional disclosure in regard to extraordinary items and material unusual charges and credits to income or major provisions for loss is necessary to enable public

investors to assess the impact of such items. This would include transactions that are classified as extraordinary items under generally accepted accounting principles and other unusual or nonrecurring material transactions or provisions for loss, such as (but not restricted to) material write-downs of inventories, receivables, or deferred research and development costs, provisions for loss on major long-term contracts or purchase commitments, and losses on disposition of assets or business segments. The release of October 2 (33-5313 and 34-9801) contained proposals for such disclosure. The comments received on these proposals have been given careful consideration in determining the amendments to adopt.

The Commission has determined not to adopt the proposed amendment calling for pro forma statements to reflect allocation of charges and credits to prior years since, on the basis of comments received, it concluded that the proposed pro forma disclosure might leave the improper implication that past historical statements were in error as well as imposing substantial clerical burdens on registrants. The amendments adopted herein call for disclosure of the years in which the costs being included in the charge were or are expected to be incurred and the amount of cost in each year by major category of cost.

The Commission has further determined not to adopt the proposed amendments to Forms 7-Q and 10-Q and other related amendments which would have required an estimate of losses by quarters and a subsequent quarterly reconciliation of reserves provided. Comments indicated that quarterly estimates and reconciliations would be difficult to make within acceptable limits of accuracy, would not supply significant data for investors, and would impose a clerical burden on registrants. The amendments adopted herein require an estimate of losses by year and a subsequent annual explanation of differences between estimated and actual amounts and a reconciliation of any reserve provided.

In addition, the Commission has determined to omit the definition of "material" contained in the proposed note to Item 10(a) of Form 8-K. Comments indicated that a definition which relates materiality to a criterion based on separate reporting of an item to stockholders might have the effect of discouraging such disclosure rather than improving the quality thereof. Materiality, therefore, must be considered within the context of the definition contained in Rule 1-02 of Regulation S-X.

(The text of the amendments of Forms 10-K, 12-K, S-1, S-7, S-8, S-9, S-11, 10 and 12 is omitted.)

A. Form 8-K

I. The caption of Item 10 and paragraph (a) have been amended as follows:

Item 10. Extraordinary Item Charges and Credits, Other Material Charges and Credits to Income of an Unusual Nature, Material Provisions for Loss, and Restatements of Capital Share Account.

(a) If there have been any extraordinary item charges or credits, any other material charges or credits to income of an unusual nature, or any material provisions for loss, the following shall be furnished for each such charge, credit, or provision:

(1) The date of the registrant's determination to make the charge, credit, or provision;

(2) A statement of the reasons for making the charge, credit, or provision;

(3) An analysis of the components (in dollar amounts) of the charge, credit, or provision, which includes

(i) A description of the various types of items written down or off;

(ii) A description of any provision for losses on liquidation of assets or for other losses including a detailed schedule showing the components of any losses provided for, which schedule shows the amount of administrative and fixed costs, if any, allocated to the loss;

(iii) A description of any estimated recoveries or costs netted against the charge or credit;

(4) A statement setting forth the years in which costs being reflected in the charge

(or net credit) being described were or are expected to be incurred and the amount of cost for each year by major category (e.g., fixed assets, research and development costs, operating losses);

(5) A statement setting forth the estimated amount of net cash outlays (or inflows) associated with the charge (or credit) in the year the charge (or credit) is made and in each subsequent year in which such estimate of the cash amount differs from the amount of total costs stated in part (4) for that year;

(6) A description of the accounting principles or practices followed and any changes therein or in the methods of applying such principles or practices which was made in connection with the transaction; and

(7) A report from the registrant's independent accountants in which they state that they have read the description in the Form 8-K of the facts set forth therein and of the accounting principles applied and whether they believe that on the basis of the facts so set forth that such accounting principles are fairly applied in conformity with generally accepted accounting principles or, if not, the respects in which they believe the principles do not conform to generally accepted accounting principles.

II. The following new instruction 8 has been added under *EXHIBITS* of Form 8-K.

8. Reports from the independent accountants furnished pursuant to Item 10.

* * * * *

The amendments are adopted pursuant to Sections 6, 7, 8, 10 and 19(a) of the Securities Act of 1933 and Sections 13, 15(d) and 23(a) of the Securities Exchange Act of 1934. The amendments shall be effective with respect to reports on Form 8-K and registration statements on Forms S-1, S-7, S-8, S-9, S-11, 10 and 12, and with respect to annual reports on Forms 10-K and 12-K filed on or after February 28, 1973.

By the Commission.

RONALD F. HUNT
Secretary

RELEASE NO. 139

January 17, 1973

Order accepting resignation from Commission practice in the Matter of Ralph Duckworth. (Rules of Practice—Rule 2(e))

Following the entry of an injunction permanently enjoining Ralph Duckworth, an accountant, from violating the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder,[1] he submitted an offer to resign from appearing or practicing before the Commission in settlement of any possible administrative proceeding based on the injunction or the activities involved. The injunction, which was issued with Duckworth's consent and without his admitting or denying the allegations of the Commission's complaint, enjoined him in connection with the purchase or sale of the securities of American Agronomics Corporation or any other issuer from engaging in certain fraudulent activities including recommending the purchase of securities without disclosing his receipt of compensation with respect to each such purchase consummated.

Duckworth represented that he had never practiced before the Commission, and he agreed that, should he apply for reinstatement of the privilege of appearing or practicing before the Commission pursuant to Rule 2(e) of the Commission's Rules of Practice, the allegations in the injunctive action may

[1] *S.E.C.* v. *American Agronomics Corp., et al.*, Civil Action No. C72-331 (N.D. Ohio, August 8, 1972).

be deemed proven only for purposes of such application.

After due consideration, and upon the recommendation of its staff, the Commission determined to accept Duckworth's resignation from Commission practice.

Accordingly, IT IS ORDERED that the resignation of Ralph Duckworth from appearing or practicing before the Commission be, and it hereby is, accepted, and he shall no longer have the privilege of so appearing or practicing.

For the Commission, by the Office of Opinions and Review, pursuant to delegated authority.

RONALD F. HUNT
Secretary

RELEASE NO. 141
February 15, 1973

SECURITIES ACT OF 1933
Release No. 5373

SECURITIES EXCHANGE ACT OF 1934
Release No. 10006

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 17882

INVESTMENT COMPANY ACT OF 1940
Release No. 7673

Interpretations and Minor Amendments Applicable to Certain Revisions of Regulation S-X

The Commission adopted amendments to Regulation S-X in Accounting Series Release Nos. 125 (June 23, 1972) and 128 (September 20, 1972) in which various sections of the Regulation were extensively revised. The amendments were made effective with respect to financial statements for periods ending on or after December 31, 1972.*

Subsequent to the issuance of the releases a number of inquiries have been received by the staff regarding the meaning or interpretation of new terms, instructions or rules in the revised regulations. Interpretations of such items on the basis of the questions raised are given in Part A of this release. In Part B, a number of minor amendments have been adopted to correct errors of a typographical or editorial nature which have been noted or to clarify certain items.

* The effective date of the requirement for compensating balance disclosure was deferred to cover periods beginning on or after December 30, 1972 (Accounting Series Release No. 136).

PART A—INTERPRETATIONS

General

Financial statements, notes and schedules filed for fiscal periods ending before December 31, 1972, the effective date specified in Accounting Series Release Nos. 125 and 128, need not, but may if a registrant prefers, be conformed to the amendments to Regulation S-X adopted in those releases.

In instances where, because of the new test for a significant subsidiary, the separate financial statements of additional subsidiaries are required in filings which had not been required in prior filings on the basis of the old tests of significance, the requirements in the filing forms for audited financial statements of such subsidiaries for earlier periods will be applicable. However, a request for waiver of the audit requirement for the financial statements for the earlier periods will be considered if such requirement is impracticable or would cause undue hardship.

Rule 1-02. Definitions of Terms Used in Regulation S-X.

In making the tests for significance called for in the definition of "significant subsidiary" in this rule the proportionate share of the assets or sales of the subsidiary after intercompany eliminations would be compared to the consolidated assets or sales after normal intercompany eliminations but without elimination of the investments and advances to subsidiaries and 50 percent or less owned persons. With respect to application of the test to unconsolidated subsidiaries or other persons who also have equity interests in other subsidiaries or other persons, the proportionate share of the assets (in lieu of the investment and advances) or of sales of such other subsidiary or other persons should not be added to the assets or sales of the unconsolidated subsidiary or 50 percent or less owned person for the purpose of this test.

Rule 3-16(i). Commitments and contingent liabilities.

The disclosure regarding noncancelable leases specified in part (2) of this rule may be limited to such leases which have a noncancelable term of one year or longer.

Rules 3-16(j) and (n).

The term "key employees" used in those rules is interpreted in the sense of "selected employees or the employees to which a bonus plan or plan for the sale of stock is applicable when such plan is not available to all employees on a pro rata basis.

Rule 3-16(o). Income tax expense.

With regard to the separate disclosure of other income taxes specified in this rule, state and foreign income taxes should be reported separately if either item amounts to five percent of the component.

Rule 4-03. Group Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons.

Under this rule, significant majority-owned unconsolidated subsidiaries may not be combined with 50 percent or less owned persons and significant 50 percent or less owned persons may not be combined with majority-owned unconsolidated subsidiaries. However, if all such persons are not significant individually or as a group, they may be combined in one statement.

Rule 4-07. Consolidation of Financial Statements of a Registrant and Its Subsidiaries Engaged in Diverse Financial Activities.

With regard to the separate audited financial statements for each significant financial subsidiary or each significant group of financial subsidiaries required under part (a) of this rule, different types of insurance companies (e.g., life; fire and casualty) may not be considered together as one group of financial subsidiaries.

With regard to whether specific subsidiaries are financial or nonfinancial activities for purposes of part (b) of this rule, the circumstances in each case would have to be considered. For example, it is considered that a leasing subsidiary with both financing and nonfinancing types of leases is a financial activity; an investment banking subsidiary or a broker-dealer subsidiary is a financial activity; and a real estate subsidiary whose primary business is holding mortgage loans would be considered a financial activity, while such subsidiary whose primary business is constructing homes or developing land would be a nonfinancial activity. Other examples of nonfinancial activities are subsidiaries which sell mutual fund securities or are advisers to mutual funds or to real estate companies which are not related to the parent or its subsidiaries.

In the determination of whether an activity is principally for the benefit of the operations of the major group as specified in part (b) of this rule, if 50 percent or more of the activity benefits or supports the major group all of the activity would be so classified.

Rule 5-02-6. Inventories.

In the determination of replacement or current cost for the purpose of disclosing the excess of that amount over the stated LIFO value, any inventory method may be used (such as FIFO or average cost) which derives a figure approximating current cost.

Rule 5-02-39. Other stockholders' equity.

In providing the disclosure regarding the undistributed earnings of unconsolidated

subsidiaries and 50 percent or less owned persons as specified in part (b) of this rule, the amount to be disclosed would be the difference between the cumulative equity in earnings of the unconsolidated persons reflected in consolidated retained earnings and the cumulative dividends received from such persons by the consolidated group. Dividends paid to shareholders of the consolidated group should not be considered in the calculation since they are not relevant to the undistributed earnings of such persons.

Rule 9-05. Financial Statements and Schedules of Banks.

When Schedule VIII, specified in part (b)(4) of this rule, is filed with the consolidated financial statements of a registrant bank holding company, the directors, officers and principal holders of equity securities of the registrant and its affiliates shall be considered as persons in those relationships with the registrant bank holding company and each bank and other affiliate, and the amounts to be reported shall be aggregate indebtedness of each of those persons to all companies in the consolidated group. Write-offs of any such indebtedness during the period being reported on shall be separately disclosed. Information need not be reported concerning indebtedness to the consolidated group from an otherwise unaffiliated person in which one or more of the persons in the categories specified above are directors, officers or principal holders of equity securities of the otherwise unaffiliated persons or its affiliates.

In connection with unconsolidated financial statements of a parent bank holding company, the schedule requirements of Rule 5-04 are applicable and the schedule prescribed by Rule 12-03 shall be filed.

Rule 12-16. Supplementary Income Statement Information.

The totals shown in this schedule should be the amounts described by each caption which are included in the income statement for the period covered.

The rents applicable to leased personal property to be included under Item 5 of Rule 12-16, in accordance with Instruction 4, would be rents for personal property which is used for an extended period of time (generally more than one year) and which the company elects to rent or lease rather than to buy such as postage meters, computers and trucks. The expected period of use of the asset rather than the legal term of the lease should govern. Temporary rentals such as a daily car rental or the rental of display space at a convention would be excluded.

Instruction 5 explaining "Advertising Costs" calls for the inclusion of "all costs related to advertising the company's name, products or services in newspapers, periodicals or other advertising media." Such costs would include the indirect cost expended in support of advertising such as the cost of an advertising department, a market research group which specializes in evaluation of advertising and promotional efforts (but not all market research), a media buying department, or a graphic arts department that specializes in the preparation of advertising copy, as well as the direct costs of advertising space. In addition, the cost of "other advertising media" would generally include expenditures for preparing and mailing sales brochures and direct mail advertising materials. In cases where a company or division is primarily in the mail order business, however, the costs of preparing a catalog would be a selling cost similar to that of a salesman in most industrial concerns, and such catalog costs should not be included in "advertising costs." The cost of employing salesmen, preparing product display signs, printing price lists and standard product catalogs, and reports to stockholders should also not be considered advertising costs for purposes of this rule.

It is recognized that the distinction between advertising costs and other selling expenses is frequently not clear cut. Where the guidance set forth herein is not sufficient to enable the registrant to determine the appropriateness of including or excluding certain classifications of significant costs, disclosure of the type of costs included or excluded from the caption will be a satisfactory solution.

Under Item 8, Research and development costs, all costs charged to expense as in-

curred in the current period for the benefit of the company in these account classifications should be reported. These would include company sponsored projects of pure and practical research as well as the development of new products or services or new or better production machinery and equipment and for the improvement of existing products and services. The amortization of deferred research and development costs should not be included herein since this amount is described in Item 3 of the schedule.

PART B—CORRECTIONS, CLARIFICATIONS AND EDITORIAL CHANGES

(The text of the amendments of Rules 1-02, 3-15, 5-02-23, 5-03-17, 5-04, 9-05, 12-02, 12-04, 12-06, 12-13, 12-16, 12-42 and 12-43 of Regulation S-X is omitted.)

The amendments to Regulation S-X are adopted pursuant to authority conferred on the Securities and Exchange Commission by the Securities Act of 1933, particularly 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.

By the Commission.

RONALD F. HUNT
Secretary

RELEASE NO. 142
March 15, 1973

SECURITIES ACT OF 1933
Release No. 5377

SECURITIES EXCHANGE ACT OF 1934
Release No. 10041

Reporting Cash Flow and Other Related Data

Introduction

The Commission has recently received preliminary registration statements which include "cash flow per share" data in the narrative section of the prospectus. Use of such data has also been noted in annual reports to shareholders, particularly in the "Financial Highlights" or "President's Letter" section. These and other means of presenting financial data appear designed to decrease the credibility of conventional financial statements as a measure of business activity.

The variation in form and purposes of such data creates confusion. The term "Cash Flow" and similar formulations such as "Earnings Before Non-Cash Charges," "Adjusted Net Income," "Net Operating Income" and "Operating Funds Generated" do not have precise definitions and may mean different things to different people. In addition to this definitional problem, there are different purposes for presenting these data. One is to present an apparent alternative to net income as a measure of performance. A second is to present information about liquid or near-liquid assets provided by operations which may be available for reinvestment or distribution to shareholders.

While differing definitions and purposes are basic sources of the confusion investors and registrants are experiencing with "cash flow" data, the presentation of such data on a per share basis compounds this confusion.

Numerous questions have been received in regard to the Commission's policy in these matters. This release is being issued to outline the Commission's views.

"Cash Flow" as a Proxy for Income Measurement

One of the principal reasons given for presenting "cash flow" is that the income meas-

urement model currently prescribed by generally accepted accounting principles does not accurately reflect the economic performance of certain types of companies, typically those with substantial assets which arguably do not depreciate or require replacement. While the Commission recognizes that there are problems of income measurement for some industries, the unilateral development and presentation on an unaudited basis of various measures of performance by different companies which constitute departures from the generally understood accounting model has led to conflicting results and confusion for investors. Additionally, it is not clear that the simple omission of depreciation and other non-cash charges deducted in the computation of net income provides an appropriate alternative measure of performance for any industry either in theory or in practice. This problem was recognized by the Accounting Principles Board in Opinion No. 19 where it was noted that "the amount of working capital or cash provided from operations is not a substitute for or an improvement upon properly determined net income as a measure of results of operations. . . ."

If accounting net income computed in conformity with generally accepted accounting principles is not an accurate reflection of economic performance for a company or an industry, it is not an appropriate solution to have each company independently decide what the best measure of its performance should be and present that figure to its shareholders as Truth. This would result in many different concepts and numbers which could not be used meaningfully by investors to compare different candidates for their investment dollars.

Where the measurement of economic performance is an industry-wide problem, representatives of the industry and the accounting profession should present the problem and suggested solutions to the Financial Accounting Standards Board which is the body charged with responsibility for researching and defining principles of financial measurement. Until new and uniform measurement principles are developed and approved for an industry, the presentation of measures of performance other than net income should be approached with extreme caution. Such measures should not be presented in a manner which gives them greater authority or prominence than conventionally computed earnings.

Where management believes that the existing conventional income model does not present the results of operations realistically or fully, an explanation of the reasons and a description of possible alternatives which might be used to measure results may be presented to shareholders and potential investors to supplement conventional financial data. The presentation of additional data in tabular form is also acceptable. Such tables should be accompanied by a careful explanation of the data presented. The adding together of figures derived by different measurement techniques (such as net income and cash flow) should be avoided as should per share data relating to measures other than net income (see discussion below). In addition, when various measurement models are used for different lines of business, there should be a consistent application of such models to all similar segments of the firm's operations. Also, results for all segments included in consolidated statements of net income should be included in any tabular or summary presentation.

Annual reports to shareholders as well as filings with the Commission should include explanations and data as discussed above whenever measurement models other than conventionally computed income are used. Such additional information and data would typically be presented in the "Financial Highlights," the "President's Letter," or the text of the report and should not be presented without also presenting net income. Terms such as "Net Operating Income" which leave the impression that a figure other than net income is really income should not be used.

In cases where a measurement problem exists for an individual company rather than in an entire industry, a solution already exists in the procedures of the accounting profession. Under the newly adopted Code of Ethics of the American Institute of CPA's, an auditor is permitted to render an opinion approving statements prepared even though

they deviate from the principles adopted by the Accounting Principles Board (or its successor body) if he believes and can support the assertion that due to unusual circumstances the financial statements would otherwise be misleading. Under such circumstances, full disclosure must be made by both company and auditor, and the basic statements must be prepared in accordance with the principles determined to present operating results most meaningfully. In such cases, the staff of the Commission will naturally consider the circumstances which gave rise to the situation, but it will normally give great weight to the judgment of the registrants and their independent accountants.

The above discussion is designed to assist companies which believe the conventional income measurement model is unsatisfactory in providing disclosure which is useful and not misleading. This discussion is not intended to support or reject any particular new measurement model and the Commission strongly urges the accounting profession and other interested parties to consider the development of new techniques for the measurement of results in industries where the current model seems deficient.

"Cash Flow" as a Measurement of Funds Generated from Operations

A second basic reason for highlighting cash or funds generated from operations data in financial summaries is to show the liquid or near-liquid resources generated from operations which may be available for the discretionary use of management. Analysts have suggested that this is a useful measure of the ability of the entity to accept new investment opportunities, to maintain its current productive capacity by replacement of fixed assets and to make distributions to shareholders without drawing on new external sources of capital.

While presentation of "funds generated from operations" is useful, these data should be considered in the framework of a source and application of funds statement which reflects management's decisions as to the use of these funds and the external sources of capital used. The implication of a presentation which shows only the funds generated from operations portion of a funds statement is that the use of such funds is entirely at the discretion of management. In fact certain obligations (e.g., mortgage payments) may exist even if replacement of non-depreciating assets is considered unnecessary. Therefore presentation of one part of a funds statement should be avoided.

The Commission has also noted situations where investors were misled by cash distributions which were in excess of net income and were not accompanied by disclosure indicating clearly that part of the distribution represented a return of capital. To highlight this fact in cases where funds distributed exceed net income, the Commission developed the "Funds Generated and Funds Disbursed" statement in Form 7-Q which begins with the caption "Income (Loss) Before Realized Gain or Loss on Investments." From that amount the first deduction is "Cash Distributed to Shareholders." The statement then provides for adding non-cash charges and deducting debt repayments to arrive at the "Excess (Deficiency) of Funds Generated Over Distributions." This indicates whether operations generated the cash to make distributions or whether distributions are made from borrowing or other sources.

Cash flow presentations designed to reflect the liquid assets or working capital generated by the firm should be consistent with the principles outlined in this section.

Per Share Information

Many of the problems outlined above are accentuated when "cash flow" data is presented on a per share basis. Most importantly, such a presentation emphasizes the implication that cash flow is more meaningful than net income as a measure of performance, particularly when a per share figure is included in the "Financial Highlights" section of a report.

The first major problem in the presentation of cash flow per share data is that of investor understanding. Investors over many years have grown accustomed to seeing operating per share data computed only in the case of net income. Accounting

authorities have considered and largely settled the measurement problems associated with the presentation of net income on a per share basis. If other data are presented in this way, there is a danger that the investor will think that what he is seeing is the conventional accounting measure of earning power when in fact this is not the case. In a number of reports, cash flow per share data have been presented in such a manner as to lead to this inference despite the strong recommendation of the Accounting Principles Board in Opinion No. 19 that "isolated statistics of working capital or cash provided from operations, especially per share amounts, not be presented in annual reports to shareholders." Such presentations run a high risk of materially misleading investors and companies are urged to avoid this type of disclosure.

Beyond the problem of understandability is the question of relevance. The investment community generally recognizes the relevance of "earnings per share" as a measure of the historically achieved earning power of an economic entity in terms of a unit which is being bought, sold and quoted in the market place, the share of common stock. The earning power represented by that share has generally been considered a significant element in the determination of its worth. Net income, as a measure of ultimate result, may reasonably be interpreted on a per share basis since no significant claims stand between it and the common stock owner. Where there are senior equity claims, these are deducted before computing the per share figure. Dividends are similarly logically presented in terms of the individual share, as are net assets.

Significant questions as to relevance arise, however, when other data are presented on a per share basis. Sales, current assets, funds flow, total assets, cash and other similar figures cannot logically be related to the common shareholder without adjustment. These are aggregate data which are of great importance to analysts and management alike in understanding the operations of the total economic entity, but they are not items which accrue directly to the benefit of the owner of a part of the common equity. Charges and claims must be considered before the owner is benefited. To reflect such items on a per share basis may mislead the unsophisticated, since there is an implication that the shareholder is directly affected. In fact, such data are only meaningful from an operating viewpoint and not from that of an external investment unit.

Accordingly, per share data other than that relating to net income, net assets and dividends should be avoided in reporting financial results.

Conclusion

In this release, the Commission has reiterated and explained its view as expressed to individual registrants for many years that certain approaches to "cash flow" reporting may be misleading to investors. All registrants are urged to examine their reporting practices in light of the problems and guidance set forth in this release and to amend them where appropriate.

The Commission recognizes that reporting financial results cannot be a static phenomenon, and it continues to examine its views and policies to determine in what respects change is desirable. In this connection, it welcomes comments and suggestions regarding its policies from registrants and other knowledgeable parties. If any parties have comments on the views and policies set forth in this release, they should be addressed to the Chief Accountant of the Commission.

By the Commission.

RONALD F. HUNT
Secretary

RELEASE NO. 143
March 20, 1973

Findings and Order imposing remedial sanction in the Matter of Robert Lynn Burroughs.

In these proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice to determine whether Robert Lynn Burroughs, an accountant, should be temporarily or permanently denied the privilege of appearing or practicing before the Commission,[1] he submitted an offer of settlement.

Under the terms of the offer, respondent, solely for the purpose of these proceedings and without admitting or denying the allegations of the order for proceedings, consented to findings in accordance with the allegations in that order and to the entry of an order censuring him.

After due consideration of the offer of settlement and upon the recommendation of its staff, the Commission determined to accept such offer.

On the basis of the order for proceedings and the offer of settlement, it is found that:[2]

1. Respondent, an employee of a public accounting firm, participated, under the supervision of a partner in the firm, in the audit of the records of a registered broker-dealer.
2. In connection with such audit and the certification of the broker-dealer's financial statement as of September 30, 1971, which was filed with the Commission on Form X-17a-5 pursuant to Rule 17a-5 under the Securities Exchange Act of 1934, respondent failed to comply with generally accepted auditing standards and the Commission's instructions for the Form. Respondent failed to evaluate the effectiveness of the broker-dealer's existing internal controls to determine the need for extending the scope of the examination, to inquire into material poststatement events, and to obtain sufficient evidence to afford a reasonable basis for the unqualified opinion given to the broker-dealer.

Under the circumstances, it is appropriate to impose the sanction specified in respondent's offer of settlement.

Accordingly, IT IS ORDERED that Robert Lynn Burroughs be, and he hereby is, censured.

For the Commission, by the Office of Opinions and Review, pursuant to delegated authority.

RONALD F. HUNT
Secretary

[1] Rule 2(e) provides in part that the Commission may deny the privilege of appearing or practicing before it to any person who is found, after notice of and opportunity for hearing, to have engaged in unethical or improper professional conduct.

[2] The findings herein are not binding upon any other respondents named in these proceedings.

RELEASE NO. 144
May 23, 1973

Order instituting proceedings and imposing remedial sanctions in the Matter of Laventhol Krekstein Horwath & Horwath.

Laventhol Krekstein Horwath & Horwath ("LKH&H"), a partnership engaged in the practice of accounting, has submitted an offer of settlement for the purpose of disposing

of issues raised under Rule 2(e) of the Commission's Rules of Practice concerning LKH&H's right to appear and practice before the Commission, based upon the entry on May 23, 1973, of a consent judgment of permanent injunction against LKH&H in an action commenced by the Commission.[1] The Commission's complaint alleged, with respect to LKH&H, that it had participated in violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder, and Sections 206(1) and (2) of the Investment Advisers Act of 1940 ("Advisers Act"), in that, in early 1970 it was involved in the dissemination of false and misleading certified financial statements of Takara Partners, a limited partnership engaged in investment activities, and in early 1971 in the dissemination of materially false and misleading information concerning Takara's investment performance during 1970.[2] The complaint also alleged that LKH&H was not independent and was not qualified to certify the financial statements of Takara because partners or employees of LKH&H's East Brunswick, New Jersey branch office, during the period of time when they were working on the preparation of such financial statements, received payments from the general partners of Takara totalling approximately $17,000 in the guise of profits from participation in the purchase and sale of "hot issues."

LKH&H, without admitting or denying the allegations of the complaint, consented to the entry of the permanent injunction enjoining it from violating the cited provisions of the Securities Act and the Exchange Act and rule thereunder in connection with the purchase or sale of securities of Takara, and from aiding and abetting any investment adviser to Takara in violations of the cited provisions of the Advisers Act, and ordering it to adopt and maintain procedures to prevent future violations of those provisions and to take all reasonable steps to conduct its professional practice in compliance with such procedures and ordering further relief.

In view of the permanent injunction, and upon the recommendation of its staff, the Commission deems it necessary that proceedings be instituted against LKH&H pursuant to Rule 2(e) of the Commission's Rules of Practice with respect to its qualifications to appear and practice before the Commission.

Under the terms of its offer of settlement, LKH&H, without admitting or denying the allegations of the Commission's complaint in the injunctive action and solely for the purpose of settlement, consented to a finding that LKH&H has been permanently enjoined as set forth above, and to the entry of an Order:

1. Requiring LKH&H to permit an investigation, within 15 months from the date of the entry of the injunction, in order to ascertain whether it is conducting its professional practice in compliance with the standards and procedures which it is required to adopt and maintain by the terms of the injunctive decree. This investigation is to be conducted in accordance with methods and procedures generally adopted or approved by the Commission for such investigations and at the expense of LKH&H. At the option of the Commission, such investigation is to be conducted by:

   (a) A team of qualified professional accountants composed of persons selected for such purpose by the American Institute of Certified Public Accountants (AICPA); or

   (b) A team of qualified professional accountants composed of persons selected for such purpose by the Chief Accountant of the Commission: (i) from among persons designated by the AICPA, or (ii) in the event that the AICPA does not designate such persons within 12 months from the date of the injunction, from among members of the AICPA; or

[1] *S.E.C.* v. *Everest Management Corporation, et al.*, S.D.N.Y., 71 Civil 4932. See SEC Litigation Release No. 5209 (November 11, 1971).

[2] The complaint also names as respondents three individuals who were partners or employees of LKH&H, and the injunctive action is still pending against them.

(c) Members of the staff of the Commission.[3]

2. Prohibiting LKH&H, for a period of one year from the date of entry of the permanent injunction, from effecting any merger with or acquisition of any other accounting firm without first submitting to the Chief Accountant of the Commission evidence that LKH&H's procedures respecting mergers or acquisitions adopted pursuant to the injunction are being followed.
3. Prohibiting it, for a period of 30 days, commencing five days after the date hereof, from accepting or undertaking any new professional engagement which can be expected to result, within one year from the date of such engagement, in filings, submissions or certifications with or to the Commission.[4]

After due consideration, the Commission determined to accept the offer of settlenent. In arriving at this determination, the Commission considered the facts that LKH&H, in order to prevent a recurrence of the violative activity alleged, revised its supervisory and control procedures, reviewed such procedures with the Chief Accountant of the Commission and, in order o insure that these procedures are being complied with, agreed to permit the above-described investigation. Further, the Commission noted that LKH&H had never before been a respondent in an administrative proceeding instituted pursuant to Rule 2(e) of the Commission's Rules of Practice or a defendant in an injunctive action brought by the Commission. In addition, the Commission considered sworn representations made by LKH&H that no partner or employee of LKH&H, other than those located in the East Brunswick office of the firm, participated in the activities alleged in the Commission's complaint or received any direct or indirect benefit from such activities other than such as pertain to fees charged for services rendered. LKH&H represented that its East Brunswick office was acquired on February 1, 1968, through a merger with a small certified public accounting firm in that city which was merged intact into LKH&H, and that LKH&H made an inquiry into, among other things, the professional competence and reputation of that firm prior to such merger.

Accordingly, IT IS ORDERED that proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice be, and they hereby are, instituted against Laventhol Krekstein Horwath & Horwath.

IT IS FURTHER ORDERED that, subject to the terms and conditions provided in the offer of settlement as set forth above, Laventhol Krekstein Horwath & Horwath be, and it hereby is: (1) prohibited, for a period of 30 days, commencing five days after the date hereof, from accepting new professional engagements for new clients which can be expected to result, within one year from the date of such engagement, in filings, submissions or certifications with or to the Commission; (2) prohibited, for a period of one year from the date of entry of the judgment of permanent injunction, from effecting any merger with or acquisition of any other accounting firm without first submitting to the Chief Accountant of the Commission evidence that its procedures respecting mergers

[3] Pursuant to the judgment of permanent injunction, which includes similar provisions for an investigation of LKH&H, in those instances where the persons conducting the investigation are other than members of the Commission's staff, such persons shall be given a copy of that judgment and of the consent attached thereto, are to hold in confidence the fact that they are engaged in such investigation as well as all information, books, papers, records, documents or other materials obtained or utilized during the course of such investigation and relating to the clients, procedures, systems or methods of LKH&H, and shall submit their report of investigation to the Commission only, which report shall be the sole property of the Commission. It is understood that LKH&H may have access to such a report on the premises of the Commission.

[4] For the purpose of this Order, "new professional engagement" is defined to mean an engagement by clients, which include any persons or corporations subject to the disclosure requirements of the Securities Act, the Exchange Act, the Investment Company Act, the Advisers Act and the Trust Indenture Act of 1939, who, five days after the effective date of this Order, do not engage the services of LKH&H. LKH&H's right or obligation to perform its normal functions and services for existing clients (including activities requiring filings, submissions or certifications with or to the Commission), shall not be affected during this period.

or acquisitions are being followed; and (3) required, within fifteen months from the date of entry of that injunction, to permit an investigation to ascertain whether it is conducting its professional practice in compliance with the standards and procedures which it is required to adopt and maintain by the terms of said injunction.

For the Commission, by the Office of Opinions and Review, pursuant to delegated authority.

RONALD F. HUNT
Secretary

RELEASE NO. 146
August 24, 1973

SECURITIES ACT OF 1933
Release No. 5416

SECURITIES EXCHANGE ACT OF 1934
Release No. 10363

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 18067

INVESTMENT COMPANY ACT OF 1940
Release No. 7955

Effect of Treasury Stock Transactions on Accounting for Business Combinations[1]

In August 1970 the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA) issued Opinion No. 16, "Business Combinations," which identifies certain conditions which must be present (or in some cases absent) if a business combination is to be accounted for as a pooling of interests. Two of these conditions, which are set forth in paragraphs 47-c and 47-d, include provisions related to the reacquisition of voting common stock within two years prior to initiation and between initiation and consummation of a business combination which is planned to be accounted for by the pooling-of-interests method. The Commission has observed that these provisions have been subject to varying interpretations in practice, and has concluded that certain of these interpretations are not compatible with concepts underlying the Opinion. Accordingly, this release sets forth the Commission's conclusions as to certain problems relating to the effect of treasury stock transactions on accounting for business combinations.

When cash or other assets are used or liabilities are incurred to effect a business combination, APB Opinion No. 16 concludes that the combination should be accounted for as a purchase. This concept might be circumvented if cash or other assets were used or liabilities were incurred to reacquire common shares and common shares were then exchanged to consummate the combination. Therefore, for the pooling-of-interests method to apply, paragraph 47-c of the Opinion requires that "none of the combining companies changes the equity interest of the voting common stock in contemplation of effecting the combination either within two years before the plan of combination is initiated or between the dates the combination is initiated and consummated; . . . ." Further, paragraph 47-d stipulates that "each of the combining companies [may reacquire] shares of voting common stock only for purposes other than business combinations. . . ."

In some cases it is difficult to determine the purposes of treasury stock acquisitions. An AICPA Accounting Interpretation of Opinion No. 16 (No. 20 issued September 1971) states: "In the absence of persuasive evidence to the contrary, however, it should be presumed that all acquisitions of treasury

[1] See also Release No. 146A (April 11, 1974) Statement of Policy and Interpretations in Regard to Accounting Series Release No. 146.

stock during the two years preceding the date a plan of combination is initiated (or from October 31, 1970 to the date of initiation if that period is less than two years) and between initiation and consummation were made in contemplation of effecting business combinations to be accounted for as a pooling of interests. Thus, lacking such evidence, this combination would be accounted for by the purchase method regardless of whether treasury stock or unissued shares or both are issued in the combination." The Commission believes that this presumption and conclusion should be followed.

In determining the purposes of treasury stock acquisitions, it is ordinarily appropriate to focus on the intended subsequent distribution of common shares rather than on the business reasons for acquiring treasury shares. For example, shares may be reacquired because management believes the company is overcapitalized or considers that "the price is right," but such reasons do not overcome the presumption that they were acquired in contemplation of effecting business combinations to be accounted for as poolings of interests. On the other hand, the presumption may be overcome when shares are acquired for a specific use unrelated to business combinations such as stock option or purchase plans or stock dividends, are associated with a combination accounted for as a purchase, or are acquired to resolve an existing contingent share agreement. However, the mere assertion that common shares are reacquired for such purposes, even where the assertion is formalized by action of the board of directors reserving the treasury shares, does not provide persuasive evidence that they were not reacquired in contemplation of pooling-of-interests combinations. If a resolution of the board of directors or other statement of intent were sufficient to provide persuasive contrary evidence, the restrictions on treasury stock acquisitions would be totally ineffective. Accordingly, while a board resolution made prior to acquisition of treasury shares may be useful evidence as to corporate intent, reference also must be made to the actual or probable issuance of shares for purposes unrelated to pooling-of-interests business combinations.

When treasury shares are acquired during a period beginning two years prior to initiation and ending at the date of consummation of a business combination to be accounted for as a pooling of interests (hereinafter referred to as the "restricted period") the issuance of an equivalent number of shares prior to the date of consummation would generally provide persuasive evidence that the treasury shares were not acquired in contemplation of the combination. The shares issued may be treasury shares or previously unissued shares since, with regard to the equity interests of the common shareholders, there is no substantive difference between the two. Thus, a company might "cure" a condition which would preclude pooling-of-interests accounting by selling common shares prior to consummation of the combination. The "cure" could not be effected by merely retiring treasury shares.

Paragraph 47-d of APB Opinion No. 16 includes the statement that "treasury stock acquired for purposes other than business combinations includes shares for stock option and compensation plans and other recurring distributions provided a systematic pattern of reacquisitions is established at least two years before the plan of combination is initiated." Further, "a systematic pattern of reacquisitions may be established for less than two years if it coincides with the adoption of a new stock option or compensation plan." In AICPA Accounting Interpretation No. 20 of Opinion No. 16, no reference is made to a systematic pattern of reacquisition, and some accountants have asserted that this test has been effectively superseded. The Commission does not accept this assertion. Accordingly, the Commission concludes that treasury shares acquired in the restricted period for recurring distributions should be considered "tainted" unless they are acquired in a systematic pattern of reacquisitions established at least two years before the plan of combination is initiated (or coincidentally with the adoption of a new stock option or compensation plan) and there is reasonable expectation that shares will be issued for such purposes.

A systematic pattern of reacquisitions might be demonstrated by the reacquisition

of a specified number of shares in successive time periods, e.g., 1,000 shares per month. A systematic pattern might also be demonstrated where, pursuant to a formal reacquisition plan, shares are acquired based on specified criteria such as the market price of the stock and cash availability. The criteria of the reacquisition plan must be sufficiently explicit so that the pattern of reacquisitions may be objectively compared to the plan. Unanticipated interruptions caused by legal constraints on a company's ability to reacquire shares would not upset an otherwise systematic pattern of reacquisitions.

The determination of whether there is reasonable expectation that shares will be issued for the stated purposes of acquiring the shares is a matter of judgment. Generally, there would appear to be such reasonable expectation where the following circumstances exist at the time a reacquisition plan is adopted or shares are reacquired:

1. As to stock option plans, warrants or convertible securities, the quoted price of the common shares is not less than 75 percent of the exercise or conversion price.
2. As to stock purchase or bonus plans or stock dividends, either (a) shares are reacquired to fulfill existing commitments or dividends declared or (b) based on a pattern of issuing shares for such purposes in the prior two years, the shares are reacquired to fulfill anticipated requirements in the succeeding year.

A systematic pattern of reacquisitions test would not apply to treasury shares acquired for issuance in a specific "purchase" business combination or to resolve an existing contingent share agreement from a prior business combination, as these issuances would not be regarded as recurring distributions. Thus, shares acquired and reserved for these purposes at the date a pooling-of-interests business combination is consummated would not be regarded as "tainted" when, based on current negotiations, presently existing earnings levels or market price of shares, etc., there is reasonable expectation that shares will be issued for the stated purposes.

APB Opinion No. 16 does not discuss treasury share acquisitions subsequent to consummation of a business combination. In specific fact situations, subsequent reacquisitions may be so closely related to the prior combination that they should be considered part of the combination plan. Thus significant reacquisitions closely following a combination which otherwise qualifies as a pooling of interests may invalidate the applicability of that method. Conversely, significant reacquisitions following a combination accounted for as a purchase might be associated with that purchase and would not adversely affect subsequent pooling combinations.

Because of the varying interpretations which have existed in practice, and the confusion which restated financial statements may cause to investors, the Commission has concluded that the accounting for business combinations which were completed prior to the issuance of this release should not be revised. The interpretation set forth herein should be applied to all subsequent business combinations even though shares issued in these combinations may have been reacquired prior to the date of this release.

By the Commission.

RONALD F. HUNT
Secretary

RELEASE NO. 146-A

April 11, 1974

SECURITIES ACT OF 1933
Release No. 5416A

SECURITIES EXCHANGE ACT OF 1934
Release No. 10363A

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 18067A

INVESTMENT COMPANY ACT OF 1940
Release No. 7955A

Statement of Policy and Interpretations in Regard to Accounting Series Release No. 146

On October 5, 1973, in Securities Act Release No. 5429, the Commission requested comments on the substance of Accounting Series Release No. 146 and stated that until these comments were considered the Commission would accept filings from registrants using principles of accounting for business combinations in accordance with practice deemed acceptable by public accountants prior to ASR 146. Comments were received from numerous individuals, companies and groups.

Statement of Policy

After considering these comments, the Commission has concluded that the statement of policy set forth in ASR 146 represents a proper interpretation of Accounting Principles Board Opinion No. 16 which deals with accounting for business combinations. It has concluded, therefore, that it will apply this policy to all business combinations and treasury stock acquisitions which occur subsequent to the date of this release. The policy will not apply in the case of subsequent business combinations which are consummated by companies which have acquired treasury shares prior to the date of this release so long as such shares are not "tainted" under the criteria deemed acceptable by public accountants prior to the issuance of ASR 146 and so long as treasury shares tainted under ASR 146 have not been acquired subsequent to the date of this release.

Several commentators were critical of the arbitrariness of some of the criteria set out in APB Opinion No. 16. The Commission notes that the subject of business combinations accounting is now on the agenda of the Financial Accounting Standards Board, and it does not intend by adopting this release to prejudge the issues now being considered by the Board. The Commission believes that the principles set forth in APB Opinion No. 16 should not be eroded while the FASB is considering this matter.

Interpretations

A number of comment letters indicated a need for the clarification of certain aspects of ASR 146. The following interpretive comments are designed to guide registrants and their independent public accountants.

1. Purpose of acquisition of shares

In determining the purposes of treasury stock acquisitions, it is *ordinarily* appropriate to focus on the intended subsequent distribution of shares, e.g., exercise of options, conversion of preferred stock, etc. APB Opinion No. 16, AICPA Accounting Interpretation No. 20 thereof, and ASR 146 all discuss and emphasize subsequent distribution in assessing purpose of acquisition. It must be recognized, however, that circumstances may exist where a company is obliged by contract to reacquire specific shares or must reacquire specific shares to settle outstanding claims. For example, reacquisition might be made to (1) comply with an agreement to purchase stock upon the death of a stockholder, (2) settle a claim or lawsuit involving alleged misrepresentation or other acts relating to the original issuance of stock, (3) repossess stock pledged as collateral for a receivable or other contractual obligation, and (4) repurchase stock from employees pur-

suant to contractual rights or obligations. Such contracts or claims provide persuasive evidence that resulting reacquisitions were not made in contemplation of a business combination to be treated as a pooling of interests. Accordingly, unless it appears that such rights or obligations are contrived to skirt the requirements of APB Opinion No. 16, resulting reacquisitions would not result in "tainted" shares.

2. Reasonable expectation of reissuance

Many of those commenting on ASR 146 expressed concern that the guidelines relating to reasonable expectation of issuance of shares for stock option plans, warrants or convertible securities, i.e., the quoted price of common shares is not less than 75 percent of the exercise or conversion price, would be applied as an immutable rule. The Commission does not intend that this guideline be a rule. Reasonable expectation is a matter of judgment. Some of the other factors which may affect that judgment are the volatility of quoted prices, the remaining time period before conversion or exercise rights expire, and price and earnings trends. The Commission intends that the 75 percent guideline be viewed as a presumption which may be rebutted by relevant, probative evidence.

3. Acquisitions subsequent to consummation

Several of those commenting on ASR 146 were concerned about the lack of specific guidelines for determining when there are "significant reacquisitions closely following a combination." The Commission does not intend to establish an additional criterion for determining the accounting treatment of a business combination. Rather, it intended simply to caution registrants and auditors that the substance of reacquisitions closely following consummation of a combination should not be ignored. For example, if a company wished to replace untainted shares issued in a purchase by acquiring an equivalent number of shares closely following its consummation, such shares would not be tainted. Conversely, if an enterprise were to complete a pooling and a very short time thereafter repurchase an equivalent number of shares, such a purchase could affect the status of the combination and bar pooling accounting.

4. Materiality

AICPA Interpretation No. 20 of APB Opinion No. 16 indicates that the presence of "tainted" treasury shares will not preclude pooling-of-interests accounting if the number of shares is not material in relation to the total number of shares issued to effect the combination. In practice, "tainted" shares are apparently being considered together with other items under paragraph 47-b. This would limit "tainted" shares to a maximum of 10% of the total number of shares issued to effect the combination. ASR 146 does not address this matter because practice appears reasonable and reasonably uniform.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 147

October 5, 1973

SECURITIES ACT OF 1933
Release No. 5428

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 18111

SECURITIES EXCHANGE ACT OF 1934
Release No. 10421

Notice of Adoption of Amendments to Regulation S-X Requiring Improved Disclosure of Leases

A. INTRODUCTION

The Securities and Exchange Commission today adopted amendments to Rule 3-16 of Regulation S-X which require increased disclosure of lease commitments by lessees in the footnotes to financial statements filed with the Commission. The proposal to amend Regulation S-X for this purpose was published for comment in Securities Act Release No. 5401 (Securities Exchange Act Release No. 10203, Public Utility Holding Company Act Release No. 17987) on June 6, 1973. Many letters of comment have been received and considered.

In its release proposing these amendments the Commission noted that it was acting to provide adequate information to investors in regard to an important and dramatically growing form of asset acquisition and financing. It also observed that it had referred the basic problem of accounting measurement of leases to the Financial Accounting Standards Board in Accounting Series Release No. 132.

Subsequent to the date of the Commission's proposal the Accounting Principles Board of the American Institute of Certified Public Accountants reversed its previously announced decision to take no action on lease disclosure and issued its Opinion No. 31 dealing with this subject. The disclosure called for in this Opinion was substantially less than that identified in the Commission's release as needed by investors. The Commission has carefully considered the contents of Opinion No. 31 to determine whether it provided for sufficient disclosure to meet the needs of investors and has concluded that it does not, although much of the disclosure called for by the Opinion will be useful to investors. Specifically, the Commission believes that disclosure of the present value of financing leases and of the impact on net income of capitalization of such leases, neither of which is required by Opinion No. 31, are essential to investors. Accordingly, the amendments adopted herein require such disclosure. In other respects, the disclosure requirements herein have been substantially conformed to those in the Opinion so as to minimize duplication of effort by registrants. The additional disclosures required by the amendments are felt necessary to enable investors to compare meaningfully the capital and asset structures and the operating results of companies making use of different methods of acquiring and financing assets.

The Commission does not intend by adopting these amendments to prejudge the issues of lease accounting now being considered by the Financial Accounting Standards Board. At such time as that body develops improved standards of accounting for leases, the Commission expects to reconsider the disclosure requirements set forth herein.

B. INTERPRETATIONS AND COMMENTS

In the comments received on the proposal a number of questions were raised. Some of these were the basis for certain changes in the proposals, while others seemed to call for clarifying interpretive comments which did not warrant inclusion in the text of the rule. These items are discussed below in the order in which they appear in Rule 3-16(q).

1. *Renewal options*—It was pointed out by many commentators that renewal op-

tions are generally a matter of prudent business precaution by lessees and do not necessarily constitute an assured stream of financial payments to the lessor. The Commission accepted these comments and deleted renewal options from the period to be used in determining whether the lease covers 75 percent of the economic life of the property. However, if the terms of the renewal option (or the nature and useful life of any lessee-provided improvements to the leased property) are such that the probability of the option being exercised is extremely high, the renewal period may in substance be part of the noncancelable period and it should be treated as such in applying the 75 percent test. In the normal case renewal options with such terms are likely to require capitalization of leases under the building up equity test of APB Opinion No. 5.

2. *Recovery of the lessor's investment*—A number of questions were raised as to whether a lease (such as a leveraged lease), where both the lessor's recovery of investment and his return are based on the timing of tax benefits which he receives as well as lease payments, should be considered as one which meets the second criterion of a financing lease even though the lease payments alone would not have that effect. The Commission believes that such a lease does meet the test set forth since it does have terms which assure the lessor a recovery of his investment and an economic return. In measuring the lessor's investment any investment credit received by him should be treated as a reduction of investment.
3. *Fair market value of leased asset*—It was pointed out that a lessor may sometimes have acquired an asset at a date far preceding the date a lease is entered into and, accordingly, his investment may be an unrealistic basis for determining whether a financing lease is being entered into. Accordingly, the proposed rule's definition of a financing lease was changed to provide that the lessor should be assured recovery of the fair market value of the property. In the normal case the lessor's cost will represent fair market value unless a substantial time period has passed between acquisition and the date of lease except that in the case of a manufacturer-dealer lessor who meets the tests of Accounting Principles Board Opinion No. 27 for revenue recognition at the date of lease, the amount of revenue recognized may be used as a measure of fair market value.
4. *Minimum rentals*—It was pointed out that in a number of circumstances contractual minimum rentals were not a good measure of the cash inflows anticipated by the lessor. In some such cases contractual minimum rentals would not recover the lessor's investment, but contingent rentals are set at such a level that the lessor is virtually certain to recover his investment plus a fair return. While the rule adopted deals only with minimum lease commitments, registrants are urged to look at the economic substance underlying the lease agreement. In cases where a lessor's recovery is in fact but not contractually assured, present value computations may be most meaningfully made on the basis of expected rental payments. Such a practice would be consistent with the rule adopted.

   Other cases were cited where no minimum rental was called for in the lease agreement but the lessor's debt service was guaranteed by the lessee. In such a case it would normally be expected that the asset and related liability would be reflected on the balance sheet. If the total lease terms did not require capitalization, the guaranteed payments would constitute the minimum rentals required to be disclosed at their present value under this rule.
5. *Net lease payments*—Many comments were received as to the difficulty in determining amounts included in lease payments applicable to taxes, insurance, maintenance and other operating expenses. In the case of financing leases, these items are frequently ex-

plicitly set forth or excluded from lease payments. The rule as adopted provides that an estimate of such costs be subtracted if practicable. If costs cannot be reasonably estimated for some leases, it is acceptable to disclose the present value of those lease payments on a gross basis, with disclosure of the amount so computed.

6. *Interest rate implicit in the terms of the lease*—In most cases such interest rates are explicitly negotiated in financing leases. Where this is not the case, interest rates applicable to the financing of purchases of similar types of properties by the lessees at the times of entering into the lease agreements may be indicative of the interest rates implicit in the terms of the lease. Paragraphs 13 and 14 of Accounting Principles Board Opinion No. 21 also discuss this problem.

   In some cases interest rates negotiated in leasing arrangements are variable and depend upon the rates for the short-term paper used to finance leased assets. In such situations present value must be calculated through the use of an estimated rate over the life of the lease, but calculations of the current impact on net income should use the current interest rate in determining the interest charge.

7. *Materiality*—Comments indicated that the originally proposed test of materiality for present value disclosure which was based on debt and the present value of leases discriminated against the company with little or no debt. In response, the Commission has changed the test to require disclosure of present value only when the amount exceeds five percent of long-term capitalization (the sum of long-term debt, stockholders' equity and the present value of leases) or when the effect on net income of capitalizing leases is greater than three percent of average net income for the most recent three years. In calculating average net income, loss years should be excluded. If losses were incurred in each of the most recent three years, the average loss shall be used for purposes of this test.

C. AMENDMENTS TO REGULATION S-X

The following amendments to Rule 3-16 are adopted. The introductory paragraph of Rule 3-16 is amended as follows:

Insert at the end of the second sentence "and for item (q) as specified therein"

Rule 3-16(i). Commitments and contingent liabilities.—

(1) No change
(2) Is deleted
(3) Becomes (2)

Rule 3-16(q). Leased assets and lease commitments.—Any contractual arrangement which has the economic characteristics of a lease, such as a "heat supply contract" for nuclear fuel, shall be considered a lease for purposes of this rule. Leases covering oil and gas production rights and mineral and timber rights are not to be considered leases for purposes of this rule. For purposes of this rule, a financing lease is defined as a lease which, during the noncancelable lease period, either (i) covers 75 percent or more of the economic life of the property or (ii) has terms which assure the lessor a full recovery of the fair market value (which would normally be represented by his investment) of the property at the inception of the lease plus a reasonable return on the use of the assets invested subject only to limited risk in the realization of the residual interest in the property and the credit risks generally associated with secured loans. The disclosures set forth under sections (1) and (2) below are only required if gross rental expense in the most recent fiscal year exceeds one percent of consolidated revenues.

(1) Total rental expense (reduced by rentals from subleases, with disclosure of such amounts) entering into the determination of results of operations for each period for which an income statement is presented shall be disclosed. Rental payments under short-term leases for a month or less which are not expected to be renewed need not be included. Contingent rentals, such as those based upon usage or sales, shall be reported separately from the basic

or minimum rentals. Rentals on non-capitalized financing leases shall be shown separately for both categories of rentals reported.

(2) The minimum rental commitments under all noncancelable leases shall be disclosed, as of the date of the latest balance sheet presented, in the aggregate (with disclosure of the amounts applicable to noncapitalized financing leases) for (i) each of the five succeeding fiscal years; (ii) each of the next three five year periods; and (iii) the remainder as a single amount. The amounts so determined should be reduced by rentals to be received from existing noncancelable subleases (with disclosure of the amounts of such rentals). For purposes of this rule, a noncancelable lease is defined as one that has an initial or remaining term of more than one year and is noncancelable, or is cancelable only upon the occurrence of some remote contingency or upon the payment of a substantial penalty.

(3) Additional disclosures shall be made to report in general terms: (i) the basis for calculating rental payments if dependent upon factors other than the lapse of time; (ii) existence and terms of renewal or purchase options, escalation clauses, etc.; (iii) the nature and amount of related guarantees made or obligations assumed; (iv) restrictions on paying dividends, incurring additional debt, further leasing, etc.; and (v) any other information necessary to assess the effect of lease commitments upon the financial position, results of operations, and changes in financial position of the lessee.

(4) For all noncapitalized financing leases there shall be disclosed:

(i) The present values of the minimum lease commitments in the aggregate and by major categories of properties, such as real estate, aircraft, truck fleets and other equipment. Present values shall be computed by discounting net lease payments (after subtracting, if practicable, estimated, or actual amounts, if any, applicable to taxes, insurance, maintenance and other operating expenses) at the interest rate implicit in the terms of each lease at the time of entering into the lease. Such disclosure shall be made as of the date of any balance sheet presented. If the present value of the minimum lease commitments is less than five percent of the sum of long-term debt, stockholders' equity and the present value of the minimum lease commitments, and if the impact on net income required to be disclosed under (iv) below is less than three percent of the average net income for the most recent three years, this disclosure is not required.

(ii) Either the weighted average interest rate (based on present value) and range of rates or specific interest rates for all lease commitments included in the amount disclosed under (i) above.

(iii) The present value of rentals to be received from existing noncancelable subleases of property included under (i) above based on the interest rates implicit in the terms of the subleases at the times of entering into the subleases.

(iv) The impact upon net income for each period for which an income statement is presented if all noncapitalized financing leases were capitalized, related assets were amortized on a straight-line basis and interest cost was accrued on the basis of the outstanding lease liability. The amounts of amortization and interest cost included in the computation shall be separately identified. If the impact on net income is less than three percent of the average net income for the most recent three years, that fact may be stated in lieu of this disclosure. In calculating average net income, loss years should be excluded. If losses were incurred in each of the most recent three years, the average loss shall be used for purposes of this test.

* * * * *

The foregoing amendments are adopted pursuant to Sections 6, 7, 8, 10 and 19(a) of the Securities Act of 1933; Sections 12, 13, 15(d) and 23(a) of the Securities Exchange Act of 1934; and Sections 5(b), 14 and 20(a) of the Public Utility Holding Company Act of 1935. The amendments shall be effective with respect to financial statements filed with the Commission subsequent to November 30, 1973.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 148
November 13, 1973

SECURITIES ACT OF 1933
Release No. 5436

SECURITIES EXCHANGE ACT OF 1934
Release No. 10493

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 18168

INVESTMENT COMPANY ACT OF 1940
Release No. 8082

Notice of Adoption of Amendments to Regulation S-X and Related Interpretations and Guidelines Regarding Disclosure of Compensating Balances and Short-term Borrowing Arrangements

A. INTRODUCTION

One of the amendments in Accounting Series Release No. 125, adopted by the Commission on June 23, 1972, changed Rule 5-02-1 of Regulation S-X relating to cash and cash items to require disclosure of funds subject to withdrawal or usage restrictions such as compensating balances. Since then the Commission has received many inquiries concerning the form of disclosure contemplated by this amendment. Preliminary interpretations and guidelines were drawn up and exposed in November 1972 to interested groups. Based on comments received from industry and professional groups at that time, it became apparent that additional amendments to the rules were required in addition to interpretations and guidelines. Accordingly, on April 12, 1973, proposed revisions to Regulation S-X Rules 5-02-1, 5-02-25, 5-02-29, 5-02-30 and 5-02-32 along with associated interpretations and guidelines were issued for public comment. These revisions attempted to refine the requirements for, and to facilitate understanding and implementation of, disclosure relating to restricted funds and the effective cost of borrowing.

Comments Received and Revisions Adopted

The letters of comment received on the April 12, 1973, proposal raised a number of problems which have been carefully considered in developing the final requirements, interpretations and guidelines set forth in this release. The principal changes in the original proposal that have been incorporated into the current release are as follows:

1. Compensating balances are to be segregated on the balance sheet only if they are legally restricted under the terms of the arrangement while any other determinable amounts of funds which are held as compensating balances are to be disclosed in the notes to the financial statements. Segregation recognizes that certain cash balances at the balance sheet date are not readily available for discretionary use by management. Footnote disclosure emphasizes information about financial management decisions which effectively restrict the availability of cash funds over

time for alternative income yielding opportunities even though no legal restrictions exist which preclude such use.

2. The proposed requirement that the effective interest rate (including the impact of compensating balances, fees, etc.) on borrowings be disclosed has been eliminated. Comments received indicated many practical difficulties in determining such a rate and the Commission has concluded that such problems make it impractical to require this disclosure in financial statements as a general rule although the Commission encourages such disclosure when significant and practicable. The other proposed disclosure requirements relating to short-term borrowings have been adopted.

In addition to these major changes, a number of other technical changes have been made in the rules, interpretations and guidelines in response to specific substantive difficulties raised or requests for clarifications of terms used. None of these changes constitutes a substantive increase in previously proposed requirements. Specifically, Rules 5-02-1, 5-02-18, 5-02-25, 5-02-29 and 5-02-32 of Regulation S-X are amended by this release.

Reasons for Requirements

The management of liquidity is an important part of the financial management of a business entity. The maintenance of short-term borrowing capacity and the ability to obtain such funds at reasonable cost are major elements of such a management responsibility. If investors are to understand the financial policies of management, disclosure relative to these elements is necessary.

It is generally recognized in the financial community that one of the major elements in short-term financing policy is the maintenance of compensating balances supporting present and future credit from financial institutions. Such balances affect liquidity and the effective cost of borrowing. Nevertheless, disclosure of the essential details of such arrangements has been infrequent. When disclosure has occurred, the information supplied has generally been insufficient to permit statement users to deal analytically with the subject. Lack of disclosure of amounts affecting liquidity such as compensating balances has been justified on the grounds that such arrangements were generally unwritten, informal and not subject to precise quantification. None of these reasons are sufficient to support a policy of nondisclosure of situations which are recognized to be both real and significant. They do, however, support the need for rule changes and disclosure guidelines so that reasonably uniform and understood standards for disclosure can be applied. They also indicate that disclosure must be based in many circumstances on reasonable estimates and that precision of measurement cannot be expected.

The interest rate paid for short-term borrowings is also of significance in appraising the financial policies and operating results of business entities. Changes in this rate over time may have a significant impact on profitability. The relationship of the rate paid at year end to short-term rates generally being charged at that date to corporate borrowers may be indicative of the future level of interest costs to be incurred by the corporation under varying conditions in the credit markets. In addition, information as to the magnitude of such borrowings during a fiscal period should further assist investors in determining the impact of changing credit conditions on business operations.

It is recognized that disclosures such as those set forth herein are of primary interest to those users of financial statements who wish to undertake detailed analysis of corporate activities and may not be required in financial disclosure oriented solely to the needs of the average investor.

B. AMENDMENTS TO REGULATION S-X

Rules 5-02-1, 5-02-18, 5-02-25, 5-02-29 and 5-02-32 are amended as follows:

Rule 5-02-1. Cash and cash items.

State separately (a) cash on hand and unrestricted demand deposits; (b) restricted deposits held as compensating balances against short-term borrowing arrangements; (c) time deposits and certificates of deposit (excluding amounts included in (b) above or Rule 5-02-18(c) below); (d) funds subject to repayment on call or immediately after the date of

the balance sheet required to be filed; and (e) other funds, the amounts of which are known to be subject to withdrawal or usage restrictions, e.g., special purpose funds. The general terms and nature of such repayment provisions in (d) and withdrawal or usage restrictions in (e) shall be described in a note referred to herein. In cases where compensating balance arrangements exist but are not agreements which restrict the use of cash amounts shown on the balance sheet, describe these arrangements and the amounts involved, if determinable, in the notes to the financial statements. Compensating balances that are maintained under an agreement to assure future credit availability shall be separately disclosed in the notes to the financial statements along with the amount and terms of such agreement.

Rule 5-02-18. Other assets.

State separately (a) noncurrent receivables from persons specified in captions 3(a)(1) and (4) above; (b) each pension or other special fund; (c) deposits held as compensating balances against long-term borrowing arrangements; and (d) any other item not properly classed in one of the preceding asset captions which is in excess of five percent of total assets.

Rule 5-02-25. Accounts and notes payable.

(a) State separately amounts payable to (1) banks for borrowings; (2) holders of commercial paper; (3) trade creditors; (4) parents and subsidiaries; (5) other affiliates and other persons the investments in which are accounted for by the equity method; (6) underwriters, promoters, directors, officers, employees and principal holders (other than affiliates) of equity securities of the person and its affiliates; and (7) others. Exclude from (6) amounts for purchases from such person subject to usual trade terms, for ordinary travel expenses, and for other such items arising in the ordinary course of business. With respect to (4) and (5), state separately in the registrant's balance sheet the amounts which in the related consolidated balance sheet are (i) eliminated and (ii) not eliminated.

(b) The average interest rate and general terms (as well as formal provisions for the extension of the maturity) of each category of aggregate short-term borrowings (the sum of items (a)(1) and (a)(2) above) reflected on the balance sheet at the end of the period shall be disclosed along with the maximum amount of aggregate short-term borrowings outstanding at any month end (or similar accounting period) during the period. In addition, the approximate average aggregate short-term borrowings outstanding during the year and the approximate weighted average interest rate (and a brief description of the means used to compute such averages) for such aggregate short-term borrowings shall be disclosed in the notes to the financial statements.

(c) The amount and terms (including commitment fees and the conditions under which lines may be withdrawn) of unused lines of credit for short-term financing shall be disclosed, if significant, in the notes to the financial statements. The amount of these lines of credit which support a commercial paper borrowing arrangement or similar arrangements shall be separately identified.

Rule 5-02-29. Bonds, mortgages and similar debt

(a) State separately here, or in a note referred to herein, each issue or type of obligation and such information as will indicate (see Rule 3-13) (1) the general character of each type of debt including the rate of interest; (2) the date of maturity, or if maturing serially, a brief indication of the serial maturities, such as "maturing serially from 1980 to 1990"; (3) if the payment of principal or interest is contingent, an appropriate indication of such contingency; (4) a brief indication of priority; (5) if convertible, the basis; and (6) the combined aggregate amount of maturities and sinking fund requirements for all issues, each year for the five years following the date of the balance sheet. For amounts owed to affiliates, state separately in the registrant's balance sheet the amounts which in the related consolidated balance sheet are (i) eliminated and (ii) not eliminated.

(b) The amount and terms (including commitment fees and the conditions under which commitments may be withdrawn) of unused

commitments for long-term financing arrangements that would be disclosed under this rule if used shall be disclosed in the notes to the financial statements if significant.

Rule 5-02-32. Other long-term debt.

(a) Include under this caption all amounts of long-term debt not provided for under captions 29(a) and 31 above. State separately amounts payable to (1) persons specified in captions 25(a)(1), (2) and (5); and (2) others, specifying any material item. Indicate the extent that the debt is collateralized. Show here, or in a note referred to herein, the information required under caption 29.

(b) The amount and terms (including commitment fees and the conditions under which commitments may be withdrawn) of unused commitments for long-term financing arrangements not provided for under caption 29(b) above shall be disclosed in the notes to the financial statements if significant.

C. GUIDELINES AND INTERPRETATIONS

Guidelines and interpretations are presented below to facilitate understanding and application of the revised rules as amended.

Compensating Balances

Rules 5-02-1 and 5-02-18 have been expanded to require disclosure of compensating balances in order to avoid undisclosed commingling of such balances with other funds having different liquidity characteristics and bearing no determinable relationship to borrowing arrangements. Rule 5-02-1 also requires footnote disclosure distinguishing the amounts of such balances maintained under a formal agreement to assure future credit availability. While these rule changes eliminate certain inconsistencies previously noted, comments received indicate considerable uncertainty in the application of any rule relating to compensating balances. Accordingly, the Commission has concluded that the following guidelines are necessary to assist registrants.

Definition

A compensating balance is defined as that portion of any demand deposit (or any time deposit or certificate of deposit) maintained by a corporation (or by any other person on behalf of the corporation) which constitutes support for existing borrowing arrangements of the corporation (or any other person) with a lending institution. Such arrangements would include both outstanding borrowings and the assurance of future credit availability.

Form of Disclosure

The manner of disclosure cannot be specified with precision since it will vary according to the factual situation involved. These rules call for disclosure of compensating balance arrangements. Such disclosure will involve segregation on the face of the balance sheet whenever such balances are maintained under an agreement which legally restricts the use of such funds. Examples of such arrangements would include situations where a certificate of deposit must be held while a loan is outstanding or where a minimum balance must be maintained at all times while credit is extended or available. Footnote disclosure will be appropriate in other circumstances where such balances are determinable amounts although not legally restricted as to withdrawal. Footnote disclosure would be required even though the arrangement is not reduced to writing if determinable amounts (e.g., a percentage of short-term borrowings, a percentage of unused lines of credit, an agreed average balance) have been agreed upon by both parties involved. An arrangement where the balance required is expressed as an average over time would ordinarily lead to additional footnote disclosure of the average amount required to be maintained for arrangements in existence at the reporting date since the amount held at the close of the reporting period might vary significantly from the average balance held during the period and bear little relationship to the amount required to be maintained over time. If arrangements requiring maintenance of compensating balances during the year were materially greater than those at year end, that fact should be disclosed. Disclosure may

also include a statement, if appropriate, that the amounts are legally subject to withdrawal with or without sanctions, as applicable. If many banks are involved, the disclosure should summarize the most common arrangements and aggregate the compensating balances involved.

Where a company is not in compliance with a compensating balance requirement, that fact generally should be disclosed along with stated or possible sanctions whenever such possible sanctions may be immediate (not vague or unpredictable) and material.

In determining whether compensating balance arrangements are sufficiently material to require segregation or disclosure, various factors should be considered. Among these may be the relationship of the amount of the balances to total cash, total liquid assets and net working capital, and the impact of the balances on the effective cost of financing. In the usual case, reportable compensating balances which in the aggregate amount to more than 15 percent of liquid assets (current cash balances, restricted and unrestricted, plus marketable securities) would be considered to be material. Lesser amounts may be material if they have a significant impact on the cost of financing.

Compensating balances maintained by the company for the benefit of affiliates, officers, directors, principal stockholders or other similar parties may be of particular significance to investors. Separate disclosure of such balances may be required under other Commission rules and regulations even if they are not of a magnitude such that they would meet the materiality guidelines set forth above.

Measurement Problems

A number of problems arise in the process of determining the amount of compensating balances. It is recognized that precision of measurement may not be practicable, but that fact should not limit the disclosure of material arrangements since reasonable estimates can be made. Since several of the problems of measurement occur frequently, and since it is desirable that they be similarly solved to assure uniformity of practice among companies, the following guidelines have been developed to assist registrants. It is recognized that every situation cannot be anticipated, and the need for judgment on the part of registrants and their auditors cannot and should not be avoided.

1. *Minimum operating balance.*—All corporations require some minimum amount of cash on which to operate. The amount will depend upon the extent of seasonal and random fluctuations in short-term cash demand as well as management judgment regarding necessary safety factors. It has been argued that, in those cases where part of the compensating balance reflects funds that would be held anyway as a minimum operating balance, such funds should be subtracted from compensating balances since the maintenance of such a compensating balance has no incremental cost to the borrower. For purposes of these disclosure requirements, such a subtraction is not appropriate. The concept of subtraction implies that the compensating balance is of secondary importance and this is by no means apparent. It would be equally reasonable to contend that operating funds are free of cost because compensating balances must be maintained. In any event, the utilization of such amounts for compensating balances precludes the sound cash management alternative of investing available cash in highly liquid interest bearing securities. It may be desirable, however, for companies to supplement disclosure with statements regarding the dual purpose of such amounts.

2. *Float.*—The balance shown on the bank's ledgers and the company's books will differ due to delays in presentment of checks and deposits in transit. In addition, some amounts included in the bank ledger figure may include funds subject to collection which may not be considered as meeting compensating balance requirements. These factors complicate the calculation of the amount of compensating balance to be disclosed both conceptually and empirically. The compensating balance arrangements negotiated between a company and its bank are normally expressed in terms of the collected bank ledger balance, but the financial statements

are presented on the basis of the company's books. In order to make the disclosure of compensating balance amounts segregated on the balance sheet consistent with the cash amounts reflected in the financial statements, the balance figure agreed upon by the bank and the company should be adjusted if possible by the estimated "float" so that such an adjusted amount shown on the balance sheet will properly relate to company book amounts for total cash. Both the agreed upon collected balance at the bank and the adjusted balance relating to the corporation's books should be disclosed along with a brief description of the criteria used to make the adjustment. Similar adjustments and disclosure should be made for arrangements disclosed only in the footnotes if practicable and relevant to the arrangements described. A reasonable estimate of "float" based on the information management uses to manage its bank relationships will be satisfactory.

3. *Compensation for other bank services.*—Balances are maintained not only in connection with financing arrangements but also to compensate the bank for its account handling function and in some cases to pay for other services such as lock boxes and account reconcilement. Balances maintained for these purposes should not be included in the disclosed compensating balances and would not be construed as special funds per 5-02-1(e) since such funds are available for use upon payment of a service charge and would not affect the cost of borrowing. If a bank allows balances to serve both purposes, the balances should be considered as a compensating balance and should be disclosed in accordance with Rules 5-02-1 or 5-02-18 as appropriate. Supplemental disclosure by companies of the dual purpose of such amounts may be desirable.

4. *Reporting periods.*—In general, compensating balance arrangements should only be disclosed for the latest fiscal year and later interim period for which statements are presented. If the terms of the arrangements require balance sheet segregation, however, this should be reflected in all balance sheets presented. In addition, if the change in the arrangements from one period to the next is so great as to constitute a fact of unusual significance to the investor in appraising the company, the change should be disclosed.

Time Deposits and Certificates of Deposit

Rule 5-02-1 calls for separate disclosure of time deposits and certificates of deposit where not included elsewhere as part of compensating balances. Where all or a material part of such separately disclosed deposits are interest bearing, this fact along with the total interest-bearing amount should be disclosed parenthetically or in the footnotes in order to appropriately reflect cash management policies.

Special Purpose Funds

Rule 5-02-1 also requires the disclosure of "other funds, the amounts of which are known to be subject to withdrawal or usage restrictions." Restrictions on the use of funds may include contracts entered into with others or company statements of intention with regard to particular deposits. Examples of the former might be letters of credit and escrow accounts. Examples of the latter are cash balances set aside for use in a capital expenditure program or to meet a particular debt obligation when it comes due. Cash balances related to statements of intention should only be segregated when particular deposits or balances have been earmarked for such special purposes. Board approval of a capital budget calling for the expenditure of certain amounts would not be the basis for segregation unless the specific amounts of cash to be spent are identified and set aside.

Funds Maintained for Future Credit Availability

Rule 5-02-1 requires disclosure of funds maintained under an agreement for the purpose of assuring future credit availability. These funds would be included as part of compensating balances disclosed separately on the balance sheet or in the footnotes in accordance with Rule 5-02-1. This requirement contemplates separate disclosure of such amounts and the related terms for both

long- and short-term future credit availability in the notes to the financial statements. Separate disclosure provides important and useful information to the investor about policies regarding cash management and future financing.

Commercial Paper and Debt Roll-Over

Rule 5-02-25 has been expanded to provide information to the investor regarding borrowing policies and their cost. The separate statement of commercial paper outstanding is a recognition of the increasing importance of this form of short-term borrowing in corporate financial management. Commercial paper represents short-term unsecured notes issued for cash by the corporation, generally supported in whole or part by outstanding lines of credit extended by financial institutions.

Commercial paper and other short-term debt should be classified as a current liability even though the issuer's intention is to roll over such debt at its maturity. The fact that an issuer has both financial strength and a past borrowing record such that sale of new paper appears reasonably assured does not constitute a basis for long-term classification, since the power to terminate the credit remains with the creditor. Only (1) when a borrower has a noncancelable binding agreement from a creditor to refinance the paper (or other short-term debt) and (2) when the refinancing extends the maturity date beyond one year or the current operating cycle of the business (whichever is longer) and (3) when the borrower's intention is to exercise this right, should borrowings under such an agreement be shown as a long-term liability (along with disclosure of the above facts).[1]

Unused Lines of Credit or Commitments

Rules 5-02-25, 5-02-29 and 5-02-32 also call for the disclosure of the amount and terms of unused lines of credit and commitments if significant. Various factors should be considered in determining significance such as total debt by term of such debt, total capital, total cash requirements, and the like.

The disclosure of unused lines and commitments supplies the investor with information regarding borrowing potential and future liquidity under varying money market conditions. It is recognized that lines of credit or commitments are frequently extended to a borrower subject to the condition that the borrower maintain certain standards of credit worthiness, and that the existence of such lines or commitments therefore does not assure the availability of credit under conditions of deteriorating financial position. Accordingly, the rule provides that disclosure be made of the conditions under which lines or commitments may be withdrawn. It is also recognized that such lines and commitments are occasionally offered by financial institutions as a marketing device and accepted by corporations without any intention of use and not as part of their financing plan. Disclosure of such lines is not contemplated by this rule.

Unused lines disclosed as supporting commercial paper or other debt arrangements should include only usable lines. For this purpose usable lines are construed to be total lines used to support commercial paper less lines needed to meet "clean-up" provisions of a borrowing arrangement. Such provisions require borrowers to retire credit extended at a bank or banks at some specified interval for a specified period. Total lines outstanding are therefore not necessarily a measure of the total credit available on a continuing basis. Similarly, if a corporation has lines arranged with several banks which in total exceed borrowing levels permitted under existing lending agreements, disclosure should be limited to usable amounts.

Rules 5-02-29 and 5-02-32 would include disclosure of commitments such as standby commitments, commitments for future disbursements, and unused revolving credits maturing after one year.

Responsibilities

The registrant is responsible for preparing financial statement disclosure of short-term

[1] This paragraph was subsequently rescinded in Accounting Series Release No. 172, June 13, 1975.

interest rates, compensating balances, unused confirmed lines of credit, commercial paper and other disclosures as specified in these rules and guidelines. The independent accountant has the responsibility of satisfying himself that the disclosure is adequate. When arrangements such as compensating balances and unused confirmed lines of credit exist, their determination and verification would be facilitated and more readily substantiated if the borrower set forth the bases of the mutual understanding in a letter submitted to the lender (or potential lender) with a request for confirmation.

* * * * *

The amendments to Regulation S-X have been adopted pursuant to authority conferred on the Commission by the Securities Act of 1933, particularly 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 above amendments to Rules 5-02-1, 5-02-18, 5-02-25, 5-02-29 and 5-02-32 of Regulation S-X shall be applicable to financial statements filed after December 31, 1973, for periods beginning on or after December 30, 1972. Requirements for disclosure of compensating balances as stated in Rule 5-02-1 prior to this release are deferred until December 31, 1973, at which time these amendments shall take effect.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 149
November 28, 1973

SECURITIES ACT OF 1933
Release No. 5441

SECURITIES EXCHANGE ACT OF 1934
Release No. 10523

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 18190

INVESTMENT COMPANY ACT OF 1940
Release No. 8104

Notice of Adoption of Amendment to Regulation S-X to Provide for Improved Disclosure of Income Tax Expense

The Securities and Exchange Commission today adopted amendments to Rule 3-16(o) of Regulation S-X calling for improved disclosure of income tax expense in financial statements filed with the Commission. These amendments were originally proposed on December 18, 1972 (Securities Act Release No. 5344) and then were reissued in revised form for additional comment on September 12, 1973 (Securities Act Release No. 5421).

The final rule includes a number of changes made in response to comments received although the basic requirements of the original proposal which called for disclosure of the components of tax expense, the reasons for timing differences between book and tax reporting resulting in deferred income taxes, and a reconciliation between the effective income tax rate indicated by the income statement and the statutory Federal income tax rate have been retained and are adopted hereby. The proposal that the amount of deferred taxes shown on the most recent balance sheet which will be reflected in tax expense reported in income statements for each of the next five years be disclosed has been revised. The revision requires disclosure of deferred tax reversals only in cases where the registrant expects that the cash outlay for income taxes with

respect to any of the succeeding three years will substantially exceed income tax expense for such year.

The objectives of these disclosure requirements are to enable users of financial statements to understand better the basis for the registrant's tax accounting and the degree to which and the reasons why it is able to operate at a different level of tax expense than that which would be incurred at the statutory tax rate. By developing such an understanding, users will be able to distinguish more easily between one time and continuing tax advantages enjoyed by a company and to appraise the significance of changing effective tax rates. In addition, users will be able to gain additional insights into the current and prospective cash drain associated with payment of income taxes.

Discussion of Comments Received

Numerous comments were received in response to the exposure of this rule. In general, analysts and other users indicated that the required disclosure would be very helpful to them in the process of analyzing results and determining the earning power of a corporation. Financial executives generally opposed the disclosure on the grounds that it would be costly to produce and would provide details which would be of little value to the average investor. The Commission has concluded that the benefits of the disclosure are sufficient to require its presentation in financial statements filed with the Commission but it recognizes that the detailed disclosure provided herein will be primarily of interest to professional analysts who have the obligation to develop an understanding in depth of corporate results and may not be required in financial disclosure designed for the average investor. The Commission notes, however, that financial statements prepared in conformity with generally accepted accounting principles as set forth in Accounting Principles Board Opinion No. 11 require disclosure of the "reasons for significant variations in the customary relationships between income tax expense and pretax accounting income if they are not otherwise apparent from the financial statements or from the nature of the entity's business" and it believes that many of the disclosures required by Rule 3-16(o) may be necessary in order to reflect the spirit of Opinion No. 11.

A number of commentators suggested that the Commission does not have the authority to require disclosure of the information relating to income taxes because such information appears on the income tax returns of the corporations and is therefore confidential. The Commission finds no merit in this position. The requirements for full and fair disclosure of material information to investigators are a basic part of the Securities Act of 1933 and the Securities Exchange Act of 1934. Each Act provides that registration statements filed under the Act must contain, in addition to other information specified, such information "as the Commission may by rules or regulations require as being necessary or appropriate in the public interest or for the protection of investors."[1] Both Acts also grant to the Commission the power to prescribe, with regard to documents required to be filed, "the form or forms in which required information shall be set forth, and the items or details to be shown in the balance sheet and earning statement. . . ."[2] The Commission believes that the amendments to Regulation S-X adopted today are entirely consistent with its express authority under the Acts. The type of information required to be disclosed by these amendments is, in the opinion of the Commission, material to investors as noted above.

Other comments indicated that the rule would require disclosure of information which would be valuable to competitors since it would reveal tax strategy or which would lead taxing authorities to question tax de-

[1] Section 7 of the Securities Act of 1933 (Act) and Section 12(g) and (b) of the Securities Exchange Act of 1934 (Exchange Act). In addition, Section 13(a) of the Exchange Act requires issuers of securities registered under that Act to file reports and information "in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security."

[2] Section 19(a) of the Act and Section 13(b) of the Exchange Act.

ductions or assess claims based on amounts provided in computing tax expense where items subject to varying tax interpretations were treated in a manner favorable to the taxpayer. Those who made such comments did not provide specific examples of items and amounts involved, but the Commission believes that most items of this sort would be of a size such that disclosure would not be required under the significance criteria set forth in the rule. In those cases, if any, where the amounts involved are sufficiently large to require disclosure the needs of present and potential investors in public corporations are best served by providing such significant information even though there may be an increased risk of adverse consequences at the hands of competitors.

Numerous commentators raised questions about the proposed requirement that disclosure be made of the amounts of deferred income taxes shown on the year-end balance sheet which are expected to be reflected as components of tax expense in each of the next five years. It was pointed out that this disclosure would not achieve the stated objective of providing insights into potential future cash outlays for taxes since in the normal case one tax deferral is expected to be replaced by another. Hence the data proposed to be required might lead to the misleading inference that a substantial cash outlay for taxes would be likely in the five-year period covered when such was not the case. The Commission recognizes the validity of these comments and has revised this particular proposal. The revised requirement calls for disclosure only in those cases when it is expected that the cash outlay for income taxes with respect to any of the succeeding three years will substantially exceed income tax expense for such year.

The Amended Rules

Inasmuch as certain of the requirements under Rule 3-16(o) relate also to Rule 5-02-19, Prepaid expenses and deferred charges, and to Rule 5-02-35, Deferred credits, these rules have been amended to include a cross-reference to Rule 3-16(o).

The text of amended Rules 3-16(o), 5-02-19, and 5-02-35 follows:

* * * * *

Rule 3-16. General Notes to Financial Statements

* * * * *

(o) *Income tax expense.*—(1) Disclosure shall be made, in the income statement or a note thereto, of the components of income tax expense, including: (i) taxes currently payable; (ii) the net tax effects, as applicable, of (a) timing differences (Indicate separately the amount of the estimated tax effect of each of the various types of timing differences, such as depreciation, research and development expense, warranty costs, etc. Types of timing differences that are individually less than 15 percent of the deferred tax amount in the income statement may be combined. If no individual type of difference is more than five percent of the amount computed by multiplying the income before tax by the applicable statutory Federal income tax rate and the aggregate amount of timing differences is less than five percent of such computed amount, disclosure of each of the separate types of timing differences may be omitted.) and (b) operating losses; and (iii) the net deferred investment tax credits. Amounts applicable to United States Federal income taxes, to foreign income taxes and to other income taxes shall be stated separately for each major component, unless the amounts applicable to foreign and other income taxes do not exceed five percent of the total for the component.

(2) If it is expected that the cash outlay for income taxes with respect to any of the succeeding three years will substantially exceed income tax expense for such year that fact should be disclosed together with the approximate amount of the excess, the year (or years) of occurrence and the reasons therefor.

(3) Provide a reconciliation between the amount of reported total income tax expense and the amount computed by multiplying the income before tax by the applicable statutory Federal income tax rate, showing the estimated dollar amount of each of the un-

derlying causes for the difference. If no individual reconciling item amounts to more than five percent of the amount computed by multiplying the income before tax by the applicable statutory Federal income tax rate, and the total difference to be reconciled is less than five percent of such computed amount, no reconciliation need be provided unless it would be significant in appraising the trend of earnings. Reconciling items that are individually less than five percent of the computed amount may be aggregated in the reconciliation. The reconciliation may be presented in percentages rather than in dollar amounts. Where the reporting person is a foreign entity, the income tax rate in that person's country of domicile should normally be used in making the above computation, but different rates should normally be used in making the above computation, but different rates should not be used for subsidiaries or other segments of a reporting entity. If the rate used by a reporting person is other than the United States Federal corporate income tax rate, the rate used and the basis for using such rate shall be disclosed.

* * * * *

Rule 5-02. Balance Sheets.

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19. *Prepaid expenses and deferred charges*—State separately any material items. Items properly classed as current may, however, be included under caption 8. (See also Rule 3-16(o).)

* * * * *

35. *Deferred credits*—State separately amounts for (a) deferred income taxes, (b) deferred tax credits, and (c) material items of deferred income. The current portion of deferred income taxes shall be included under caption 26 (see Accounting Series Release No. 102). (See also Rule 3-16(o).)

* * * * *

In order to clarify the rules as adopted, an example of disclosure and associated assumptions and computations has been attached as an exhibit to this release.

* * * * *

The amendments to Regulation S-X have been adopted pursuant to authority conferred on the Commission by the Securities Act of 1933, particularly 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 above amendments to Regulation S-X shall be applicable to financial statements for periods ending on or after December 28, 1973. Such disclosure is recommended but not required for financial statements of prior periods included in filings with the Commission subsequent to December 31, 1973.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

EXHIBIT

The following example of the disclosure required under Rule 3-16(o) is provided to assist registrants in appraising the proposal and in complying with it.

I. Assumptions

The following facts apply to a hypothetical business corporation for the calendar year 1973 (all figures in thousands)

Book income before tax ---------- $15,000

(1) Assets purchased at the beginning of 1973 at a cost of $10,000, eight year life, double declining balance depreciation for tax purposes, straight line on books, eligible for 7% investment credit.
(2) Research costs of $3,000 deducted on tax return but amortized over following years for book purposes.
(3) Warranty reserve of $1,400 provided for book purposes is not deductible for tax purposes until warranty costs are incurred.
(4) Income before taxes includes $2,000 related to construction-type contracts still in process which are accounted for on the percentage of completion method for book purposes and on the completed contract method for tax purposes.
(5) Amortization of goodwill of $800 is not deductible for tax purposes.
(6) Book income before taxes includes $2,400 which represents the net income of wholly-owned foreign subsidiaries that are expected to indefinitely invest their undistributed earnings. Foreign Subsidiary A is permitted under its local tax laws to deduct a provision for an inventory reserve related to increased inventory levels. The reserve would be reduced in periods of inventory decline. For consolidated financial statement purposes, no such accrual is made and the associated deferred tax expense is $420. The subsidiaries have reportable taxes in their respective foreign jurisdictions as follows:

	Foreign Subsidiary A	Foreign Subsidiary B	Total
Foreign Book Income before Taxes	$2,100	$300	$2,400
Foreign Jurisdiction Tax Rate	30%	50%	
Currently Taxable Income	$ 700	$300	$1,000
Current Tax Expense	210	150	360
Deferred Tax Expense	420	-0-	420
Total Foreign Income Tax Expense	$ 630	$150	$ 780

(7) Investments sold during the year resulted in a gain of $1,000, which is taxed at capital gain rates of 30%.
(8) Included in income is $1,500 of interest on tax exempt municipal bonds.
(9) State and local income taxes amounted to $400.

II. Illustrative Note

Note—Income tax expense (all data in thousands).
Income tax expense is made up of the following components:

	U. S. Federal	Foreign	State & Local	Total
Current Tax Expense	$2,312	$360	$400	$3,072
Deferred Tax Expense	2,328	420	-0-	2,748
	$4,640	$780	$400	$5,820

Deferred tax expense results from timing differences in the recognition of revenue and expense for tax and financial statement purposes. The sources of these differences in 1973 and the tax effect of each were as follows:

Excess of tax over book depreciation	$ 600
Research and development costs expensed on tax return and deferred on books	1,440
Revenue recognized on completed contract basis on tax return and on percentage of completion basis on books	960
Tax deductible inventory reserve provided in foreign tax jurisdiction	420
Warranty cost charged to expense on books but not deductible until paid	(672)
	$2,748

Total tax expense amounted to $5,820 (an effective rate of 38.8%), a total less than the amount of $7,200 computed by applying the U. S. Federal income tax rate of 48% to income before tax. The reasons for this difference are as follows:

	$ Amount	% of pretax income
Computed "expected" tax expense	$7,200	48.0%
Increases (reductions) in taxes resulting from:		
Foreign income subject to foreign income tax but not expected to be subject to U. S. tax in foreseeable future ($2,400 × 48%) − $780 = $372	$ (372)	(2.5)
Tax exempt municipal bond income	(720)	(4.8)
Investment tax credit on assets purchased in 1973	(700)	(4.7)
Goodwill amortization not deductible for tax purposes	384	2.6
State and local income taxes, net of Federal income tax benefit*	208	1.4
Benefit from income taxed at capital gains rate (1,000 × 48%) − (1,000 × 30%) = $180*	(180)	(1.2)
Actual tax expense	$5,820	38.8%

Based upon currently anticipated expenditures and operations, it is expected that the deferred income tax balance will be substantially reduced in 1976 and the cash outlay for taxes associated with that year will exceed tax expense by approximately $4,000, primarily due to the book amortization in that year of research and development expense previously deducted for tax purposes.

III. Computational Guide

(Furnished only to enable interested parties to determine source of numbers shown in above illustrative note; not to be required of registrants in filings.)

A. Tax computations

Book income before tax		$15,000
State income tax		(400)
Permanent differences:		
Goodwill amortization	800	
Municipal bond income	(1,500)	
Foreign income, no domestic income tax	(2,400)	
Capital gain	(1,000)	(4,100)
		$10,500

* Since these amounts are less than 5% of the computed "expected" tax expense, they could be combined with any other items less than $360 into an aggregate total. For example, these items could be disclosed as follows: "Miscellaneous items . . . $28 . . . 0.2%."

If no single item had exceeded $360 in this case and the total net difference of all items was also less than $360, this reconciliation would not have been required.

Timing differences:	
Excess depreciation	(1,250)
R & D deducted on tax return	(3,000)
Warranty cost not deductible until paid	1,400
Percentage of completion income	(2,000)
Tax income (excl. cap. gain)	$ 5,650

Tax to be paid		
Tax on ordinary income	.48 × 5,650	$ 2,712
Plus capital gain tax	.30 × 1,000	300
Less investment credit		(700)
Actual tax paid		$ 2,312

Tax expense per books	
Tax expense on ordinary income .48 × 10,500	$ 5,040
Plus capital gain tax	300
Less investment credit	(700)
Tax expense—Federal	$ 4,640
Foreign tax	$ 780
State and local income tax	$ 400

B. Facts affecting disclosure of net deferred income taxes.
Estimated Changes in Deferred Income Tax Accounts on Balance Sheets:

	1974	1975	1976
Balance—beginning of year	$10,000	$11,000	$10,500
Additions for timing differences in each year[1]	3,000	1,500	500
Reversals of balances at beginning of each year	(2,000)	(2,000)	(4,500)
Balance—end of year	$11,000	$10,500	$ 6,500

C. Computations of disclosure limits per Rule 3-16(o)

Computed amount	15,000 × .48 = 7,200
5% of computed amount	.05 × 7,200 = 360
15% of deferred tax	.15 × 2,728 = 409

NOTE:
[1] Includes effect of expected expenditures in each subsequent period which give rise to additional tax deferrals.

RELEASE NO. 150
December 20, 1973

Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards

Various Acts of Congress administered by the Securities and Exchange Commission clearly state the authority of the Commission to prescribe the methods to be followed in the preparation of accounts and the form and content of financial statements to be filed under the Acts and the responsibility to assure that investors are furnished with information necessary for informed investment decisions. In meeting this statutory responsibility effectively, in recognition of the expertise, energy and resources of the accounting profession, and without abdicating its responsibilities, the Commission has historically looked to the standard-setting bodies designated by the profession to provide leadership in establishing and improving accounting principles. The determinations by these bodies have been regarded by the Commission, with minor exceptions, as being responsive to the needs of investors.

The body presently designated by the Council of the American Institute of Certified Public Accountants (AICPA) to establish accounting principles is the Financial Accounting Standards Board (FASB). This designation by the AICPA followed the issuance of a report in March 1972 recommending the formation of the FASB, after a study of the matter by a broadly based study group. The recommendations contained in that report were widely endorsed by industry, financial analysts, accounting educators, and practicing accountants. The Commission endorsed the establishment of the FASB in the belief that the Board would provide an institutional framework which will permit prompt and responsible actions flowing from research and consideration of varying viewpoints. The collective experience and expertise of the members of the FASB and the individuals and professional organizations supporting it are substantial. Equally important, the commitment of resources to the FASB is impressive evidence of the willingness and intention of the private sector to support the FASB in accomplishing its task. In view of these considerations, the Commission intends to continue its policy of looking to the private sector for leadership in establishing and improving accounting principles and standards through the FASB with the expectation that the body's conclusions will promote the interests of investors.

In Accounting Series Release No. 4 (1938) the Commission stated its policy that financial statements prepared in accordance with accounting practices for which there was no substantial authoritative support were presumed to be misleading and that footnote or other disclosure would not avoid this presumption. It also stated that, where there was a difference of opinion between the Commission and a registrant as to the proper accounting to be followed in a particular case, disclosure would be accepted in lieu of correction of the financial statements themselves only if substantial authoritative support existed for the accounting practices followed by the registrant and the position of the Commission had not been expressed in rules, regulations or other official releases. For purposes of this policy, principles, standards and practices promulgated by the FASB in its Statements and Interpretations[1] will be considered by the Commission as having substantial authoritative support, and those

[1] Accounting Research Bulletins of the Committee on Accounting Procedure of the American Institute of Certified Public Accountants and effective opinions of the Accounting Principles Board of the Institute should be considered as continuing in force with the same degree of authority except to the extent altered, amended, supplemented, revoked or superseded by one or more Statements of Financial Accounting Standards issued by the FASB.

contrary to such FASB promulgations will be considered[2] to have no such support.

In the exercise of its statutory authority with respect to the form and content of filings under the Acts, the Commission has the responsibility to assure that investors are provided with adequate information. A significant portion of the necessary information is provided by a set of basic financial statements (including the notes thereto) which conform to generally accepted accounting principles. Information in addition to that included in financial statements conforming to generally accepted accounting principles is also necessary. Such additional disclosures are required to be made in various fashions, such as in financial statements and schedules reported on by independent public accountants or as textual statements required by items in the applicable forms and reports filed with the Commission. The Commission will continue to identify areas where investor information needs exist and will determine the appropriate methods of disclosure to meet these needs.

It must be recognized that in its administration of the Federal Securities Acts and in its review of filings under such Acts, the Commission staff will continue as it has in the past to take such action on a day-to-day basis as may be appropriate to resolve specific problems of accounting and reporting under the particular factual circumstances involved in filings and reports of individual registrants.

The Commission believes that the foregoing statement of policy provides a sound basis for the Commission and the FASB to make significant contributions to meeting the needs of the registrants and investors.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 151

January 3, 1974

SECURITIES ACT OF 1933
Release No. 5449

SECURITIES EXCHANGE ACT OF 1934
Release No. 10580

Disclosure of Inventory Profits Reflected in Income in Periods of Rising Prices

The year 1973 was a period of rapidly increasing prices in the United States when compared to historical economic norms for this country. During the year consumer prices rose by about 8 percent, wholesale prices by about 16 percent and the crude industrial materials component of the wholesale price index by about 30 percent. There were wide fluctuations in the prices of individual items.

Under such conditions the usefulness of the traditional accounting measurement model based upon historical cost is significantly reduced. The process of matching costs against revenues is less likely to produce meaningful economic information if the costs were incurred at a time when the price level associated with such goods and services differed significantly from that at the time when revenues were realized.

While a continuation or acceleration of the rate of price-level change might require a fundamental change in the basic accounting

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[2] It should be noted that Rule 203 of the Rules of Conduct of the Code of Ethics of the AICPA provides that it is necessary to depart from accounting principles promulgated by the body designated by the Council of the AICPA if, due to unusual circumstances, failure to do so would result in misleading financial statements. In such a case, the use of other principles may be accepted or required by the Commission.

measurement model used in preparing financial statements, it would be premature for the Commission to suggest such a change at this time. Careful consideration of the many implications of such a major step would be necessary both by the Financial Accounting Standards Board and by the Commission. At the same time, it does not seem appropriate that registrants and accountants should simply ignore the impact of rapidly changing prices on financial statements.

The most significant and immediate impact of price fluctuations on financial statements is normally felt in cost of goods sold in the income statement. In periods of rising prices, historical cost methods result in the inclusion of "inventory profits" in reported earnings. "Inventory profit" results from holding inventories during a period of rising inventory costs and is measured by the difference between the historical cost of an item and its replacement cost at the time it is sold. Different methods of accounting for inventories can affect the degree to which "inventory profits" are included and identifiable in current income, but no method based upon historical cost eliminates or discloses this "profit" explicitly. Such "profits" do not reflect an increase in the economic earning power of a business and they are not normally repeatable in the absence of continued price-level increase. Accordingly, where such "profits" are material in income statements presented, disclosure of their impact on reported earnings and the trend of reported earnings is important information for investors assessing the quality of earnings.

In recognition of the need for additional disclosure in regard to inventories and cost of goods sold, the Commission recently proposed amendments to Regulation S-X (Securities Act Release No. 5427, October 4, 1973) which would require registrants to indicate "the effect on net income, if significant, of using current replacement cost [for valuing inventories] in the computation of cost of sales." To date the Commission has received a large number of comments on this proposed disclosure and the effectiveness of that requirement in eliciting information about "inventory profits." The comments also indicated that problems of implementation existed. The Commission has given careful consideration to these comments and has concluded that it would not be desirable to adopt final requirements in this area which would be effective for 1973 financial statements. At the same time, the Commission recognizes that the impact of "inventory profits" on currently reported earnings appears to be significant in many cases and that failure to make appropriate disclosure may result in investors being inadequately informed as to the source and replicability of earnings.

The Commission therefore believes that it would be in the best interest of both statement preparers and users to disclose the extent to which reported earnings are comprised of potentially unrepeatable and usually unsegregated "inventory profits." Accordingly, the Commission urges registrants to make disclosure of such amounts prior to the adoption of final requirements by the Commission. Such disclosure may be made in the financial statements, the notes thereto or in textual material accompanying financial statements.

The Commission recognizes that registrants usually do not compute cost of goods sold on both an historical cost and current value basis so that computation of such amounts may often require estimation by the registrant. It is also recognized that computational methods or bases of valuation other than current replacement cost for each item sold might be used in developing useful information about such "profits." For example, computing the cost of goods sold for each month using a price-level adjusted inventory amount might produce a reasonable and useful estimate of such "profits" in some cases. Until final requirements are established, registrants are encouraged to use any method or basis deemed appropriate by management in exhibiting the impact of such "profits" along with a statement of the method or basis used and the reasons for adopting it.

The determination of cost of sales on a current replacement cost basis, however, provides only partial information regarding the effects of inflation on a company's operations. A second factor is the responsiveness of a company's selling prices to changes in

costs. If a company is able to raise selling prices immediately upon realizing costs increases (or in anticipation of cost increases), its net income in dollar terms benefits from inflation. On the other hand, as price increases lag behind cost increases the benefit of inventory "profits" is offset and the net inflation effect on income may be negative. Because of various regulatory restraints on prices, many companies may have experienced significant pricing lags in the current year.

The impact of price-level changes does not fall equally among companies. Some firms operate in sectors of the economy where prices of goods purchased are more volatile than selling prices. Accordingly, the Commission urges registrants to discuss the relationship of costs and prices experienced in the current year in connection with disclosing inventory profits.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 152
February 14, 1974

SECURITIES ACT OF 1933
Release No. 5456

SECURITIES EXCHANGE ACT OF 1934
Release No. 10642

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 18284

INVESTMENT COMPANY ACT OF 1940
Release No. 8232

Notice of Adoption of Revision of Regulation S-X and Amendment of Forms 10 and 10-K to Revise Requirements as to Form and Content and Certification of Financial Statements of Life Insurance Companies

The Commission today adopted a general revision of its requirements as to form and content of financial statements of life insurance companies and also eliminated the exemption from the certification requirements applicable to these companies. These changes were proposed on September 12, 1973 and involve Article 7A and related schedules in Article 12 of Regulation S-X and Instructions 13 and 7 of Instructions as to Financial Statements of Forms 10 and 10-K, respectively.* Letters commenting on the proposal have been given consideration in determining the form of the revision of Article 7A and the timing of its adoption and of the elimination of the certification exemption.

The revision reflects developments in accounting practice during the past ten years including the publication in 1972 of an Audit Guide for life insurance companies by the American Institute of Certified Public Accountants. This publication contains guidelines for the preparation of life insurance company financial statements in accordance with generally accepted accounting principles (GAAP) in place of the prescribed statutory accounting requirements followed by these companies up to this time.

As issued for comment the proposal would have applied GAAP accounting to both stock and mutual life insurance companies. A number of comments were received from mutual companies concerning the need for and applicability of GAAP to their financial statements. The mutual companies stated

* Notice of these proposed amendments was made in Securities Act Release No. 5420, Securities Exchange Act Release No. 10381, Public Utility Holding Company Act Release No. 18089 and Investment Company Act Release No. 7988 (September 12, 1973).

that because they have no stock ownership interest their operations were basically different from those of stock companies. They pointed out that the American Institute of Certified Public Accountants did not make the GAAP requirements in its life insurance company Audit Guide applicable to mutual companies. Filings by mutual companies with the Commission are generally in the capacity of co-issuers of variable annuity contracts and are included in prospectuses because of the guarantee of certain liabilities of the related variable annuity account. In consideration of the nature of the filings by mutual companies and the absence of a body of established generally accepted accounting principles for them, an exemption from the requirement for GAAP financial statements has been provided in Article 7A. In addition, a similar exemption has been provided for wholly owned stock life insurance subsidiaries of mutual life insurance companies.

In response to a number of comments concerning the problems of meeting the new requirements, the revised Article 7A and related schedules have been made effective for financial statements filed after June 30, 1974, since it may not be possible for some companies to prepare financial statements using GAAP by March 30, 1974, the due date for filing annual reports for calendar year 1973. However, it should be recognized that the establishment of standards for reporting on a GAAP basis makes the disclosure of results of operations on that basis very important and it is urged that companies should make every effort to follow the new requirements in reporting for the year 1973. Those that cannot do this because of time pressures should consider filing amended 10-K or 8-K reports to disclose the effect of using GAAP as soon as they are in a position to do so. Financial statements prepared on a statutory basis should include a note indicating the reasons why the GAAP basis was not adopted for 1973 and advising users that the 1974 financial statements will be prepared differently. The requirements for certification by independent accountants of financial statements filed under the Securities Exchange Act of 1934 will be applicable to statements for periods ending after November 30, 1974.

In addition to the new general requirement that the financial statements be prepared in accordance with generally accepted accounting principles, the following are the more significant specific changes from the requirements of the existing Article 7A:

1. Where appropriate, captions and instructions have been conformed with corresponding captions of Article 5 of Regulation S-X which applies to commercial and industrial companies. It is also made clear that the general rules in Articles 1, 2, 3 and 4 of Regulation S-X are applicable to life insurance financial statements to the extent they are pertinent (7A-02-1).
2. It is intended that, in preparing consolidated financial statements for an insurance holding company whose consolidated subsidiaries are primarily life insurance companies, consideration shall be given to utilization of the format of the financial statements, notes and schedules in Article 7A (7A-01).
3. A requirement for a statement as to accounting principles (7A-05-1).
4. Provision is made that a company may follow statutory accounting requirements only if the statutes of its state of domicile prohibit publication of its primary financial statements on a basis other than in accordance with such requirements; however, in such event the statutory financial statements shall be accompanied by supplemental GAAP statements (7A-02-2, 3 and 5).
5. The name of any person in which the investment exceeds two percent of total investment. As originally proposed this provision would have required reporting of an investment exceeding one percent (7A-03-1).
6. In recognition of comments concerning the difficulty of ascertaining market quotations for certain types of security investments, particularly bonds and notes, the requirement has been changed so as to call for disclosure of "value." Problems related to the deter-

mination of value are discussed in Accounting Series Release No. 118, issued in December 1970 (7A-03-1, 7A-05-4 and 12-27).

7. Information as to policy, nature and changes in deferred policy acquisition costs (7A-03-6, 7A-04-7, 7A-05-1 and 12-31A).
8. Reporting of aggregate amounts in separate accounts as single items of assets and liabilities (7A-03-9 and 19).
9. A requirement that considerations for supplementary contracts shall be reduced by the related amounts of death and other benefits and increase in future policy benefits (7A-04-1).
10. Elimination from the income statement of details of sources of investment income. Such information may now be stated separately in a note (7A-04-2).
11. Details of restrictions on stockholders' equity (7A-05-2).
12. Revision of requirement relating to income tax disclosure. In addition to specific requirements related to life insurance companies, the general requirements of recently amended Rule 3-16(o) are referred to (7A-05-3).
13. An analysis of investment gains for the period consisting of a statement comparing realized and unrealized gains or losses on investments in bonds and notes and stocks (7A-05-4).
14. Information concerning the significance of reinsurance ceded and assumed (7A-05-6).
15. Detailed schedules of bonds, stocks, mortgage loans and real estate, and a summary of realized gains or losses on sale of investments will no longer be required. The schedules requiring a summary of investments (12-27) and details of future policy benefits and insurance in force (12-31) have been completely revised. A schedule has been added to provide details of deferred policy acquisition costs (12-31A).

Registrants with life insurance subsidiaries whose financial statements for 1973 will follow statutory accounting requirements may have special problems if they have any significant nonlife insurance activities. Under those conditions the life subsidiaries should not be consolidated and the registrant's equity in their stockholders' equity and net income or loss should be based on GAAP. Separate statements (or group statements) of the life subsidiaries should accompany the parent's statements.

These amendments are adopted pursuant to authority conferred on the Securities and Exchange Commission by the Securities Act of 1933, particularly Sections 6, 7, 9, 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 text of the amendments, which include revisions of Article 7A and Rules 12-27 and 12-31, new Rule 12-31A, all of Regulation S-X, and revisions of Instructions 13 and 7 of the Instructions as to Financial Statements in Forms 10 and 10-K, respectively, is omitted.) These amendments shall be effective with respect to financial statements filed after June 30, 1974, although they may be used in statements filed prior to that time.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 153
February 25, 1974

SECURITIES ACT OF 1933
Release No. 5459

SECURITIES EXCHANGE ACT OF 1934
Release No. 10654

Findings, Opinion and Order Accepting Waiver and Consent and Imposing Remedial Sanctions in the Matter of Touche Ross & Co.

Information furnished to the Commission in a non-public investigation into the affairs and financial reporting of U. S. Financial, Inc. ("USF")[1] for the period 1969 to 1972 indicated that financial reports issued by USF and filed with the Commission including the annual financial statements for the years ended 1970 and 1971 were false and misleading. Touche Ross & Co. ("Touche"), a partnership engaged in the practice of public accounting, certified the annual financial statements for those years.

It appears that as part of a scheme to mislead the public by publishing false financial statements reflecting fictitious earnings, USF and certain of its officers, directors and associates intentionally deceived Touche by making untrue representations and by furnishing false information in connection with its audits. The Commission has instituted legal proceedings against these parties.[2]

Any such deception, however, did not relieve Touche of its responsibility to perform its audits in conformity with generally accepted auditing standards. The information furnished to the Commission indicated that Touche's conduct of the 1970 and 1971 audits in a number of respects did not meet the professional standards required of public accountants who practice before the Commission.

Such information indicated that Touche failed to obtain sufficient independent evidentiary material to support its professional opinion in regard to a number of highly material transactions which were constructed by management in such a way as to make it appear that income had been earned when in fact it had not been. In connection with these transactions it also appeared that Touche failed to fully appraise the significance of information known to it and to extend sufficiently its auditing procedures under conditions which called for great professional skepticism. These transactions resulted in USF improperly recognizing millions of dollars of revenues and profits in 1970 and 1971.

Touche has submitted to the Commission a waiver of the institution of formal administrative proceedings under Rule 2(e) and has consented to the entry of an order containing certain findings, conclusions and remedial sanctions.

Under the terms of Touche's waiver and consent, Touche, solely for the purpose of settlement of this matter, and without admitting or denying any violations, and without admitting or denying any fact except for the purposes of this settlement, consented, among other things, to the entry of an appropriate order.

After due consideration of the consent and upon the recommendation of our staff, we have determined that it is appropriate in the public interest to accept the consent.

The Commission believes that the responsibilities of independent public accountants are an essential part of our capital market system, which is based upon investor confidence in the reliability and fairness of finan-

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[1] Prior to 1969, USF was engaged in the development, construction and sale of single family residential homes and home sites. During 1969, 1970 and 1971, USF's reported income was derived primarily from real estate financing and the development and sale of multiple family and commercial real estate projects. USF's common stock was listed on the New York Stock Exchange on December 29, 1970 and was delisted on December 10, 1973.

[2] *Securities and Exchange Commission* v. *U. S. Financial, Inc., et al.,* 74 Civil 92-S (S.D.Cal., February 25, 1974).

cial statements. Any lack of diligence and professionalism on the part of independent auditors seriously erodes confidence in the financial reporting of public companies and tends to impair the functioning of the capital and trading markets with the result that our economy as a whole may suffer. By the acceptance of this consent, which includes the following findings describing the facts and auditing deficiencies discovered as a result of our staff investigation, the Commission hopes to reduce the likelihood of similar future cases.[3]

The 1970 Audit

In the 1970 audit, Touche permitted USF to record profit on two major transactions where the evidence available to Touche should have indicated that no profit in fact had been earned.

Burnham Management Corp.

On August 27, 1970, USF purportedly sold three properties to Burnham Management Corp. ("BMC") for $5,399,000 and recognized profit of $550,000 from the transaction. The letter agreement which covered the sale committed USF to use its best efforts to secure permanent financing on the properties for BMC and to pay certain underwriting costs upon BMC's syndication of the properties. Furthermore, the agreement provided that upon final documentation, which was not prepared and executed, USF was to deliver to BMC USF's guarantee that BMC would suffer no loss from operations of the properties. The agreement was also subject to an addendum which provided BMC with an absolute guarantee against loss from ownership of the properties and a commitment by USF to complete construction of the properties. The terms of this agreement made the recogniton of profit on the transaction improper in that as a result of the terms of the agreement and addendum USF had not shifted the risk of loss to BMC.[3a]

Shortly after year-end, BMC requested USF to take back the properties or find other buyers pursuant to a verbal "put" agreement entered into with BMC by Robert Walter ("Walter"), chief executive officer of USF. In response, USF "found" two buyers who were actually nominees of USF and one of whom assumed BMC's interest with funds provided by USF.

In connection with its review of the BMC transaction, Touche was aware that the final documentation was not prepared and executed. Although Touche was delivered a copy of the above addendum with a confirmation letter from BMC, Touche failed to examine or review the addendum. In addition, Touche did not pursue the implications of the post year-end disposition of the properties by BMC. On the basis of the information in its working papers, Touche should have refused to permit the recognition of profit on this transaction. Additional investigation would have developed further evidence as to the impropriety of the transaction.

Grubb & Ellis—Gribben

In late December 1970 a series of related agreements was entered into with Grubb & Ellis, Inc., an independent real estate enterprise, and with Walter P. Gribben ("Gribben"). Grubb & Ellis purchased certain properties from USF for $13.2 million, resulting in a book loss of $532,000 to USF. Grubb & Ellis prepaid $855,000 interest on this transaction which was treated as deferred income on USF's books. USF leased the properties back for two years and retained Grubb & Ellis to manage them for that period. At the same time, USF purportedly sold to Gribben, actually a USF nominee, its leasehold interest in the properties for $855,000 and recorded income in this amount. To cover Gribben's $855,000 check dated December 31, 1970, USF paid $855,000 to Gribben on January 4, 1971 allegedly to purchase Gribben's interest in the Grubb & Ellis management agreements which interest Gribben never owned.

Touche did not obtain documentation to warrant the inclusion in USF's financial statements of Gribben's purported purchase

[3] Our findings are not binding upon any other persons against whom proceedings may be brought as a result of the investigation.

[3a] See Accounting Series Release No. 95, December 28, 1962.

of the lease interest. No confirmation was obtained from Grubb & Ellis to support Gribben's purported ownership of the management agreements or his participation in the transaction. There was no confirmation from Gribben concerning his purported purchase of the lease. The only independent documentation supporting Gribben's purported purchase was his $855,000 check to USF. Touche was aware of but did not attach appropriate significance to USF's $855,000 payment to Gribben. Touche relied on a written representation of the principal financial officers of USF that Gribben was independent and on misleading explanations of Walter and John B. Halverson ("Halverson") USF's executive vice president[4], that the USF—Grubb & Ellis—Gribben transactions represented a complex transaction meant to satisfy everyone's tax objectives (which objectives were unspecified) and constituted an inseparable unit not susceptible to separate analysis.

Had Touche penetrated this transaction rather than having placed reliance upon management's representations as to its purpose, the evolving pattern of manufacturing profits would have been evident at an earlier stage.

The 1971 Audit

Circumstances surrounding the commencement of Touche's 1971 audit of USF should have caused it to approach the audit with the highest degree of skepticism. In October 1971, at the time Touche was prepared to commence the audit, Touche was terminated by USF, which then engaged Haskins & Sells ("H&S"). On January 21, 1972, Walter terminated H&S[5], and on the following day USF re-engaged Touche. In addition, Touche's experience on the 1970 audit indicated that USF was increasingly dependent on a relatively small number of large and complex transactions to achieve its income goals. It was also aware that management was aggressively seeking income to meet stated growth objectives.

In connection with the audit, Touche discovered that USF had structured a number of year-end transactions to give the appearance of income when in fact the income from these transactions could not properly be recognized in 1971. Touche required USF to defer $13 million of profits which reduced its previously calculated unaudited net income by nearly 60%.

The circumstances should have required Touche to extend substantially its auditing procedures in respect to the remaining transactions and to regard management representations with extreme care. Under such conditions, it is the Commission's view that Touche should have given closer consideration to criteria for revenue recognition including evidence of the purchaser's financial strength, effective control of the properties, control of the buyer by the seller and uncertainty as to the amount of costs to be incurred by the seller. While Touche did prepare a checklist with which to review USF's real estate transactions, the guidelines on the checklist, including a question regarding the source of funds received by USF from such transactions, were not consistently applied in evaluating the transactions.

Among the fraudulent real estate transactions on which USF improperly recognized revenue and profits in 1971 were the following:

[4] In December 1971, Halverson became USF's president and chief operating officer.

[5] A report of USF's Audit Committee submitted to the Board of USF in mid-February 1972 stated: "2. The January 1972 termination of HS was motivated in part by the inability of HS to complete the 1971 audit by the end of February, in part by an incompatibility which developed between management and HS and in part by potential disagreements as to matters of accounting principles. 3. The potential disagreements as to accounting principles between the management of USF and HS involved the question of when income should be recognized by USF in the following types of transactions: (a) Commissions, fees, and financing-type income received in cash by USF in 1971 from joint ventures or partnerships in which USF had an interest, where the cash received by USF came out of moneys loaned by USF. (b) Gains, profits and commissions income received by USF in 1971 where USF's profit or gain was represented at the end of 1971 by notes rather than cash, or where USF had a continuing cash investment in the transaction or had a contingent obligation to supply funds." Touche received a copy of the Audit Committee Report shortly thereafter.

Palm Springs Mobile Country Club ("PSMCC")

On March 26, 1971, USF sold PSMCC to National Community Builders ("NCB") for $5,750,000 in a "swap" transaction whereby USF also bought property from NCB. Because of the "swap," of which Touche was aware, USF could not recognize the $1.9 million net profit realized on the sale in the first quarter of 1971. In an effort to perfect such profit, however, on April 13, 1971, USF caused NCB to sell PSMCC to TSL, Inc. ("TSL"),[6] a USF nominee of which Gribben was nominal owner, and USF then improperly recognized these revenues and profits in the second quarter of 1971.

TSL, on December 31, 1971, sold PSMCC to Carlsberg Resources Corp. ("Carlsberg") which had the right to "put" PSMCC back to TSL. At Carlsberg's insistence, USF guaranteed TSL's performance under the agreement. Carlsberg had 120 days to examine the PSMCC property and books and decide whether to put the property back to TSL. In a separate agreement, USF agreed to guarantee Carlsberg a cash flow of $105,000 per annum on the property in the event the put was not exercised.

It is the Commission's view that Touche should have determined from the evidence available that TSL was in fact a nominee of USF without independent economic substance.[7] Such a determination would have led to the conclusion that no profit should have been realized on the transaction since a put option to TSL remained outstanding on the property at the date the auditor's opinion was signed.[8]

Coastal Land Corporation ("CLC")

On December 27, 1971 USF sold certain mobile home parks to CLC for approximately $19.2 million, receiving approximately $1.9 million cash and the remainder in long-term notes. USF improperly recognized approximately $3 million in profit in 1971 from the sale. USF had acquired the parks from Boise Cascade Corp. ("Boise") in September 1971 purportedly "in-trust" for CLC pursuant to a September 10, 1971 agreement between CLC and USF which was contingent upon closing prior to year-end 1971. On November 24, 1971 USF and CLC purportedly rescinded the September 10 agreement (but for one park which was syndicated to certain of USF's officers and directors) because of CLC's purported inability to obtain the cash down payment.[9]

CLC thereafter obtained the requisite $1.9 million cash down payment through a loan in that amount from Union Bank of California, San Diego. The loan was nominally guaranteed by Bayview Investments ("BI"), a Walter nominee, but was actually secured by Walter's pledge of 80,000 shares of USF stock.

In connection with Touche's audit of the CLC transaction, Touche made extensive inquiries as to the source of CLC's $1.9 million down payment because of the following concerns Touche had regarding CLC's affiliates' other transactions with USF: that CLC was owned by Richard W. Arneson, Jr., ("Arne-

[6] USF could direct NCB to sell PSMCC to a buyer chosen by USF for the same sales price of $5,750,000 pursuant to the March 26, 1971 sales agreement.

[7] Touche knew that a $375,000 note given by TSL to NCB as a part of TSL's down payment for the purchase of PSMCC was paid with a $375,000 advance by Walter to TSL, that the stock of PSMCC secured TSL's debt to USF, assumed from NCB in connection with TSL's purported purchase, that under a management agreement USF was obligated to pay all operating expenses of PSMCC, and that TSL assumed BMC's "interest" in two of the three properties purportedly sold to BMC as described above. Touche also had in its possession TSL's unaudited balance sheet as of December 31, 1971, which showed that all of TSL's assets were acquired from USF and all of TSL's liabilities were owed to USF. Touche did not obtain TSL's income statement.

[8] In any event, Touche did not contact Carlsberg to determine the likelihood of the "put" being exercised but relied upon Walter's representation that exercise of the "put" was highly unlikely after April 15, 1972. Touche issued its certificate on April 1, 1972, at about the same time that Carlsberg indicated its intention to put PSMCC to TSL.

[9] The November 24 rescission letter was a fiction created by Walter at year-end and back dated to support Walter's claim that USF be allowed to recognize the $1 million commission paid USF by Boise in connection with the transaction as income rather than a reduction in cost basis, which sum USF improperly recognized in the third quarter of 1971, and that USF be allowed to recognize an additional $3 million in sale income as a result of the December 27, 1971 purported resale to CLC.

son"); that Arneson together with Dennis P. Hill ("Hill") were the nominal owners of A-H Properties ("A-H"), which entity was indebted to USF as of November 1971 in the amount of approximately $15.2 million and was in default on such debt; that A-H and USF were involved in a $4.5 million sale and leaseback transaction whereby A-H sold to and leased-back from USF the land underlying certain A-H properties in December 1971[10] to partially fund the elimination of A-H's delinquent secured debt and certain unsecured "advances" from USF; and that USF had given A-H a guarantee against loss from operations and other expenses until 80% occupancy was reached on the properties, which had not been accomplished as of the 1971 audit.

Because of Touche's concern that CLC's down payment might have been funded indirectly by USF through A-H, Touche determined that Union Bank had loaned the funds to CLC, and that the loan was guaranteed by an unnamed corporation (BI) which purportedly used its undisclosed credit sources to support the guarantee. A Touche representative stated during the Commission's investigation that Touche's concurrence with the recordation of the profits "realized" from the transaction was conditioned on a negative determination of "no direct or indirect involvement" in the CLC loan by USF, its officers or directors.

Touche requested from USF certain financial information concerning CLC and A-H but was informed by Walter that such information was not available. Touche did not contact Union Bank to inquire whether USF or any of USF's officers or directors were directly or indirectly involved in the CLC loan. Touche requested from Arneson a representation that USF and its affiliated persons were not "directly or indirectly involved." Arneson stated in a written representation that USF's officers "were not directly involved." While Arneson failed to disclaim in writing any indirect involvement, Touche's representative felt assured from his concurrent conversation with Arneson that there was also no indirect involvement. Touche received a representation letter from counsel to the unnamed corporate guarantor of the CLC loan (BI) which stated that the unnamed corporation had undisclosed beneficial owners (who were in fact Arneson and Hill) whom counsel refused to identify to Touche, and that the corporation used its credit sources as a basis for its guaranty, which credit sources were not identified. Touche further received from Walter an intentionally false and misleading written representation intended to deceive Touche that "neither USF ... nor any affiliated persons have guaranteed, either directly or indirectly any obligation of CLC." Touche relied upon the above representations and concurred in USF's profit recognition from the CLC transaction.

It is the view of the Commission that had Touche's confirmation procedures included a direct inquiry to Union Bank and had Touche insisted upon knowing the identity of the corporate guarantor, it is likely that Walter's involvement in the loan would have come to light—despite Walter's express representations to the contrary.

Relationship with Predecessor Auditors

As previously noted, Touche succeeded H&S in the 1971 audit. During the course of Touche's audit it reviewed some of H&S's work papers prepared during the course of the latter's brief engagement, but in the view of the Commission communication between the firms was not as complete as it should have been. When one auditor succeeds another, be it on the same engagement or on a different one, it is important that the successor obtain access to and carefully review the results of the predecessor's work. In most instances, this will entail some review of the predecessor's work papers. In other instances, it may require discussions with those responsible for the predecessor's work. If a client refuses to permit such discussions, such a refusal should constitute a reason for rejecting the engagement. It is essential

[10] The properties were sold to Equity Investment Corp., predecessor of A-H, a 35%-owned USF affiliate, on December 31, 1969. Arneson and Hill purportedly purchased Equity Investment Corp. from that company's stockholders in April 1970.

that both the successor and the predecessor be fully advised of the reasons surrounding the termination and the new engagement, of any questions raised or problems encountered in the audit by the terminated firm, and of any other relevant circumstances, so that the public interest that the accounting profession is supposed to protect will be properly served. No one's interests are served by one independent accountant not revealing information known to it which may bear upon the work of another independent accountant who is examining financial statements which are destined to be disseminated to the public or filed with the Commission. As the Commission has previously pointed out, the public accountant's first duty is to safeguard the public interest, not that of his client.[10a]

Summary

While it appears that Touche was deliberately misled in many respects by USF's management in the course of the 1970 and 1971 audits, Touche's failure in a number of respects to conduct these engagements in accordance with generally accepted auditing standards makes Touche responsible for certifying financial statements which proved to be materially false and misleading.[11] As the Commission stated in its report on *McKesson & Robbins, Inc.*:[12]

"... We believe that ... [with respect to] examinations for corporations whose securities are held by the public, accountants can be expected to detect gross overstatements of assets and profits, whether resulting from fraud or otherwise. We believe that alertness on the part of the entire [audit] staff, coupled with intelligent analysis by experienced accountants of the manner of doing business, should detect overstatements in the accounts, regardless of their cause, long before they assume the magnitude reached in this case. Furthermore, an examination of this kind should not, in our opinion, exclude the highest officers of the corporation from its appraisal of the manner in which the business under review is conducted.... [W]e feel that the discovery of gross overstatements in the accounts is a major purpose of ... an audit...."

Although Touche's San Diego, California, office was primarily responsible for the audits in question, Touche partners from other offices, including the national office, also participated in and were consulted with respect to certain aspects of the audits. They also planned and supervised a review of certain USF audit programs and working papers, as well as the findings, conclusions and accounting principles to be followed. While every firm is responsible for the opinions issued by any of its partners, the involvement in this case of other partners and offices of Touche, as is customary and expected of a national accounting firm, emphasizes that the firm as a whole must share the responsibility.

In accepting the offer of settlement, the Commission has considered the fact that Touche, with one exception noted below, has not previously been subject to disciplinary or enforcement proceedings instituted by the Commission and that the one exception[13] arose out of conduct which occurred in connection with financial statements for the year 1947. In accepting Touche's undertaking to adopt certain procedures to

[10a] See, *e.g.*, *In the Matter of McKesson & Robbins, Inc.*, Accounting Series Release No. 19 (1940).

[11] As stated in the AICPA's recently issued Statement on Auditing Standards §110.05 (1973), which was substantially a restatement of existing practice, in making an ordinary examination, the auditor must be alert to and recognize "the possibility that fraud may exist" and that fraud, "if sufficiently material, may affect his opinion on the financial statements...." Accordingly, "his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility," even though the ordinary examination is not "primarily or specifically designed" to detect fraud. The failure, therefore, to conduct an examination in accordance with generally accepted auditing standards means that the auditor is responsible for his failure to detect fraud when such failure results from a departure from auditing standards.

[12] *In the Matter of McKesson & Robbins, Inc.*, Accounting Series Release No. 19 (1940).

[13] *In the Matter of Touche, Niven, Bailey & Smart*, 37 S.E.C. 629 (1957).

strengthen its existing ones, the Commission does not contemplate that they will encompass steps which are other than required by generally accepted auditing standards. Rather, Touche and the Commission contemplate that these procedures will improve Touche's ability to carry out its responsibility to exercise due professional care in the conduct of its future engagements. While we do not believe that any form of procedure can ever be a substitute for the kind of healthy skepticism which a good audit requires, we anticipate that these procedures will materially aid in the performance of the firm's responsibility.[14] In this connection, our order will specifically direct Touche to strengthen its procedures so that all future audit engagements will include a specific review to determine any private involvement of the management and other related persons in corporate transactions reflected in financial statements under examination. Fundamental to financial reporting is the assumption that financial statements reflect the results of arm's-length bargaining between independent parties. The presence of transactions between affiliates inevitably raises questions as to the meaningfulness of the resulting information. Further, as is apparent in this case, it should raise broader questions as to the reliability and completeness of the information being provided. It is for this reason, among others, that the Commission has long required that transactions which involve persons related to the management of a filing corporation be specifically disclosed to the Commission and public investors.[15]

In reviewing significant transactions, it is not enough for auditors to accumulate documents relating to the transactions. It is critical that an analysis be made of transactions and all of their ramifications, including any involvement management or persons acting for management may have in such transactions. It is equally insufficient to obtain negative assurances that no such involvement is present if at the same time all of the details are not known as to the various transactions in question. Thus, for example, when an accountant becomes aware that a party to a transaction has received a guarantee or some other form of assurance which may relieve him of some risk of loss, it is critical that the accountant not only receive assurances that such guarantee does not involve members of management, but also that he obtain information concerning the nature and extent of the guarantee, as well as the identity of the guarantor. It is only when armed with that information that the accountant may properly evaluate whether or

[14] "Due professional care" requires the exercise of a "critical review at every level of supervision of the work done and the judgment exercised by those assisting in the examination." AICPA *Statement on Auditing Standards, supra* §230.02. As previously described in the CPA Handbook,

> "On the negative side of care there is the avoidance of negligence and the kind of laziness that is satisfied with a task only partly done or performed by rote in a reverie more appropriate to an assembly bench than to an audit examination. On the positive side there are the requirements that each person engaged in an examination must be aware of the purpose of what he is doing, must understand and perform with mental alertness, inquisitiveness, and a sense of responsibility, even those tasks which may appear to be routine, and must respond diligently by further inquiries or examinations to circumstances indicating them to be necessary. The auditor should carry out his examination with an attitude of healthy skepticism which seeks corroboration of explanations offered for matters that have aroused questions in his mind, particularly when those explanations come from persons who could have personal reasons for diverting further inquiry. Care is required even when personal acquaintanceship with the client or its employees and their unquestioned reputation in the community for the highest standards of righteousness and probity, may appear to justify complete reliance on them. In such cases it is desirable to keep three facts in mind:
>
> 1. An independent examination is a check on representations of management however honest and competent that management may be, and reliance on managerial virtues is not a check.
> 2. Banks sometimes make character loans, but there is no such thing as a character audit.
> 3. Defalcations are nearly always perpetrated by old and trusted employees of good reputation."

Wilcox, "Professional Standards," CPA Handbook, Vol. I, Chapter 13, pp. 11–12 (American Institute of Accountants, 1952).

[15] See, for example, Item 20 of Form S-1, requiring disclosure of the interests of management and others in certain corporate transactions.

not the transaction, including the guarantee, will be properly reported.

In view of the above findings, the Commission concludes that Touche engaged in improper professional conduct.

* * * * *

Under the terms of its offer of settlement, Touche, without admitting or denying the Commission's findings and solely for the purpose of settlement, consented to the entry of an order embodying the following sanctions.

Accordingly, IT IS ORDERED that proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice be, and they hereby are, instituted against Touche Ross & Co.

IT IS FURTHER ORDERED that, subject to the terms and conditions provided in the offer of settlement Touche Ross & Co., be, and it hereby is:

A. Censured by the Commission.

B. Required to adopt, maintain and comply with procedures which shall be submitted to the Commission for its review and approval within thirty (30) days after the date hereof, to prevent future violations of the federal securities laws, which procedures shall provide, among other things, as a means of strengthening Touche's procedures

1) That in all audit engagements specific review shall be made which is designed to determine the management's direct or indirect involvement in material transactions which are included in the financial statements;
2) For the formulation and implementation of qualitative office review procedures requiring periodic review at least once every two years of all Touche offices under the control and supervision of Touche's national staff to evaluate and ensure the quality of the audit engagements of such offices.

C. In order to ascertain that Touche is conducting its professional practice in compliance with paragraph B above, an investigation, which shall be conducted at the expense of Touche, shall be conducted by the Commission in accordance with methods and procedures adopted or approved by it by the use of members of the profession in public practice selected or approved by the Chief Accountant of the Commission or, at its option, by use of qualified professional accountants drawn from its own staff. Provided, however, that in those instances where persons conducting the aforesaid investigation are not members of the Commission's staff such persons (who shall be given a copy of these Findings, Opinion and Order and Consent) shall hold in confidence the fact that such persons are engaged in such investigation as well as all information, books, papers, records, documents or other materials obtained and/or utilized during the course of such investigation and relating to the clients, procedures, systems or methods of Touche. The report of investigation, in those instances where the investigation is conducted by persons other than members of the Commission's staff, shall be submitted to the Commission only and shall be the sole property of the Commission and shall be maintained in the Commission's non-public investigative files. Nothing herein is intended in any way to alter or amend the powers or jurisdiction of the Commission.

D. For a period of twelve (12) months after the date of this order, Touche's San Diego, California, branch office will not accept or undertake any new professional engagement which can be expected to result, within twelve (12) months from the date of such engagement, in filings, submissions or certifications with the Commission. For the purpose of such offer of settlement, "new professional engagement" is defined to mean an engagement entered into after five (5) days subsequent to the effective date of this order between Touche's San Diego, California, branch office and any person or corporation subject to the disclosure requirements of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Trust Indenture Act of 1939 and the Public Utility Holding Company Act of 1935. Nothing herein shall be construed to affect the right or obligation of Touche's San Diego, California, branch office during this

twelve (12) month period to perform its normal functions and services for existing clients (including activities requiring filings, submissions or certifications with the Commission), or to undertake engagements for new clients which cannot be expected to result, within twelve (12) months from the date of such engagement, in filings, submissions or certifications with the Commission.

E. Touche will not accept or undertake any new professional engagement of any client whose business, revenues and net profit (loss) is materially derived from real estate development or sales, including financing related thereto, as defined herein, which engagement can be expected to result, within twelve (12) months from the date of such engagement, in filings, submissions, or certifications with the Commission until the Chief Accountant of the Commission is satisfied that adequate audit guides and programs for application have been adopted, including appropriate testing thereof as applied to audits. For the purposes of such offer of settlement, "new professional engagement" is defined to mean an engagement entered into after five (5) days subsequent to the effective date of this order between Touche and any person or corporation subject to the disclosure requirements of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Trust Indenture Act of 1939 and the Public Utility Holding Company of 1935. For the purposes of such offer of settlement, "any client whose business revenues and/or net profit (loss) is materially derived from real estate development, or sales, including financing related thereto," is defined to mean any client at least twenty-five (25) percent of whose gross revenues or pre-tax net profits (losses) were derived from real estate development or sales, including financing related thereto, within two (2) of the preceding three (3) fiscal years. Nothing herein shall be construed to affect the right or obligation of Touche during this twelve (12) month period to perform its normal functions and services for existing clients (including activities requiring filings, submissions or certifications with the Commission), or to undertake engagements for new clients which cannot be expected to result, within twelve (12) months from the date of such engagement, in filings, submissions or certifications with the Commission.

F. The Commission shall retain jurisdiction of this matter pending final receipt of a report of investigation referred to in paragraph C above and thereafter for either the taking, if necessary, of appropriate action to ensure compliance, including but not limited to the re-opening of these proceedings for the imposition of such other and further relief as may be required under the circumstances, or the approval of the report and termination, on notice, of this proceeding.

By the Commission (Commissioner Pollack not participating).

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 154

April 19, 1974

SECURITIES ACT OF 1933
Release No. 5483

SECURITIES EXCHANGE ACT OF 1934
Release No. 10746

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 18383

INVESTMENT COMPANY ACT OF 1940
Release No. 8315

Notice of Adoption of Amendments to Rule 4-02 and Rescission of Rule 4-07 of Regulation S-X Relating to Consolidated Financial Statements

The Commission today adopted amendments to Rule 4-02 and rescinded Rule 4-07 of Regulation S-X, both relating to requirements for consolidated and combined financial statements. This action was originally proposed on December 13, 1973, in Securities Act Release No. 5445.

The rescission of Rule 4-07 eliminates the restriction on consolidation of subsidiaries engaged in financial and nonfinancial activities contained in Rule 4-07(b). Consolidated financial statements will now be subject to the general provisions of Rule 4-02(a) that a "registrant shall follow ... principles of inclusion or exclusion which will clearly exhibit the financial position and results of operations."

The amendment to Rule 4-02 continues the present requirement of Rule 4-07 for supporting financial statements of consolidated subsidiaries engaged in certain financial activities. Consideration should also be given to improving the disclosure in annual reports to stockholders by including this information, suitably condensed, as supporting financial statements or as line of business disclosure. Although information concerning nonfinancial activities is not specifically required, such information may be given if deemed appropriate for a better understanding of registrant's business. The Financial Accounting Standards Board is considering the matter of reporting by diversified companies including the extent of disclosure of information about the different segments. These requirements will be reconsidered when a statement on this matter is adopted by the FASB.

A subparagraph added to Rule 4-02(a) is intended to prevent consolidation of subsidiaries of a registrant subject to the Bank Holding Company Act of 1956 as to which a decision has been made requiring divestiture or in cases where there is a substantial likelihood that divestiture will be necessary in order for registrant to comply with provisions of the Act.

The following changes are made to Article 4 of Regulation S-X:

1. Rule 4-07 is revoked and reserved.
2. Rule 4-02(a) is amended by addition of the following subparagraph (3)—

   (3) Any subsidiary or group of subsidiaries of a registrant subject to the Bank Holding Company Act of 1956 as amended as to which (a) a decision requiring divestiture has been made, or (b) there is substantial likelihood that divestiture will be necessary in order to comply with provisions of the Bank Holding Company Act.
3. Rule 4-02 is amended by addition of the following paragraph (e)—

   (e) Separate financial statements shall be presented for each subsidiary or group of subsidiaries engaged in the business of life insurance, fire and casualty insurance, securities broker-dealer, finance, savings and loan or banking, including bank related finance activities; provided, however, that separate financial statements may be omitted:

   (1) For a consolidated subsidiary or group of subsidiaries in the same busi-

ness in which the registrant's and registrant's other subsidiaries' proportionate share of total assets or total sales and revenues (after intercompany eliminations) exceeds 90 percent of consolidated assets or consolidated sales and revenues.

(2) For a nonsignificant consolidated subsidiary which is registrant's only subsidiary in a business, or for a group of consolidated subsidiaries constituting all of registrant's subsidiaries in the same business which if considered in the aggregate would not constitute a significant subsidiary.

(3) For a consolidated subsidiary or group of subsidiaries in the same business if in excess of 90 percent of their sales and revenues are derived from registrant and registrant's other subsidiaries.

The foregoing amendments are adopted pursuant to Sections 6, 7, 8, 10 and 19(a) of the Securities Act of 1933; Sections 13, 15(d) and 23(a) of the Securities Exchange Act of 1934; Sections 5(b), 14 and 20(a) of the Public Utility Holding Company Act of 1935; and Sections 8, 30, 31(c) and 38(a) of the Investment Company Act of 1940. The amendments shall be effective with respect to financial statements filed with the Commission subsequent to May 31, 1974.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 155
April 25, 1974

SECURITIES ACT OF 1933
Release No. 5488/

SECURITIES EXCHANGE ACT OF 1934
Release No. 19754

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 18392

Notice of Amendments to Forms S-1, S-7, S-8, S-9, S-11, 10, 12, 8-K, 10-K, 11-K, 12-K and U5S, and Regulation S-X

The Securities and Exchange Commission today adopted certain amendments of the instructions pertaining to financial statements, summaries of operations and exhibits in the above forms and amendments of a related definition in Rule 1-02 and of Rule 5-02-39(d) of Regulation S-X. The instructions in the forms are amended generally to conform the terminology to that adopted in Regulation S-X in Accounting Series Release No. 125, to correct references to changed rule and caption numbers in Regulation S-X which were changed in Accounting Series Release No. 125, to achieve consistency among similar requirements in various forms, and to provide clarifications and modifications of the instructions in some respects. The definition of the term "significant subsidiary" in Rule 1-02 of Regulation S-X is amended to achieve consistency with the bases and tests of significance of subsidiaries and other affiliates in the instructions to the forms, e.g., Instruction 8 of Form S-1. The amendment to Rule 5-02-39(d), which was not included in the proposals that were published for comment, reduces the requirements specified in that rule for summaries of stockholders' equity accounts.

The amendments were proposed in Securities Act Release No. 5405 (Securities Exchange Act Release No. 10272, Public Utility Holding Company Act Release No. 18025) on July 9, 1973. Forms S-1, S-7, S-8, S-9 and S-11 are used for registration of securities under

the Securities Act of 1933; Forms 10 and 12 are used for registration of securities under the Securities Exchange Act of 1934; Forms 8-K, 10-K, 11-K and 12-K are used for special or annual reports pursuant to the 1934 Act; and Form U5S is used for annual reports by holding companies registered under the Public Utility Holding Company Act of 1935. Regulation S-X states the requirements applicable to the form and content of financial statements filed under the forms.

The comments received on the proposals were given careful consideration in the determination of the definitive amendments. Numerous suggestions for changes in the rules of an editorial or clarifying nature were adopted. The more significant or extensive changes which were adopted are discussed below. Areas in the rules where substantive changes were effected in the proposals are underlined.

In the requirements for summaries of operations in Forms S-1, S-8, S-11, 10 and 10-K (e.g., Item 6 in Form S-1) and for statements of income in Forms S-7 and S-9 (e.g., Item 6 in Form S-7), the format and the order of the instructions were made consistent and the instructions regarding the items of revenue and expense to be included in the summaries and regarding the computation of ratios of earnings to fixed charges in the summaries and the statements were updated to reflect current requirements. In this connection in the specifications for "fixed charges" (e.g., Instruction 5(c) of Item 6 of Form S-1), the criterion for the interest factor of one third of all rentals has been deleted inasmuch as reliable estimates of the portion of rentals which represent interest can now generally be made and there is considerable evidence that one third of rentals is not a reasonable approximation of the interest factor today. In Form S-9 the general instruction pertaining to the use of the form is amended to conform the requirements relating to the fixed charge ratios to the comparable requirements under Item 3, Statements of Income.

Comments were made that the requirements for the ratios of earnings to fixed charges and to combined fixed charges and preferred dividends should be reconsidered in view of questions regarding whether the criteria for the computations continue to be appropriate and whether the disclosures have sufficient analytical value to readers to warrant their continuation. A further study is planned in the light of these questions to determine what, if any, additional amendments would be appropriate.

The proposed clarification of the instructions for the furnishing of separate summaries of operations of the registrant in addition to consolidated statements was deleted and the original language in the instructions was restored, inasmuch as most commentators considered that the requirements for separate registrant statements would be extended by the proposal. Many also indicated a belief that the general requirements for separate financial statements of registrants in addition to consolidated statements should be reduced. This matter will also be given further consideration.

The proposal to change the requirements for a summary of operations in Form S-8 to requirements for statements of income consistent with Form S-9 was eliminated on the basis of comments that this would be an extension of requirements which could not be justified by the purposes of Form S-8. In this form also the instructions to the summary were clarified regarding the periods for which various statements are required.

The instruction to the summaries (and the statements of income) regarding reconciliations of revenues and net income for differences in reports previously issued (e.g., Instruction 3 of Item 6 of Form S-1) has been revised to conform it closely to a comparable rule in Regulation S-X (Rule 3-07(b)).

One of the instructions to the summary of operations in Form 10-K (Instruction 5 to Item 2) which requires a statement by the registrant and a letter by the independent accountant regarding changes in accounting principles or practices, as amended in this release, has been adopted in Form 12-K (Instruction 7 as to Exhibits). This requirement which was adopted in Form 10-K in Release No. 34-9344 is considered to be applicable to utility company registrants who utilize Form 12-K in filing their annual reports in lieu of Form 10-K. The instruction has been further

amended to provide that the independent account's letter regarding a specific change need be filed only one time.

Certain of the instructions regarding financial statements (i.e., Instructions 4, 6, 7 and 8 as to Financial Statements of Form S-1 and similar instructions in Forms S-7, S-9, 10 and 10-K) were modified or clarified and made consistent among forms with respect to the requirements for financial statements of the registrant to be filed and for the filing or omission of financial statements of subsidiaries not consolidated and of 50 percent or less owned persons. Similar instructions regarding these latter requirements were also included for consistency under Exhibits in Forms 12 (Instructions 7 and 8) and 12-K (Instructions 4 and 5). A test relating to income, which is considered an important test of significance of affiliates, is adopted in the instructions in the forms and in the definition of "significant subsidiary" in Regulation S-X as an addition to the existing tests relating to assets and revenues. The tests as proposed have been modified to eliminate certain exclusions in relation to the assets and income tests on the basis of comments that their effect would be minimal in most instances. In Form 8-K the tests in Instruction 4 of Item 2 for determining the significance of acquisitions and dispositions of assets or businesses were conformed to the tests in the definition in Regulation S-X.

The instructions pertaining to succession to and acquisition of other business (i.e., Instructions 11 and 12 as to Financial Statements of Form S-1 and similar instructions in Forms S-7 and 10) have been updated to reflect current requirements and practices and clarified as between past and future successions. Further clarifications have been made in the instructions as proposed and the requirements for pro forma income statements have been stated in accordance with suggestions received. Comparable instructions have been included in Form S-9 to achieve consistency with Form S-7.

In Form S-11 corrections of several references and requirements relating to Regulation S-X were made to reflect revisions of the regulation in Accounting Series Release No. 125. Item 26 and special provision C-3 of the Instructions as to Financial Statements are revised and special provisions C-5, 6 and 7 are omitted to reflect the adoption in Regulation S-X of new schedules as Rules 12-42 and 12-43 in substitution for the schedules specified in Rules 12-37 and 12-38 and new instructions in Rule 5-04 for Schedules XVII, XVIII and XIX which were previously designated as Schedules XVIII, XIX and XX in Form S-11.

In Form U5S corrections of references to the revised Regulation S-X were also made. Paragraphs 1(c)(i) and (ii) of the Instructions as to Financial Statements, which provide for the omission of certain schedules specified in Rule 5-04 of Regulation S-X, are revised to provide for the omission also of new Schedule XVIII which was adopted under Rule 5-04. Schedule XVII, which is presently specified for omission in paragraphs (c)(i) and (ii), formerly required compliance with Rule 12-17 of Regulation S-X, the requirements of which rule were combined with Rule 12-04 and Schedule III under Rule 5-04. Schedule XVII in Rule 5-04 now requires compliance with new Rule 12-42 and it is considered appropriate to continue to permit the omission in Form U5S of Schedule XVII with regard to the new requirements as well as the old by the continued omission of Schedule III. New Schedule XIX, which requires information regarding certain other investments, would be required if applicable. Also in Form U5S, the Instructions as to Financial Statements are updated to make them consistent with those of Form 10-K with respect to requiring statements of source and application of funds and the examination by the independent accountant of the schedules filed in support of the financial statements.

These amendments are adopted pursuant to authority conferred on the Securities and Exchange Commission by the Securities Act of 1933, particularly 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; and the Public Utility Holding Company Act of 1935, particularly Sections 5(b), 14 and 20(a) thereof.

(The text of the amendments to Forms S-1, S-7, S-8, S-9, S-11, 10, 12, 8-K, 10-K, 11-K, 12-K and U5S and Rules 1-02 and 5-02-39 of Regu-

lation S-X is omitted.) The amendments shall be effective with respect to the applicable rules and forms on July 1, 1974.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 156
April 26, 1974

SECURITIES EXCHANGE ACT OF 1934
Release No. 10756

Statement Regarding the Maintenance of Current Books and Records by Brokers and Dealers

Inquiries have been received by the Commission requesting clarification of the requirement of Rule 17a-3(a) under the Securities Exchange Act of 1934 that every broker-dealer shall "make and keep current" certain books and records enumerated in the rule. Also, subparagraph (c) of Rule 17a-11 requires that telegraphic notice be given to the Commission when a broker or dealer fails to comply with the requirements of Rule 17a-3 to "make and keep current" books and records prescribed by the rule.

Rule 17a-3(a) requires that registered broker-dealers prepare records of transactions and dealings in securities for the accounts of the firm's customers as well as for its own risk and account, and to prepare records of other financial transactions related to the business of the broker-dealer. These requirements are intended to serve three basic regulatory purposes. First, it is expected that the broker-dealer maintain current books and records for the protection and convenience of customers; that is, customers are entitled to prompt responses to inquiries and resolution of claims relating to their accounts. Secondly, these requirements are intended to enable a broker-dealer to be aware of the extent of its compliance with the various rules and requirements, particularly the net capital and other customer protection rules,[1] and be able to demonstrate compliance to the Commission and the self-regulatory authorities without the burden of bringing books and records up-to-date being placed upon the regulatory authorities. Third, a broker-dealer should have current books and records to enable it to fulfill its obligations and responsibilities to other broker-dealers with whom business is transacted. Additionally, good business practice requires timely information for effective management decisions. In order to serve these purposes, we discuss in the following paragraphs general guidelines for the maintenance of current books and records with respect to the requirements of Rules 17a-3(a) and 17a-11.[2]

Order Tickets and Confirmations

Subparagraphs (6) and (7) of Rule 17a-3(a) require the preparation of a memorandum of each brokerage order and each principal transaction and subparagraph (8) requires maintenance of copies of confirmations of transactions for the accounts of customers and partners. These are the basic source documents and transaction records of a broker-dealer. By their nature the memoranda of brokerage and principal transactions should be prepared at the time of the transactions, and the confirmations, which are prepared from the memoranda, should be prepared and mailed on the day of the transaction or the following business day.

[1] Including Rule 15c3-1 or comparable requirements of a national securities exchange of which the broker-dealer is a member and Rule 15c3-3.

[2] Subsequent modification or change of applicable rules may result in the revision of the guidelines set forth herein (for example, see proposed revisions to Rule 15c1-4, Securities Exchange Act Release No. 10681, Investment Company Act Release No. 8275).

Records of Original Entry

The blotters or other records of original entry described in subparagraph (1) of Rule 17a-3 itemize each day's transactions in a format that facilitates posting to the general and subsidiary ledgers. Blotter records relating to securities transactions—e.g., daily purchase and sale blotters—should reflect all transactions as of the trade date and should be prepared no later than the following business day. Similarly, blotter records relating to securities movements and the receipt and disbursement of cash should reflect such transactions on the date they occur and should be prepared no later than the following business day.

General Ledgers

The ledgers prescribed in subparagraph (2) of Rule 17a-3 are the general records reflecting all asset, liability and capital accounts and all income and expense accounts and include control accounts for subsidiary ledgers. The blotters and other records of original entry should be maintained not only on a daily basis as discussed above, but in a form which will facilitate posting of the general ledger as frequently as necessary to enable the broker-dealer to make the computations necessary to ascertain his compliance with the net capital rule and the customers' reserve requirement rule.[3] For many broker-dealers, compliance with the customers' reserve requirement entails a weekly computation based on updated general ledger account balances.

A broker-dealer is required to be in compliance with the net capital rule at all times and the general ledger must be posted as frequently as may be necessary to make that determination. Compliance with this rule and the concern for frequent computations becomes particularly important in periods of sharp changes in securities prices and increases in trading volume. Firms which are frequent participants in underwriting syndicates or which effect transactions in large blocks of stock may also find it necessary to post their ledger on a daily basis because of the need for making frequent net capital computations. If a broker-dealer effects only a limited number of transactions during an accounting period and it is clear from the nature of the business conducted that such transactions would have no material adverse effect on the broker-dealer's financial and operational condition, net capital or customer's protection requirements during the period it may be appropriate to post the general ledger on a monthly basis.[4]

Customer's Ledger Accounts

Transactions involving the purchase and sale of securities should be posted to the customer's ledger accounts described in subparagraph (3) of Rule 17a-3 no later than settlement date. Other customer transactions relating to securities movements and cash receipts and disbursements should be reflected as of the transaction date and should be posted to the accounts no later than the first business day following the transaction.

Subsidiary Ledgers

The subsidiary ledgers and other records[5] relating to securities in transfer, dividends and interest received, securities borrowed and securities loaned, and monies loaned required under subparagraphs (4)(A)-(D) should be posted no later than two business days subsequent to the date of the securities or money movements. Transactions between brokers not completed on settlement date should be posted to the appropriate fail to deliver or fail to receive ledger (or other record) no later than the first business day

[3] Rule 15c3-3(e).

[4] In the course of posting the books at interim dates during a month, it may not be necessary to make adjustments for accruals and deferrals such as for depreciation or prepaid expenses if they would not materially affect the financial condition of the broker-dealer.

[5] As used in subparagraph (4) and elsewhere in Rule 17a-3, the term, "other records" should be construed to include, where appropriate, copies of vouchers, confirmations, or similar documents which reflect the information required by the applicable subparagraph arranged in appropriate sequence and in permanent form, including similar records developed by the use of automatic data processing systems and produced or reproduced on microfilm.

following settlement date; resolution of fail transactions should be recorded no later than the first business day following resolution. A broker-dealer who maintains his accounts on the trade date basis of accounting and uses "fail" accounts to reflect transactions with other brokers should post transactions to the accounts no later than two business days subsequent to the transaction date. In accordance with the provisions of Rule 17a-13(b)(5), long and short stock record differences shall be entered in an appropriate ledger account (subparagraph (4)(F)) no later than seven business days after the date of a required quarterly securities examination and verification.[6]

Securities Position Record

The securities record required by subparagraph (5) of Rule 17a-3(a) shall reflect the changes resulting from purchase and sale transactions either as broker or dealer as of clearance date, or settlement date, and should be recorded no later than the following business day.[7] In addition, other changes in securities positions should be reflected on the date of the security movement or on the following business day as of the date of the movement. Long and short securities record differences shall be entered concurrently with their recording in the subsidiary ledger required by subparagraph (4)(F).

Transactions in Options

The record of puts, calls, spreads, straddles, and other options described in subparagraph (10) should reflect transactions as of the date an option is written, guaranteed, traded or exercised and should be prepared no later than the business day following the transaction.

Trial Balances and Capital Computation

Subparagraph (11) requires the monthly preparation of a trial balance of all ledger accounts and a computation of aggregate indebtedness and net capital as of the trial balance date. These records should be prepared no later than 10 business days after the end of the accounting period, except in those instances where the records must be prepared in a lesser period to satisfy any reporting requirements established by any self-regulatory authority of which the broker-dealer is a member.[8]

Other Records

The record of beneficial ownership of each cash or margin account (subparagraph (9) of Rule 17a-3) should be prepared before transactions are effected in an account. The employment questionnaire or application (subparagraph (12) of Rule 17a-3) should be prepared at or prior to the commencement of employment.

Time Lag in Transmission of Data

Under certain limited circumstances the accounting department of a broker-dealer may not be aware of a transaction until a few days after it occurs. Transactions such as receipts and disbursements in out-of-town branches or by correspondents should be recorded no later than the day after the transaction is reported to the accounting department, and dividend and interest claims from other brokers should be recorded no later than the day after the validity of the claim is established.

Service Bureaus

If a broker-dealer hires or engages an outside service bureau or other recordkeeping service to handle its records, the require-

[6] If counts are made on a cyclical basis in accordance with Rule 17a-13(c), any stock record difference shall be recorded within seven business days subsequent to examination and verification of a particular security.

[7] The requirement for current maintenance of the securities record can be met by broker-dealers through preparation of a full securities record weekly, supplemented by a daily "takeoff" sheet summarizing and balancing each day's securities movements.

[8] Although not specifically referred to in Rule 17a-3, the weekly or monthly computation of the amount to be on deposit under the customers' reserve requirement rule must be made in sufficient time to enable the broker-dealer to make the required deposit no later than one hour after the opening of banking business on the second business day following the date on which the computation is based, as required by Rule 15c3-3(e).

ment to make and keep current the broker-dealer's books and records is in no way diminished and under such circumstances the broker-dealer is responsible to the same degree for maintaining current books and records as if he were maintaining them himself. Where a broker-dealer undertakes to have his books and records prepared and maintained by a service bureau or recordkeeping service, he should assure himself that the service will be provided in conformity with the Commission recordkeeping rules.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 157
July 8, 1974

SECURITIES ACT OF 1933
Release No. 5512

SECURITIES EXCHANGE ACT OF 1934
Release No. 10906

Findings and Opinion Accepting Waiver and Consent and Imposing Remedial Sanctions in the Matter of Arthur Andersen & Co. (Rule 2(e) of the Rules of Practice)

In May, 1973 information came to the attention of the Commission which indicated that the Commission and the public had not been fully informed of the facts relating to a settlement negotiated between Whittaker Corporation ("Whittaker") and its auditors, Arthur Andersen & Co. ("Arthur Andersen") arising out of an audit performed by Arthur Andersen of the inventory of a subsidiary of Whittaker. Accordingly, the Commission ordered a formal investigation into this matter which confirmed that public disclosure and disclosure of this settlement to the staff had been incomplete. As a result of this investigation, an injunctive proceeding was instituted on February 8, 1974 against Whittaker and the captioned proceeding pursuant to Rule 2(e) of the Commission's Rules of Practice was instituted thereafter.

Since the proceedings were instituted, Arthur Andersen, solely for the purposes of settling this matter, and without admitting or denying any of the allegations, findings or conclusions has consented to the entry of an order censuring the firm and to the publication of certain findings and conclusions by the Commission. For purposes of this settlement, Arthur Andersen has waived separation of functions and consented to the staff's participation in the preparation of this order and opinion.

The Arthur Andersen settlement with Whittaker arose out of its audit of the inventory of Crown Aluminum Corporation, a major subsidiary of Whittaker, as part of its examination of the financial statements of Whittaker Corporation for the fiscal year ended October 31, 1971. Subsequent to this examination, in connection with the proposed sale of Crown, a physical inventory was taken which indicated that inventory on the books exceeded physical inventory on hand by approximately 100%. In the subsequent investigation, it was determined that the inventory overstatement resulted from the fraudulent alteration of inventory records by Crown management and other Crown personnel. By recreation of inventory records, it was calculated that the $9.2 million book inventories of Crown at October 31, 1971 were overstated by approximately $4.4 million, and that income for fiscal years 1970 and 1971 was overstated. Of this total shortage, approximately $2.5 million occurred at Crown's Roxboro plant. The Roxboro physical inventory had been observed by Arthur Andersen.

In connection with this observation, the Arthur Andersen auditors did not adequately control inventory count tags even though the firm's own procedures require such control. Accordingly, Crown personnel

were able to alter certain tags and to create other tags which were included with actual count tags prior to the tabulation of the inventory. In addition, the fraudulent tags were printed out in numerical sequence on the inventory tabulation listing and indicated quantities of aluminum coil in units of 50,000 pounds per coil which are quantities in excess of that which could have been reasonably expected to be physically contained in the Roxboro plant or any other plant. The plant did not manufacture or purchase aluminum coils in excess of 5,000 pounds. The auditors and any reviewers of the inventory work papers did not notice this block of 100 tags which constituted a substantial portion of the total inventory on the computer listing with quantities 10 times as large as the largest actual inventory item. Normal inventory auditing procedures would require that special attention be paid to the largest items in the inventory.

Further, this inventory observation took place under circumstances which should have warranted special care. Arthur Andersen was aware that in 1969 and 1970 certain inventory tags originally accounted for as unused were included as used by Crown in the computer runs. Arthur Andersen also knew that Crown's system for accounting for the inventory resulted in differences between the physical and book inventories among various subcategories, though not in net amounts.[1] Further, the 1971 audit took place in the context where an internal Arthur Andersen memorandum had expressed questions concerning the "credibility" in other respects of Crown's management.[2]

In the judgment of the Commission, Arthur Andersen did not follow generally accepted auditing standards in the audit of Crown's inventory, and must share responsibility for the misstatements which resulted, even though it is apparent that the firm was the victim of a deliberate scheme to defraud perpetrated by certain management, supervisory and plant personnel of Crown.

The Commission has been advised that Arthur Andersen has taken steps to prevent the recurrence of similar audit deficiencies. The firm has thoroughly reviewed the audit program used to audit Crown's inventory in order to make the most constructive use of its experience in this regard. While Arthur Andersen did not find that the programs themselves were deficient within the parameters for which they were designed, nevertheless it has revised its audit guides in such a way as to enable reviewing personnel to detect breakdowns in audit procedures such as occurred here. Further, Arthur Andersen is in the process of preparing a case study of the Crown Aluminum situation. This case study will be used in Arthur Andersen's staff training program in order to alert its professional staff to situations of this nature and to make its professional staff more aware of the areas in which a fraud can be perpetrated and the methods used to cover up such fraudulent conduct.

In addition, the Arthur Andersen personnel involved in the audit on both a staff and a supervisory level have either left the firm or been reassigned to responsibilities not related to the firm's professional practice.

The Commission believes that these corrective measures and the settlement negotiated at arm's length with the party damaged make unnecessary any further action by the Commission in regard to the inventory auditing deficiency. Subsequent actions by Arthur Andersen in the disclosure of the settlement

[1] Employees at Crown improperly prepared and/or recorded production and other accounting records so that the overall book inventory was virtually equal to the inflated physical accounts.

[2] An Arthur Andersen internal memorandum dated March 14, 1970, expressed the following:

"... There may be a question as to this client's [Crown] credibility as their position changes relative to the net income they wish to report and pressures Whittaker is exerting on them.

* * * * *

"In our opinion, the Crown personnel have not been kept fully informed by Whittaker on just what we are doing in relation to the S-1. It is their opinion that we should pass adjustments so they can show a very favorable trend. They have told us that this is what our other offices are doing, and that you have agreed that our treatment of the inventory and bad debt adjustments is not valid—they are definitely trying to play off you against us to get favorable treatment."

and related matters require further discussion and action.

Promptly following discovery of the inventory problem, Whittaker and Arthur Andersen agreed that it would be desirable to conduct a comprehensive review of the company's accounting systems and internal controls and an examination of its major inventories as well as to engage in a balance sheet audit of expanded scope at the end of the 1972 fiscal year in order to assure both Whittaker and Arthur Andersen that similar problems did not exist at operating units in addition to those discovered at Crown. Initially, Arthur Andersen offered to conduct this review, to assist in the implementation of any recommendations, and to perform the expanded scope audit work at "loan staff rates," approximately one-half of Arthur Andersen's normal billing rates, which would approximate its out-of-pocket costs. At the time, Arthur Andersen estimated that the review work, if billed at normal rates, would amount to approximately $340,000. At Whittaker's request Arthur Andersen agreed to perform the review at no charge. Arthur Andersen also said to Whittaker that it would assist in performing any systems work recommended in the review at approximately one-half the normal billing rates.

At about the same time, Whittaker retained special counsel to determine whether it had a cause of action against Arthur Andersen. It did so because it was of the belief that Arthur Andersen had conducted an inadequate audit in connection with Crown's inventory. Because Whittaker's own investigation relating to the cause of the inventory discrepancies was not then completed, it was decided that the company would defer determining whether it had a cause of action against Arthur Andersen until the results of investigation were known. Whittaker did not advise Arthur Andersen that Whittaker was evaluating its legal rights against Arthur Andersen. Following the conclusion of its investigation into the cause for the inventory discrepancies, and in December 1972, after Arthur Andersen had completed its review of Whittaker's accounting systems and internal control and issued a report thereon, Whittaker was advised by its special counsel as well as its General Counsel that in their opinion Whittaker had a cause of action against Arthur Andersen. This conclusion was communicated to Whittaker's Board of Directors, which decided that the company should pursue its claims against Arthur Andersen. However, because Arthur Andersen was then in the process of completing its audit of Whittaker's 1972 financial statements, and Whittaker was concerned that the assertion of a claim might jeopardize the ability of Arthur Andersen to complete its audit, Whittaker intentionally withheld from Arthur Andersen any indication that Whittaker intended to assert a claim against Arthur Andersen.[3] On December 28, 1972, the board of directors decided to assert a claim against Arthur Andersen but concluded that it should not be brought to Arthur Andersen's attention until Arthur Andersen had completed its audit and had signed its report on Whittaker's financial statements which was to be included in a registration statement to be filed with the Commission in a few days.

On January 4, 1973, Arthur Andersen executed its report on Whittaker's financial statements for the fiscal year ended October 31, 1972. The auditor's report and financial statements were contained in a registration statement filed with the Commission by Whittaker on January 5, 1973. On the same day that the registration statement was filed with the Commission, officers of Whittaker advised Arthur Andersen that Whittaker felt it had a claim against Arthur Andersen. At that time, Whittaker asserted a claim of ap-

[3] At a board of directors meeting in early December, the topic of submitting the name of Arthur Andersen to the shareholders for ratification as the auditors for the following year was discussed even though Whittaker had not previously submitted to their shareholders the question of ratifying the selection of auditors. At a board meeting held on December 22, 1972, it was decided that Arthur Andersen would be recommended to the shareholders, provided that the claim Whittaker intended to assert against Arthur Andersen could be resolved. However, when Arthur Andersen requested a copy of the minutes in connection with its audit, Whittaker furnished only a summary of the minutes of this meeting, claiming that the full minutes had not as yet been prepared. The summary made no mention of the claim against Arthur Andersen.

proximately $3 million against Arthur Andersen. During the month of January 1973, there followed a number of meetings between top officers of Whittaker and senior partners of Arthur Andersen. During these meetings, Arthur Andersen indicated that the pending claim against it jeopardized its independence and therefore that it would be unable to sign amendments to the pending registration statements. Whittaker told Arthur Andersen that if the issues were not settled, Whittaker would not be able to recommend Arthur Andersen to its shareholders in connection with the next shareholder's meeting. On January 30, 1973 personnel from Whittaker and Arthur Andersen met to see if they could resolve their differences.

During the negotiations, Arthur Andersen maintained that it would not settle for any amount in excess of $1 million. Initially, they offered to settle by paying Whittaker $500,000 in cash. They also proposed to establish a ceiling of $250,000 at loan staff rates for the implementation work relating to the recommendations of the previous review in accordance with the agreement made prior to the review. At that time, they explained that Whittaker was going to receive almost $2 million: $500,000 in cash, $250,000 in free services at loan staff rates equal to $500,000 in normal billings, plus the $1 million in free services that had already been performed. This was the first time that Whittaker had been advised that the review work Arthur Andersen had previously performed without charge to Whittaker would have cost approximately $1 million at normal billing rates and not the originally estimated $340,000. Whittaker, however, insisted upon a minimum of $1 million in cash in addition to the $250,000 loan staff assistance which Arthur Andersen had offered, for a total of $1,250,000. After several intermediate offers, Whittaker finally offered to settle on a cash payment of $875,000. Agreement was also reached on a ceiling of $375,000 for the implementation program at loan staff rates. Whittaker executed and delivered to Arthur Andersen a written release of its claim in consideration of the payment to it of $875,000.

According to Whittaker, immediately preceding agreement to the terms of this final proposal, Arthur Andersen inquired of Whittaker whether Arthur Andersen would be recommended to the shareholders at the forthcoming shareholders meeting and were told they would be recommended.

According to Whittaker, Arthur Andersen desired to have disclosures concerning the settlement limited to the $875,000 cash payment.[4] According to Arthur Andersen the settlement amounted only to the cash payment of $875,000 and, since the other factors were not a part of the settlement, no disclosure was necessary.

Following the settlement, counsel for Whittaker requested a meeting with the staff of the Commission, including the Chief Accountant of the Commission, in order to discuss the possible effect the settlement might have on Arthur Andersen's independence. This meeting took place February 6, 1973 and was attended by senior management of Whittaker and senior partners of Arthur Andersen, including on both sides persons who had attended the negotiating meetings described above, and by their respective counsel. At that time, the $875,000 cash payment settlement was described to the Commission as the settlement. No mention was made of the earlier free review work that Arthur Andersen had performed several months before

[4] The disclosure of the settlement in Whittaker's proxy material dated February 16, 1973, was as follows:

> "Arthur Andersen & Co. has acted as the Company's independent auditors since 1952. Upon discovery in May, 1972 that the book inventory at one of the company's subsidiaries exceeded the physical inventory by approximately $6,300,000, Arthur Andersen & Co. undertook a detailed review of the accounting and financial controls at each of the Company's operating units and developed recommendations for the improvement of such controls. These recommenations have been reviewed by the Company and are being implemented by the Company with the assistance of Arthur Andersen & Co. Arthur Andersen & Co. has agreed to pay the Company $875,000 as reimbursement for certain expenses of the Company related to the inventory discrepancy, and the Company has agreed that it will not initiate against Arthur Andersen & Co. any claims it might have as a result of the inventory discrepancy. The agreement preserves all of the Company's other rights relating to the inventory discrepancy, including its right to prosecute its full claim against its fidelity insurance carriers."

any threat of suit (which had been estimated to have involved almost $1 million if billed at normal rates), and no mention was made of the additional agreement by Arthur Andersen to assist in implementing the review recommendations at loan staff rates up to an amount of $375,000. In addition, no mention was made of the deficiencies in the Crown audit even though the Commission staff, concerned because of the apparent size of the settlement, asked Arthur Andersen representatives whether there were significant audit deficiencies. Arthur Andersen personnel at the meeting stated that they stood by the quality of their audit and were making a settlement solely to avoid protracted litigation. As a result of that meeting, the staff of the Commission concluded, considering all of the circumstances then known to it, that it would not challenge Arthur Andersen's independence.

Following the meeting with the staff, Whittaker recommended to its shareholders in a proxy statement dated February 16, 1973 that Arthur Andersen be selected as Whittaker's auditors for the fiscal year 1973. At the annual meeting of shareholders held on March 20, 1973, the shareholders approved management's recommendation.

Shortly thereafter, the Commission learned of the fee arrangements between Whittaker and Arthur Andersen with respect to review work and implementation. As a result of this, it ordered that a formal investigation be undertaken into this matter. As noted *supra*, as a result of that investigation, the Commission on February 8, 1974 instituted an injunctive proceeding against Whittaker,[5] and ordered the institution of these proceedings. In the injunctive action, the Commission charged Whittaker with violating Section 14(a) of the Securities Exchange Act of 1934 and Rule 14a-9 thereunder in connection with Whittaker's February 16, 1973 proxy statement in which Whittaker sought shareholder ratification of the appointment of Arthur Andersen as Whittaker's auditors for the fiscal year 1973.[6] Contemporaneous with the filing of the complaint, Whittaker, without admitting or denying the allegations contained therein, consented to the entry of an order enjoining Whittaker from future violations of Section 14(a) of the Securities Exchange Act and Rule 14a-9 thereunder. Whittaker also consented to the entry of an order requiring it to disclose to its shareholders in the first proxy solicitation made by Whittaker following the entry of the court's decree, "the full details of its relationship with Arthur Andersen & Co." On March 26, 1974, Whittaker mailed to its shareholders a proxy statement setting forth its relationship with Arthur Andersen.

In many respects, Arthur Andersen must share responsibility for the incomplete disclosure contained in Whittaker's 1973 proxy statement. Arthur Andersen must also share responsibility for the incomplete statement that was given to the staff of the Commission when the staff's advice was sought concerning Arthur Andersen's continued independence.

Anything less than full disclosure cannot be considered consistent with the securities laws. The keystone of the securities laws is disclosure, disclosure which puts a premium on two objectives:

> "The emphasis on disclosure rests on two considerations. One related to the proper function of the federal government to investment matters. Apart from the prevention of fraud and manipulation, the draftsmen of the '33 and '34 Acts viewed that responsibility as being primarily one of seeing to it that investors and speculators had access to enough information to enable them to arrive at their

[5] *Securities and Exchange Commission* v. *Whittaker Corporation*, C.D. Calif., C.V. 74 345 HP (filed February 8, 1974).

[6] In September 1973, during the pendency of the Commission's investigation which preceded the filing of the above-mentioned complaint, Whittaker's board of directors concluded that the interests of the company required the appointment of a successor to Arthur Andersen as the company's auditor so that the fiscal 1973 financial statements could be audited on a timely basis. Whittaker concluded that in the context of that investigation, "Arthur Andersen & Co. would be disabled from rendering an opinion with respect to the company's financial statements for the 1973 year."

> own rational decisions. The other rests on the belief that appropriate publicity tends to deter questionable practices and to elevate standards of public conduct."[7]

The ultimate goal of the securities laws is, of course, shareholder and investor protection. Effective disclosure is essentially a means to that end and the entire legislative scheme can be frustrated by technical or formalistic attempts to comply with the statutes and rules involved without complying with the substance and hence the spirit and purpose of the laws involved. The Commission has consistently attempted to achieve disclosure in terms which are "clearly understandable."[8] Unfortunately, actual disclosures made have not always achieved the objectives of the statute. As District Judge Weinstein noted in this connection:

> "In at least some instances, what has developed in lieu of the open disclosure envisioned by the Congress is a literary art form calculated to communicate as little of the essential information as possible while exuding an air of total candor. Masters of this medium utilized turgid prose to enshroud the occasional critical revelation in a morass of dull, and—to all but the sophisticates—useless financial and historical data. In the face of such obfuscatory tactics the common or even the moderately well informed investor is almost as much at the mercy of the issuer as was his pre-SEC parent."[9]

In the instant case both Whittaker and Arthur Andersen, in seeking the advice of the Commission's staff in the manner in which they did, not only frustrated the purposes of the statute but imposed upon the Commission and its staff by seeking advice without providing the staff with all of the material facts. The representatives of Arthur Andersen in this regard emphasize that they were acting in good faith and in reliance on advice of several counsel, and that they believed additional disclosure was not germane or required. It should be apparent to all, however, that the securities laws and their administration by the Commission and its staff cannot function well if those who practice before the Commission and those who file documents with it fail to operate in an atmosphere of unquestionable candor and full disclosure. Adequate disclosure does not take place when there are salient facts bearing on the merits of a negotiated settlement which are not disclosed.

Whatever the merits of the argument that disclosure of the other aspect of the settlement were not required to be made in the proxy statement, there is no excuse for their non-disclosure to the staff of the Commission when its advice was being sought. The advice sought and the advice given are only as good as the information upon which they are predicated. The limited review engaged in by the staff of the Commission, whether it relates to registration statements, proxy statements or other materials filed with the Commission, and the advice sought and the comments given by the staff cannot take place consistent with the objectives of the statutes in an adversarial atmosphere. The Commission and its staff do not and cannot investigate representations made to it, but must be able to rely on their completeness if this process is to work. The objectives of the securities laws can only be achieved when those professionals who practice before the Commission, both lawyers and accountants, act in a manner consistent with their responsibilities. Professionals involved in the disclosure process are in a very real sense representatives of the investing public served by the Commission, and, as a result, their dealings with the Commission and its staff must be permeated with candor and full disclosure. It cannot resemble an adversary relationship more appropriate to litigants in court, because the Commission is not an adverse party in this context. All who are familiar with the Commission's policies know that too much importance is attached to the word of the professional, to permit his or her word to become the subject of question. A professional's word is often the functional equiva-

[7] *See* F. Wheat, *Disclosure to Investors*, 10 (1969) hereinafter referred to as the "Wheat Report").

[8] Wheat Report, at 78.

[9] *Feit* v. *Leasco Data Processing Equipment Corp.*, 332 F.Supp 544, 565 (E.D.N.Y., 1971).

lent of his or her reputation. Conferences with the staff of the Commission serve a vital role in the administration of the securities laws, and such conferences are predicated, for the most part, upon full disclosure by the professionals involved. It must be understood by all who practice before the Commission, lawyers and accountants alike, that the Commission and its staff cannot tolerate less than full disclosure.

By the Commission, Commissioner Sommer not participating.

GEORGE A. FITZSIMMONS
Secretary

ORDER

Under the terms of its offer of settlement, Respondent without admitting or denying the Commission's findings and only for the purpose of settlement, consented to the entry of an order embodying the following sanctions.

Accordingly, it is ORDERED that, subject to the terms and conditions provided in the offer of settlement, Respondent is censured by the Commission.

By the Commission. Commissioner Sommer not participating.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 158

July 19, 1974

SECURITIES ACT OF 1933
Release No. 5514

SECURITIES EXCHANGE ACT OF 1934
Release No. 10921

Order Accepting Sworn Undertaking Not to Engage in Practice Before The Commission in the Matter of Adolph F. Spear

On March 18, 1974, in an action brought by the Commission,[1] the United States District Court for the Southern District of New York entered an order permanently enjoining Adolph F. Spear, a Certified Public Accountant, from violating or aiding and abetting violations of Section 17(a) of the Securities Act of 1933, and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. The order, which was issued with Mr. Spear's consent and without his admitting or denying the allegations of the Commission's complaint, enjoins him from, among other things, engaging in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person in connection with, but not limited to, the preparation and dissemination of false certified financial statements of World Acceptance Corporation or any other issuer, the value and existence of properties owned by World Acceptance Corporation or any other issuer and the business operations of World Acceptance Corporation or any other issuer.

At the same time that he consented to the order of permanent injunction, Mr. Spear executed a sworn statement stating that he has no intention of resuming practice as a Certified Public Accountant and, in any event, that he will not perform any services as a Certified Public Accountant in connection with any administrative matter within the Commission's jurisdiction.[2]

After due consideration, and upon the rec-

[1] *Securities and Exchange Commission v. World Acceptance Corporation, et al.*, Civil Action No. 74-794 (S.D.N.Y.).

[2] In the Commission's view, the language of Mr. Spear's undertaking would, at a minimum, encompass practice before the Commission as defined in Rule 2(g) of the Commission's Rules of Practice.

ommendation of its staff, the Commission has determined to accept Mr. Spear's sworn undertaking not to practice before the Commission.

Accordingly, IT IS ORDERED that the sworn undertaking of Adolph F. Spear not to practice before the Commission be, and hereby is, accepted; and it is further ORDERED that the privilege of appearing or practicing before the Commission be, and it hereby is, permanently denied him.

For the Commission, by the Office of Opinions and Review, pursuant to delegated authority.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 159
August 14, 1974

SECURITIES ACT OF 1933
Release No. 5520

SECURITIES EXCHANGE ACT OF 1934
Release No. 10961

Notice of Adoption of Amendments to Guide 22 of the Guides for Preparation and Filing of Registration Statements under The Securities Act of 1933 and Adoption of Guide 1 of The Guides For Preparation and Filing of Reports and Registration Statements under The Securities Exchange Act of 1934 (Textual Analysis of Summary of Earnings or Operations)

Effective Date: September 30, 1974

The Securities and Exchange Commission today authorized the adoption of amendments to Guide 22, "Summary of Earnings," of the Guides for Preparation and Filing of Registration Statements under the Securities Act of 1933 ("Securities Act"). The Commission also authorized the adoption of Guide 1, "Summary of Operations," of Guides for Preparation and Filing of Reports and Registration Statements under the Securities Exchange Act of 1934 ("Exchange Act"). These Guides are not rules of the Commission nor are they published as bearing the Commission's official approval; they represent policies and practices followed by the Commission's Division of Corporation Finance and, in this instance, the Commission's Office of the Chief Accountant in administering the disclosure requirements of the federal securities laws. The proposals to amend Guide 22 under the Securities Act and adopt Guide 1 under the Exchange Act were originally published for comment on December 19, 1972 (Securities Act Release No. 5342) and then were reissued in revised form for additional comment on December 12, 1973 (Securities Act Release No. 5442). These Guides will require disclosure to clarify and explain the financial information called for by the Summary of Earnings and Statement of Income items of certain forms under the Securities Act and similar summaries required by certain forms under the Exchange Act.

The relevant forms under the Securities Act provide in part that, in addition to the columnar presentation of summary financial data, registrants must supply information of material significance to investors in appraising the results shown. Securities Act Guide 22, as amended, indicates the type of supplementary information needed to explain periodic changes in financial data included in the Summary of Earnings. In order to apply disclosure standards similar to those required by Securities Act Guide 22, as amended, to filings under the Exchange Act, the new Exchange Act Guide 1 is adopted.

In issuing the Guides for additional comment in December 1973, the Commission pointed out that it has long recognized the need for narrative explanation of financial statements. Over the years the rules under the various securities acts have been amended a number of times to require addi-

tional narrative disclosure of complex financial transactions. Securities Act Guide 22 and Exchange Act Guide 1 require an explanation of the Summary of Earnings and Summary of Operations to enable investors to appraise the quality of earnings. Investors should understand the extent to which accounting changes, as well as changes in business activity, have affected the comparability of year-to-year data and should be in a position to assess the source and probability of recurrence of net income (or loss). Thus, whenever there are material changes in the amount and source of revenues and expenses, including tax expenses, or changes in accounting principles or methods or their application that have a material effect on net income, an appropriate analysis and explanation is required. In addition, this analysis should include a discussion of material facts, whether favorable or unfavorable, required to be disclosed or disclosed in the prospectus, registration statement, or report which in the opinion of management may make historical operations or earnings as reported in summary of earnings not indicative of current or future operations or earnings.

Some commentators on the revised Guides felt that the standards for determining materiality were too inclusive and that items that were not material would still fall within the percentage test set forth in the Guides. The Guides, as adopted, provide that if in management's opinion an explanation of a change is not necessary to an understanding of the summary of earnings even though the change meets the percentage tests set forth in the Guides, the issuer should furnish the Division as supplemental information, a written statement of the reasons for such opinion. On the other hand, if the issuer believes an explanation of a change is necessary to an understanding of the summary, it should be given notwithstanding the fact that the change does not meet such percentage tests. For example, if sales and net earnings increased only 2% in the most recent period after having increased by 10% or more in previous periods an explanation of the 2% change would be appropriate. Also in response to comments, the Guides as finally adopted limit the issuer's explanation of material periodic revenue and expense item changes to changes beginning after the third most recent fiscal year of the Summary of Earnings (Summary of Operations) and provide that this explanation of material periodic changes in revenues and expenses be included in a section captioned "Management's Discussion and Analysis of the Summary of Earnings" immediately following the Summary of Earnings (Summary of Operations).

A number of commentators also objected to the requirement that management discuss facts that would indicate that historical earnings were not indicative of present and future earnings. Difficulty in deciding what "facts" would have to be included and in presenting forward looking information were cited. These comments have been taken into consideration in revising the Guides, which as adopted require discussion of only material facts required to be disclosed or disclosed in the relevant document which, in management's opinion, may make historical operations or earnings not indicative of current or future operations or earnings. The discussion called for would be in broad terms only; no specific quantitative estimates or projections would be required. Commentators also raised the question whether the Guide calls for disclosure relating to anticipated changes in the trend of earnings or in absolute numbers. Depending on the facts and circumstances, discussion of material facts indicating changes in either absolute amounts or in trends would be required.

It should be noted that the disclosures proposed would be in addition to "Information as to Lines of Business" called for by Item 9(b) of Form S-1 and Item 5(b)(1) of Form S-7 under the Securities Act and similar disclosure required by Item 1(c)(1) of Forms 10 and 10-K under the Exchange Act.

The text of Securities Act Guide 22 is set forth below. Exchange Act Guide 1 is also set forth below.

* * *

Guide 22 Summary of Earnings

(Note: This Guide applies to the items of the registration forms under the Act that provide for a Summary of Earnings, Statement of Income, Summary Financial Data, or Condensed Financial Information, i.e., Forms S-1, S-7, S-8, S-9, S-11 and S-14).

(a) The content of the Summary of Earnings is specified in general in the instructions to the pertinent items of the form. The necessity of disclosing items in addition to those specified in such instructions will depend upon the circumstances. These instructions cannot, of course, cover all situations which may arise nor is it practicable to set forth a Guideline dealing specifically with all possible situations.

(b) To enable investors to understand and evaluate material periodic changes in the various items of the summary of earnings, a separately captioned section (entitled "Management's Discussion and Analysis of the Summary of Earnings") immediately following such summary should include a statement explaining (1) material changes from period to period in the amounts of the items of revenues and expenses, and (2) changes in accounting principles or practices or in the method of their application that have a material effect on net income as reported. The purpose of this statement is to provide investors with management's analysis of the financial data included in the summary through a discussion of the causes of material changes in the items of the summary and of disclosure of the dollar amount of each such change and the effect of each such change on the reported results for the applicable periods. This discussion is necessary to enable investors to compare periodic results of operations and to assess the source and probability of recurrence of earnings (losses). The analysis should include a discussion of material facts, whether favorable or unfavorable, required to be disclosed or disclosed in the prospectus which, in the opinion of management, may make historical operations or earnings as reported in the summary of earnings not indicative of current or future operations or earnings.

(c) In general, the discussion of material periodic changes should be limited to: (1) the latest interim period presented and the comparable interim period in the immediately preceding fiscal year; (2) the most recent fiscal year presented and the fiscal year immediately preceding it; and (3) the second most recent fiscal year presented and the fiscal year immediately preceding it. There may be circumstances, however, under which an explanation of revenue or expense item changes between two or more of the earlier periods of the five year summary may be material to an understanding of the summary. Further, to better explain revenue and expense item changes for interim periods it may be necessary to give an analysis of changes between consecutive fiscal quarters.

(d) While it is not feasible to specify all subjects which should be covered in the discussion and analysis of the summary, the following are examples which registrants should consider in making disclosure:

1. Material changes in product mix or in the relative profitability of lines of business;
2. Material changes in advertising, research, development, product introduction or other discretionary costs;
3. The acquisition or disposition of a material asset other than in the ordinary course of business;
4. Material and unusual charges or gains, including credits or charges associated with discontinuation of operations;
5. Material changes in assumptions underlying deferred costs and the plan for amortization of such costs;
6. Material changes in assumed investment return and in actuarial assumptions used to calculate contributions to pension funds; and
7. The closing of a material facility or material interruption of business or completion of a material contract.

(e) The textual analysis should be presented in a manner that will best communicate the significant elements necessary to a

clear understanding by the investor of the financial results. Favorable as well as unfavorable trends and changes should be discussed. Tables and charts may be used where appropriate. A mechanistic approach to this analysis which uses boiler plate or compliance jargon should be avoided.

(f) For purposes of this Guide discussion of a change in an item of revenue or expense generally is required when an item required to be set forth in the summary or disclosed pursuant to Rule 12-16 of Regulation S-X increased or decreased by more than 10% as compared to the prior period (but only if such prior period is presented), and increased or decreased by more than 2% of the average net income or loss for the most recent three years presented. In calculating average net income, loss years should be excluded. If losses were incurred in each of the most recent years, the average loss shall be used for purposes of this test. Should the issuer be of the opinion that an explanation of a change is not necessary to an understanding of the summary even though the change meets the foregoing standards, the issuer shall furnish the Division, as supplemental information, a written statement of the reasons for the omission.

> Note: If an income statement in the form prescribed by Regulation S-X is used in lieu of the summary, then the discussion should cover the period to period changes in revenue and expense items required by such Regulation.

(g) Notwithstanding the fact that a change in an item of revenue or expense does not meet the standards set forth in paragraph (f), it should be discussed if the issuer believes an explanation of such a change is necessary to an understanding of the summary.

(h) When the text of the prospectus contains a discussion of factors indicating a material change in operating results, whether favorable or unfavorable subsequent to the latest period included in the summary of operations, the management discussion and analysis should call attention to the change and refer to the place in the prospectus where it is discussed.

* * *

Guide 1 Summary of Operations

(a) The content of the summary of operations is specified in general in the instructions to the pertinent items of Forms 10 and 10-K. The necessity of disclosing items in addition to those specified in such instructions will depend upon the circumstances. These instructions cannot, of course, cover all situations which may arise nor is it practicable to set forth a Guideline dealing specifically with all possible situations.

(b) To enable investors to understand and evaluate material periodic changes in the various items of the summary of operations, a separately captioned section (entitled "Management's Discussion and Analysis of The Summary of Operations") immediately following such summary should include a statement explaining (1) material changes from period to period in the amounts of the items of revenues and expenses, and (2) changes in accounting principles or practices or in the method of their application that have a material effect on net income as reported. The purpose of this statement is to provide investors with management's analysis of the financial data included in the summary through a discussion of the causes of material changes in the items of the summary and of disclosure of the dollar amount of each such change and the effect of each such change on the reported results for the applicable periods. This discussion is necessary to enable investors to compare periodic results of operations and to assess the source and probability of recurrence of earnings (losses). The analysis should include a discussion of material facts, whether favorable or unfavorable, required to be disclosed or disclosed in the registration statement or report which, in the opinion of management, may make historical operations or earnings as reported in the summary of operations not indicative of current or future operations or earnings.

(c) In general, the discussion of material periodic changes should be limited to: (1) the

latest interim period presented and the comparable interim period in the immediately preceding fiscal year; (2) the most recent fiscal year presented and the fiscal year immediately preceding it; and (3) the second most recent fiscal year presented and the fiscal year immediately preceding it. There may be circumstances, however, under which an explanation of revenue or expense item changes between two or more of the earlier periods of the five year summary may be material to an understanding of the summary. Further, to better explain revenue and expense item changes for interim periods it may be necessary to give an analysis of changes between consecutive fiscal quarters.

(d) While it is not feasible to specify all subjects which should be covered in the discussion and analysis of the summary, the following are examples which registrants should consider in making disclosure:

1. Material changes in product mix or in the relative profitability of lines of business;
2. Material changes in advertising, research, development, product introduction or other discretionary costs;
3. The acquisition or disposition of a material asset other than in the ordinary course of business;
4. Material and unusual charges or gains, including credits or charges associated with discontinuation of operations;
5. Material changes in assumptions underlying deferred costs and the plan for amortization of such costs;
6. Material changes in assumed investment return and in actuarial assumptions used to calculate contributions to pension funds; and
7. The closing of a material facility or material interruption of business or completion of a material contract.

(e) The textual analysis should be presented in a manner that will best communicate the significant elements necessary to a clear understanding by the investor of the financial results. Favorable as well as unfavorable trends and changes should be discussed. Tables and charts may be used where appropriate. A mechanistic approach to this analysis which uses boiler plate or compliance jargon should be avoided.

(f) For purposes of this Guide discussion of a change in an item of revenue or expense generally is required when an item required to be set forth in the summary or disclosed pursuant to Rule 12-16 of Regulation S-X increased or decreased by more than 10% as compared to the prior period (but only if such prior period is presented), and increased or decreased by more than 2% as compared to the average net income or loss for the most recent three years presented. In calculating average net income, loss years should be excluded. If losses were incurred in each of the most recent years, the average loss shall be used for purposes of this test. Should the issuer be of the opinion that an explanation of a change is not necessary to an understanding of the summary even through the change meets the foregoing standards, the issuer shall furnish the Division, as supplemental information, a written statement of the reasons for the omission.

Note: If an income statement in the form prescribed by Regulation S-X is used in lieu of the summary, then the discussion should cover the period to period changes in revenue and expense items required by such Regulation.

(g) Notwithstanding the fact that a change in an item of revenue or expense does not meet the standards set forth in paragraph (f), it should be discussed if the issuer believes an explanation of such a change is necessary to an understanding of the summary.

(h) When the text of the registration statement or report contains a discussion of factors indicating a material change in operating results, whether favorable or unfavorable, subsequent to the latest period included in the summary of operations, the management discussion and analysis should call attention to the change and refer to the place in the registration statement or report where it is discussed.

* * *

The Commission has authorized the adoption of Guide 22 and Guide 1 pursuant to authority in Sections 6, 7, 10 and 19(a) of the Securities Act, as amended, and Sections 12, 13, 15(d) and 23(a) of the Exchange Act, as amended. The amendments will be effective September 30, 1974 and will apply to registration statements under the Securities Act and to reports and registration statements under the Exchange Act filed on or after that date, but not to such registration statements and reports filed before that date.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 160

August 27, 1974

Findings and Order Suspending From Commission Practice in the Matter of Loux, Gose & Co. and Galen Lloyd Gose

These are proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice to determine whether Loux, Gose & Co. ("the firm"), a public accounting firm, and Galen Lloyd Gose, a partner of the firm, should be temporarily or permanently denied the privilege of appearing or practicing before the Commission.

Respondents have submitted an offer of settlement which the Commission determined to accept. Solely for the purpose of these proceedings and without admitting or denying the allegations of the order for proceedings, respondents consent to findings of misconduct as alleged in that order and to a specified sanction.

On the basis of the order for proceedings and the offer of settlement, it is found that:

1. The firm audited the records of a then registered broker-dealer, and certified its financial statement as of September 30, 1971. Gose was the partner in charge of the engagement.
2. In connection with the audit and the certification of the broker-dealer's financial statement, which was filed with the Commission on Form X-17a-5 pursuant to Rule 17a-5 under the Securities Exchange Act of 1934, respondents failed to comply with generally accepting auditing standards and the Commission's instructions for the Form. The audit was not adequately planned. The accountant conducting it lacked adequate training and proficiency as an auditor, and was not supervised properly by respondents. In addition, respondents failed to evaluate the effectiveness of the broker-dealer's existing internal controls to determine the need for extending the scope of the examination, to inquire into material post-statement events, and to obtain sufficient evidence to afford a reasonable basis for the unqualified opinion given to the broker-dealer.

Respondents consent to the entry of an order suspending them from appearing or practicing before the Commission for 18 months. They agree that prior to appearing or practicing before the Commission they will request a quality review of their auditing procedures under the quality review program of the American Institute of Certified Public Accountants, correct any deficiencies so discovered, and submit the findings upon such review to the Commission's Chief Accountant's Office and Fort Worth Regional Office. In addition, the firm agrees to give notice in writing of the findings in these proceedings to any client who requests auditing services for the purpose of registration with or reporting to the Commission.

Under the circumstances, it is appropriate

to impose the sanction specified in the offer of settlement.

Accordingly, IT IS ORDERED that, subject to the undertakings specified in the offer of settlement, Loux, Gose & Co. and Galen Lloyd Gose be, and they hereby are, suspended from appearing or practicing before the Commission for a period of eighteen months, effective immediately.

For the Commission, by the Office of Opinions and Review, pursuant to delegated authority.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 161
August 29, 1974

SECURITIES ACT OF 1933
Release No. 5524

SECURITIES EXCHANGE ACT OF 1934
Release No. 10993

Order Permanently Suspending Accountant from Appearance or Practice Before Commission in the Matter of Jerry A. McFarland

On June 26, 1973, the Commission entered an order, pursuant to Rule 2(e)(3)(i) of its Rules of Practice, temporarily suspending Jerry A. McFarland, a certified public accountant, from appearing or practicing before it. That order was based on the fact that, on February 25, 1974, the United States District Court for the Western District of Texas granted the Commission's motion for summary judgment and permanently enjoined McFarland from aiding or abetting further violations of Sections 5(a), 5(c) and 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder (*Securities and Exchange Commission* v. *Bankers Trust Company, Inc., et al.*, No. EP-73-CA-225).

The complaint in the injunctive action alleged, among other things, that McFarland had violated those provisions by his preparation and certification of materially false and misleading financial statements for Bankers Trust Company, which were used by that company and others in connection with the offer and sale of unregistered securities to the public.

Rule 2(e)(3)(ii) of the Rules of Practice provides that any person temporarily suspended in accordance with paragraph (i) may, within 30 days after service upon him of the order of temporary suspension, petition the Commission to lift such suspension, but that if no petition has been received by the Commission within 30 days after such service, the suspension shall become permanent. McFarland was duly notified of this provision. The 30-day period has expired and no petition to lift the suspension has been received by the Commission.

Accordingly, IT IS ORDERED that Jerry A. McFarland be, and he hereby is, permanently suspended from appearing or practicing before the Commission.

For the Commission, by the Office of Opinions and Review, pursuant to delegated authority.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 162

September 27, 1974

SECURITIES ACT OF 1933
Release No. 5528

SECURITIES EXCHANGE ACT OF 1934
Release No. 11029

Requirements for Financial Statements of Certain Special Purpose Limited Partnerships in Annual Reports Filed with the Commission

In recent years there have been an increasing number of registration statements filed with the Commission under the Securities Act of 1933 for the sale to the public of interests in limited partnerships which are formed in connection with activities involving income tax shelter or deferral opportunities, as well as the opportunity for investment gain in one form or another. Pursuant to Rule 15d-1 under the Securities Exchange Act of 1934 registrants under the Securities Act are required to file an annual report on Form 10-K for the fiscal year in which a registration statement becomes effective and for each subsequent fiscal year thereafter unless the registrant is exempt under Section 15(d) of the Exchange Act from such subsequent filings. Many of these limited partnership registrants qualify for the exemption from filing 10-K reports in subsequent fiscal years provided in Section 15(d) when securities to which the registration statement relates are held of record by less than 300 persons at the beginning of a fiscal year.

Some registrants, particularly those of the type which develop and sell a single asset, have filed Form 10-K reports presenting the required audited financial statements of the limited partnership on a tax basis of accounting rather than on the basis of generally accepted accounting principles (GAAP). Historically, presentation of financial statements of commercial and industrial companies on a GAAP basis has been considered the only acceptable basis for investors and potential investors in a public company. The independent accountants' reports accompanying the financial statements presented on a tax basis acknowledge that the financial statements do not purport to be in conformity with GAAP, and an opinion is expressed on the fairness of presentation of the financial statements on the tax basis. Heretofore, the staff has not, in general, requested amendment of these financial statements presented and audited on a tax basis. However, experience gained with the increased number of recent filings has caused a reconsideration of this matter.

One of the basic purposes of both the Securities Act and the Exchange Act is to require registrants to provide full and fair disclosure regarding all significant aspects and activities of the business for the benefit of the investing public. The requirements for financial statements under the Acts implement this objective by causing disclosures regarding the stewardship of financial resources of the company with respect to their utilization and their condition. Since financial statements prepared on a tax basis do not necessarily give a complete presentation of the stewardship of the resources, they do not in general meet the requirements for full and fair disclosure as envisioned in the Acts.

Complete data relating to many aspects of financial position and operations are frequently not included in financial statements prepared on a tax basis and the scope of the independent audit of such tax basis statements also may not be the equivalent of the usual audit of financial statements prepared on a GAAP basis. In addition, some problem areas arising out of relationships between a general partner in the limited partnership and other related parties may cause particular accounting and auditing difficulties. If the financial statements of these limited partnerships are prepared on a GAAP basis, it is likely that these factors would receive more attention and have an important bear-

ing on the determination of the scope of the audit.

While it is contended that, in some instances, investors in these limited partnerships are primarily interested in the tax status of their investments and thus tax basis financial statements are of more value to them, the ultimate realization of the tax benefits, as well as the ultimate recovery of the investment through sale of the project, depends on the proper utilization and stewardship of the resources of the enterprise. Independent verification of the reporting on these matters can best be obtained from audited financial statements presented on a GAAP basis. Presentation of the financial data on a tax basis may also be desirable but the presentation should be in addition to the presentation on a GAAP basis and should not supplant it. It is common practice for companies to make adjustments to their GAAP based accounts for income tax reporting purposes, and it is considered that these limited partnerships can provide the tax basis financial statements in addition to the GAAP basis statements without undue difficulty. In the rare instances where the sole 10-K report required for the limited partnerships covers a period near the start of the venture, the GAAP basis financial statements serve a useful purpose by providing important information to the original investors on the custody of the funds received and whether plans and commitments are being made in conformity with the proposed schedule of development of the project.

The Commission has concluded that exemptions should not be granted to these limited partnership registrants from the general requirement that financial statements should be presented in conformity with GAAP with the audit opinion rendered thereon on that basis in filings with the Commission. Accordingly, financial statements in Form 10-K reports filed by limited partnership registrants for fiscal years ending on or after December 27, 1974, should be presented on the basis of generally accepted accounting principles. Financial data presented on a tax basis may be necessary in footnotes or supporting schedules to provide disclosures regarding tax aspects of the investments.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 163
November 14, 1974

SECURITIES ACT OF 1933
Release No. 5540

SECURITIES EXCHANGE ACT OF 1934
Release No. 11100

Capitalization of Interest by Companies Other Than Public Utilities

The Commission has noted with concern an increase in the number of nonutility companies changing their accounting method to a policy of capitalizing interest cost. On June 21 a proposed Accounting Series Release was issued for comment (Securities Act Release No. 5505) proposing a statement of accounting policy on this issue and an amendment to Regulation S-X requiring additional disclosure of capitalized interest costs. After consideration of the comments received, the Commission has determined to issue the following statement of policy and to adopt certain amendments to Regulation S-X as set forth below. In addition, the comments indicated the need for certain interpretive guidelines and these are included as an appendix to this release.

A. COMMENTARY

The conventional accounting model applicable to companies other than public utilities

has not traditionally treated the cost of capital as part of the cost of an asset and, except for two specific industries, no authoritative statement on this subject presently exists. Interest cost on debt is generally treated as a period expense of the period during which debt capital is used, while the cost of equity capital is reflected neither in asset cost nor in the income statement.

This approach has been adopted for a number of reasons. First, it is impossible to follow cash once it has been invested in a firm. Even when a loan is made for a designated purpose and secured by a lien on specific assets, it can be argued that capital made available for one purpose frees other capital for other purposes, and it is therefore unrealistic to allocate the cost of any particular financing to any particular asset. Thus, any allocation of capital cost to particular assets is based on allocation decisions which are inherently arbitrary.

Second, the cost of capital is extremely difficult to measure. While interest rates may be associated with borrowings, any debt normally rests in part on the existence of an equity base which provides borrowing capacity. Suppliers of debt capital almost inevitably look to a borrower's overall economic position in making credit granting decisions. In addition, restrictive covenants and other terms such as compensating balance requirements may make the stated interest rate an unrealistic measure of capital. The cost of common equity capital is even more difficult to measure since it represents the cost of sharing an uncertain future earnings stream rather than a contractual out-of-pocket payment.

Third, it has been felt that interest costs were generally costs of a continuing nature, usually fixed by contract, and that deferral of certain of these costs might leave an erroneous impression as to the level of interest expense (and the cash outlay for interest) that might be expected in the future. Interest would not halt, for example, when an asset constructed with the use of capital funds was completed and placed in service.

For these reasons, interest cost has generally been reflected as an expense of the period during which capital was used rather than associated with the assets acquired by the use of the capital, even though it can be argued that interest cost is a cost which should be allocated to assets like other costs and that expensing interest as accrued is not consistent with the matching model in general use. Two exceptions to this general rule exist in the authoritative accounting literature. These are set forth in the Industry Audit Guide issued by the American Institute of Certified Public Accountants for "Savings and Loan Associations" and the AICPA Industry Accounting Guide "Accounting for Retail Land Sales." In addition, electric, gas, water and telephone utilities have traditionally capitalized an allowance for funds used in construction, including both interest and return on equity components on the basis of rate-making considerations.

The Commission has recently noted an increasing number of cases where interest has been capitalized by registrants other than electric, gas, water and telephone utilities and the exceptions noted above. This has created a source of incomparability between financial statements of companies following different practices in this respect.

While the Commission recognizes that arguments can be made for each of the accounting practices in this area, it does not seem desirable to have an alternative practice grow up through selective adoption by individual companies without careful consideration of such a change by the Financial Accounting Standards Board, including the development of systematic criteria as to when, if ever, capitalization of interest is desirable.

Accordingly, the Commission concludes that companies other than electric, gas, water and telephone utilities and those companies covered by the two exceptions in the authoritative literature described above which had not, as of June 21, 1974, publicly disclosed an accounting policy of capitalizing interest costs shall not follow such a policy in financial statements filed with the Commission covering fiscal periods ending after June 21, 1974. At such time as the Financial Accounting Standards Board develops standards for accounting for interest cost, the

Commission expects to reconsider this conclusion. Until such time, companies which have publicly disclosed such a policy may continue to apply it on a consistent basis but not extend it to new types of assets. Return on equity invested shall not be capitalized by companies other than electric, gas, water and telephone utilities.

In addition, the Commission has amended Regulation S-X to require that all companies which capitalize interest costs make disclosure in the face of the income statement of the amount capitalized in each year an income statement is presented and, in addition, that companies other than electric, gas, water and telephone utilities disclose the effect on net income of this accounting policy as compared to a policy of charging interest to expense as accrued. This disclosure requirement includes companies in the two industries mentioned above where there is an authoritative support for interest capitalization, since companies in those industries are not capitalizing interest in reliance upon a concept that recovery is virtually assured through the rate-making process which is the basis for capitalization by electric, gas, water and telephone utilities. Accordingly, interest capitalization in those industries results from an accounting variation rather than a variation in the economic characteristics of the assets involved, and disclosure of the impact of the accounting practice which is peculiar to these industries is appropriate to facilitate comparisons with other industries.

It is recognized that disclosure as required herein of the effect on net income of capitalizing interest as compared to a policy of charging to expense as accrued is of primary interest to those users of financial statements who wish to undertake a detailed analysis of corporate activities and may not be required in financial disclosure oriented solely to the needs of the average investor.

B. AMENDMENT TO REGULATION S-X

The following amendment to Rule 3-16 of Regulation S-X is adopted hereby:

Rule 3-16. General Notes to Financial Statements.

* * * * *

(r) *Interest capitalized.*

(1) The amount of interest cost capitalized in each period for which an income statement is presented shall be shown within the income statement. Companies other than electric, gas, water and telephone utilities which follow a policy of capitalizing interest cost (See Accounting Series Release No. 163) shall make the following additional disclosures required by items (2) and (3) below.

(2) The reason for the policy of interest capitalization and the way in which the amount to be capitalized is determined.

(3) The effect on net income for each period for which an income statement is presented of following a policy of capitalizing interest as compared to a policy of charging interest to expense as incurred.

* * * * *

This amendment shall be applicable to all financial statements filed on or after January 1, 1975.

The above rule is adopted pursuant to authority conferred on the Commission by the Securities Act of 1933, particularly Sections 6, 7, 8, 10 and 19(a) thereof; and the Securities Exchange Act of 1934, particularly Sections 12, 13, 15(d) and 23(a) thereof.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

APPENDIX

INTERPRETIVE COMMENTS AND GUIDELINES

1. Calculation of Income Effect

The original proposal made by the Commission would have required disclosure of the amount of interest capitalized in any balance sheets presented. In response to comments that questioned the need for such data this proposal was not adopted. In calculating the effect of interest capitalization on net income, however, it will be necessary to compute the amount of amortization of capitalized interest which was charged against income in each year so that the net effect of an alternative accounting practice may be calculated. The effect of an alternative policy on tax expense should also be considered in calculating the net income effect. Disclosure of the elements of the computed net income effect, while not required, may be desirable in some cases in order to clarify the presentation.

2. Meaning of "Publicly Disclosed"

The release forbids companies other than electric, gas, water and telephone utilities and companies covered by the two industry exceptions in authoritative accounting literature to follow a policy of capitalizing interest if such a policy had not been publicly disclosed prior to June 21, 1974. Numberous questions were raised in letters of comment as to the meaning of "publicly disclosed." The Commission believes that any public disclosure of such a policy in any format will meet this requirement. Formal financial statement disclosure would not be necessary. If, for example, disclosure was made in a supplemental document disseminated to analysts on request, the test of public disclosure would be met. If a company making an initial filing with the Commission after June 20, 1974 had adopted such a policy prior to June 21, 1974 and discloses the policy in its initial filing, it will be considered to meet this requirement.

On the other hand, the mere filing of statements following such an accounting method with the Commission without disclosure that the method was being used would not constitute "public disclosure." Since Accounting Principles Board Opinion No. 22 required disclosure of accounting policies and emphasized that such disclosure should "encompass those accounting principles and methods that involve ... a selection from existing acceptable alternatives ... (or) ... methods peculiar to the industry in which the reporting entity operates," it would seem likely that any company which had capitalized a material amount of interest would have disclosed this accounting policy. If a company has capitalized interest and not made disclosure of this accounting policy, but intends to continue this policy, it should supply full details to the staff for their consideration, including an explanation of why disclosure was not made in previous filings with the Commission.

3. Meaning of "New Types of Assets"

The release prohibits companies who have a publicly disclosed policy of interest capitalization from applying such a policy to "new types of assets." Comments requested a clarification of this phrase. The Commission believes that the phrase should not be interpreted too narrowly in order to maintain the present level of comparability. For example, if a company had a policy of capitalizing interest on shopping centers, it would not be prohibited from capitalizing interest on residential properties if it expanded its lines of business. On the other hand, if it were presently in two lines of business and capitalized interest in only one, it would not be permitted to expand its interest capitalization policy to the second line.

4. Income Statement Presentation of Capitalized Interest Cost

A number of comments on the proposed release asked for an illustration of the type of presentation contemplated by the Commission when it required disclosure of interest cost capitalized "within the income statement." The following example provides such an illustration:

	1973	1974
Sales	$10,000	$15,000
Cost of sales	5,000	7,000
Selling, general and administrative expense	2,000	3,000
Interest cost accrued	1,500	2,000
Less interest capitalized	(600)	(800)
	7,900	11,200
Income before income tax expense	2,100	3,800
Income tax expense	1,000	1,825
Net Income	$ 1,100	$ 1,975

RELEASE NO. 164

November 21, 1974

SECURITIES ACT OF 1933
Release No. 5542

SECURITIES EXCHANGE ACT OF 1934
Release No. 11110

Notice of Adoption of Amendments to Regulation S-X to Provide for Improved Disclosures Related to Defense and Other Long-Term Contract Activities

A. INTRODUCTION

The Securities and Exchange Commission has long been concerned about the quality of disclosures made by registrants engaged in defense and other long-term contract activities because these activities involve inventories and receivables with unique risk and liquidity characteristics. After initially urging corporate managers to review their disclosure policies with respect to such contracting activities,[1] the Commission published for comment proposed amendments to Rules 5-02.3 and 5-02.6 of Regulation X-X.[2]

As noted in its release proposing these amendments, the Commission believes that it is necessary and appropriate to expand these Rules to require disclosure of greater detail in certain critical areas of long-term contract activity, particularly with respect to the nature of costs accumulated in inventories, the effect of cost accumulation policies on cost of sales, and the effect of revenue recognition practices on receivables and inventories.

The proposed amendments elicited numerous letters of comment which have been duly considered by the Commission in the formulation of the amendments specifically adopted in this release. The following discussion outlines the Commission's responses to certain of these comments as reflected in the adopted rules on receivables and inventories.

Comments on Disclosure of Receivables—Rule 5-02.3

Paragraph (b). Several commentators pointed out that the proposed amendment could be broadly construed to require additional disclosure for receivables other than those arising from long-term contract activities. At the present time the Commission intends only to improve disclosures related to long-term contract activities. Consequently, the amendment to this paragraph has been deleted and the proposed disclosure of collection expectations has been incorporated in the amendments addressed specifically to receivables arising from such activities.

Paragraph (e). Some commentators suggested that the retainage disclosure should be limited to amounts not expected to be collected within one year. Due to the unique liquidity characteristics of retainage, the Commission believes that any material amount of retainage should be disclosed no matter when such amount is expected to be collected. However, the Commission also believes that the significant uncertainties which often affect the determination of a mutually satisfactory contract completion may cause the estimates of amounts to be collected within specific years to become progressively less reliable. Consequently, the amendment as adopted requires the isolation of only the aggregate amount of retainage expected to be collected after one year. However, registrants are encouraged to provide estimated collections by year if their experience or other factors enable them to do so with reasonable accuracy.

Several commentators suggested that the amendment should be modified to provide for amounts retained by contractors pursuant to the provisions of subcontracts. The Commission believes that this is unnecessary because Rule 5-02.25 can be interpreted to require separate disclosure of significant

[1] Securities Act Release No. 5263, Securities Exchange Act Release No. 9650, June 22, 1972.

[2] Securities Act Release No. 5492, Securities Exchange Act Release No. 10775, May 6, 1974.

amounts of retentions payable to subcontractors.

Paragraph (f). Numerous commentators pointed out that a literal interpretation of the proposed amendment would call for disclosures regarding all accrued receivables rather than just those related to long-term contracts and might also result in a duplication of disclosures made under paragraph (g). The Commission recognizes the validity of these comments and the amendment has been modified accordingly.

The amendment as adopted also calls for disclosure of the amounts of receivables not billed or billable that are expected to be collected after one year. The Commission believes that disclosure of the timing of expected collections provides investors with meaningful liquidity and risk information.

It should be noted that the amendment is not directed at items which are "unbilled" at the balance sheet date merely because the necessary paperwork has not been processed in accordance with the normal operation of a billing system. Such items would generally be considered "billable" for purposes of this Rule.

Paragraph (g). Many commentators argued that the proposed amendment was too broad since it would require the disclosure of amounts which could be determined with reasonable certainty under express contractual escalation or change order clauses and which would be virtually assured of realization. The commission has concluded that amounts due under routine change orders and escalation features commonly found in the terms of contracts are typically not subject to such uncertainty that separate disclosure is required. On the other hand, it believes that disclosure is necessary when amounts are recorded which are not reasonably determinable under the specific terms of existing contracts. Accordingly, the text of this rule has been amended to require disclosure where the amounts included in receivables whether billed or unbilled, are either claims or other similar items subject to uncertainty concerning their determination or ultimate realization.

Several commentators questioned the meaning of the term "components" as used in the requirement for footnote disclosure of the principal items comprising the aggregate of claims and other similar items subject to uncertainties. In response, the Commission has used the terms "nature and status" to more accurately reflect its intentions and has expanded the attached Exhibit to provide examples of disclosure envisioned by these terms.

Comments on Disclosure of Inventories—Rule 5-02.6

Paragraph (b). In response to numerous comments, this amendment has been modified in several significant ways. First, in recognition of the recently adopted Statement of Financial Accounting Standards No. 2, the Commission has deleted the requirements for disclosure of the amounts of research and development costs incurred during the period or remaining in inventory. Compliance with that Statement will obviate the need for the disclosure of these amounts. However, the amendment still contemplates a description of such costs being carried in inventory in compliance with the new Statement.

Second, the Commission recognizes that some registrants may find it impracticable to determine the actual amount of general and administrative costs remaining in inventory at the balance sheet dates. However, the Commission believes that registrants can provide reasonable estimates of such remaining costs determined, for example, on the assumption that costs related to a particular contract or program have been removed from inventory on a basis proportional to the totals of the various cost elements expected to be charged to cost of sales for that contract or program. The assumptions used to develop these estimates should be described in a note to the financial statements.

Third, the Commission expects that the description of the cost elements included in inventory will appropriately disclose the existence of items not typically included in inventoried costs in a usual manufacturing operation. Described items may include, for example, retained costs representing the excess of manufacturing or production costs

over the amounts charged to costs of sales for delivered or in-process units, initial tooling and other deferred start-up costs, general and administrative costs, or research and development under contractual arrangements. In general, the Commission believes that the accounting treatment of such costs is sufficiently unique to warrant the disclosure of their existence and, to the extent noted below, their magnitude.

Paragraph (c). This paragraph contains the last sentence of Rule 5-02.6(b) as it existed prior to the amendments adopted in this release. However, the requirements of this paragraph may be amended by the proposal published in Securities Act Release No. 5427. Comments on that proposal are still being considered.

Paragraph (d). Numerous commentators pointed out that the proposed definition would include supply or service contracts expected to be in process for more than one year even though such contracts may not involve the unique risk and liquidity characteristics associated with long-term manufacturing and construction contracts or programs. The Commission believes that the proposed definition was susceptible to an overly broad interpretation. Consequently, the Commission has modified the definition to deal explicitly with all contracts or programs accounted for on either a percentage of completion or a completed contract basis provided that any such contract or program has associated with it material amounts of inventories or unbilled receivables and has been or is expected to be performed over a period of more than twelve months.

Paragraph (d) (i). Many commentators argued that the amounts reported under this proposed amendment would not be mutually exclusive from the amounts reported under subparagraph (iii). To eliminate this problem, the Commission has modified proposed subparagraphs (i) and (iii) and now deals with these matters in one subparagraph which requires disclosure of (1) the aggregate amount of (a) manufacturing or production costs which have been carried forward under a "learning curve" concept and (b) any related costs which have been deferred for allocation to future production, and (2) the portion of such aggregate amount which would not be absorbed in cost of sales based on existing firm orders. The amendment also calls for the isolation of the cost elements included in the costs carried forward if it is practicable for the registrant to provide this detail. The Commission believes that these disclosures will provide investors with meaningful information concerning the nature of costs accumulated in inventories.

Paragraph (d) (ii). Many of the comments noted above under proposed Rule 5-02.3(g) were also directed to this amendment. The commission has modified this subparagraph to reflect those comments. This amendment recognizes that certain registrants classify amounts representing claims or other similar items subject to uncertainties as inventories rather than as receivables reportable under Rule 5-02.3(g). Regardless of where such amounts are classified, the Commission believes that material amounts must be disclosed together with an appropriate description of the nature and status of the principal items comprising such amounts. In this connection, the Commission has expanded the accompanying Exhibit to provide helpful examples of the type of disclosure envisioned by this Rule.

Paragraph (d) (v). Numerous commentators expressed the view that the concept of "title" is fraught with substantial difficulties of legal interpretation and that in any event it would be unduly burdensome to attempt such an analysis of the items included in inventory. The Commission accepts these comments and accordingly has deleted this proposal.

The subject rules, as amended herein, apply to disclosure in financial statements filed with the Commission. Registrants and their independent public accountants must make the determination as to what information regarding such matters is required to constitute satisfactory financial statement disclosure under generally accepted accounting principles.

B. AMENDMENTS

Rules 5-02.3 and 5-02.6 of Regulation S-X are amended as follows:

Rule 5-02.3. Accounts and notes receivable.—

(a) through (d) (No change)

(e) If receivables include amounts representing balances billed but not paid by customers under retainage provisions in contracts, state the amount thereof either in the balance sheet or in a note to the financial statements. In addition, state the amounts, if any expected to be collected after one year. If practicable, state by years when the amounts are expected to be collected.

(f) If receivables include amounts (other than amounts reportable under paragraph (g) below) representing the recognized sales value of performance under long-term contracts (see Rule 5-02.6(d)) and such amounts had not been billed and were not billable to customers at the date of the balance sheet, state separately in the balance sheet or in a note to the financial statements, the amount thereof and include a general description of the prerequisites for billing. In addition, state the amount, if any, expected to be collected after one year.

(g) If receivables include amounts under long-term contracts (see Rule 5-02.6(d)), whether billed or unbilled, representing claims or other similar items subject to uncertainty concerning their determination or ultimate realization, state separately in the balance sheet or in a note to the financial statements, the amount thereof and include a description of the nature and status of the principal items comprising such amount. In addition, state the amount, if any, expected to be collected after one year.

Rule 5-02.6. Inventories.—(a) State separately here, or in a note referred to herein, if practicable, the major classes of inventory such as (1) finished goods; (2) inventoried costs relating to long-term contracts or programs (see (d) below and Rule 3-11); (3) work in process (see Rule 3-11); (4) raw materials; and (5) supplies.

(b) The basis of determining the amounts shall be stated.

If "cost" is used to determine any portion of the inventory amounts, describe the method of determining cost. This description shall include the nature of the cost elements included in inventory.

If "market" is used to determine any portion of the inventory amounts, describe the method of determining "market" if other than current replacement cost.

The method by which amounts are removed from inventory (e.g., "average cost," "first-in, first out," "last-in, first-out," "estimated average cost per unit") shall be described. If the estimated average cost per unit is used as a basis to determine amounts removed from inventory under a total program or similar basis of accounting, the principal assumptions (including, where meaningful, the aggregate number of units expected to be delivered under the program, the number of units delivered to date and the number of units on order) shall be disclosed.

If any general and administrative costs are charged to inventory, state in a note to the financial statements the aggregate amount of the general and administrative costs incurred in each period and the actual or estimated amount remaining in inventory at the date of each balance sheet.

(c) If the LIFO inventory method is used, the excess of replacement or current cost over stated LIFO value shall, if material, be stated parenthetically or in a note to the financial statements. (Note: Paragraph (c) as proposed in Securities Act Release 5427 would modify this requirement. Comments on that proposal continue under consideration.)

(d) For purposes of Rules 5-02.3 and 5-02.6, long-term contracts or programs include (1) all contracts or programs for which gross profits are recognized on a percentage-of-completion method of accounting or any variant thereof (e.g., delivered unit, cost to cost, physical completion) and (2) any contracts or programs accounted for on a completed contract basis of accounting where, in either case, the contracts or programs have associated with them material amounts of inventories or unbilled receivables and where such contracts or programs have been or are expected to be performed over a period of more than twelve months. Contracts or programs of shorter duration may also be included, if deemed appropriate.

For all long-term contracts or programs, the following information, if applicable, shall

be stated in a note to the financial statements:

(i) The aggregate amount of manufacturing or production costs and any related deferred costs (e.g., initial tooling costs) which exceeds the aggregate estimated cost of all in-process and delivered units on the basis of the estimated average cost of all units expected to be produced under long-term contracts and programs not yet complete, as well as that portion of such amount which would not be absorbed in cost of sales based on existing firm orders at the latest balance sheet date. In addition, if practicable, disclose the amount of deferred costs by type of cost (e.g., initial tooling, deferred production, etc.).

(ii) The aggregate amount representing claims or other similar items subject to uncertainty concerning their determination or ultimate realization, and include a description of the nature and status of the principal items comprising such aggregate amount.

(iii) The amount of progress payments netted against inventory at the date of the balance sheet.

* * * * * *

The amendments to Regulation S-X have been adopted pursuant to authority conferred on the Commission by the Securities Act of 1933, particularly Sections 6, 7, 8, 10 and 19(a) thereof and the Securities Exchange Act of 1934, particularly Sections 12, 13, 15(d) and 23(a) thereof.

The above amendments to Regulation S-X shall be applicable to financial statements for periods ending on or after December 20, 1974. Such disclosure is recommended but not required for financial statements for fiscal periods ending prior to December 20, 1974.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

C. EXHIBIT

The following hypothetical example is furnished to illustrate the character and detail of the disclosures which might be furnished in response to Rules 5-02.3 and 5-02.6 of Regulation S-X as amended by the accompanying release. The illustration is provided to assist in understanding and evaluating the amendments.

* * * * * * *

XYZ Company and Subsidiaries
Consolidated Balance Sheets
At December 31,

	1974	1973
	(000 omitted)	
ASSETS		
CURRENT ASSETS:		
Cash	$ 438	$ 627
Accounts receivable:		
Trade and other receivables, net of allowance for uncollectible accounts of $38,000 in 1974 and $36,000 in 1973	2,846	2,396
Long-term contracts and programs (notes 1 and 2)	18,985	19,036
Total accounts receivable	21,831	21,432
Inventories and costs relating to long-term contracts and programs in process, net of progress payments (notes 1 and 3)	6,278	6,257
Prepaid expenses	46	27
Total current assets	$28,593	$28,343

Note 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Revenue Recognition. Sales of commercial products under long-term contracts and programs are recognized in the accounts as deliveries are made. The estimated sales values of performance under Government fixed-priced and fixed-price incentive contracts in process is recognized under the percentage of completion method of accounting whereunder the estimated sales value is determined on the basis of physical completion to date (the total contract amount multiplied by percent of performance to date less sales value recognized in previous periods) and costs (including general and administrative, except as described below) are expensed as incurred. Sales under cost-reimbursement contracts are recorded as costs are incurred and include estimated earned fees in the proportion that costs incurred to date bear to total estimated costs. The fees under certain Government contracts may be increased or decreased in accordance with cost or performance incentive provisions which measure actual performance against established targets or other criteria. Such incentive fee awards or penalties are included in sales at the time the amounts can be determined reasonably.

Inventories. Inventories, other than inventoried costs relating to long-term contracts and programs, are stated at the lower of cost (principally first-in, first-out) or market. Inventoried costs relating to long-term contracts and programs are stated at the actual production cost, including factory overhead, initial tooling and other related nonrecurring costs, incurred to date reduced by amounts identified with revenue recognized on units delivered or progress completed. General and administrative costs applicable to cost-plus Government contracts are also included in inventories. Inventoried costs relating to long-term contracts and programs are reduced by charging any amounts in

excess of estimated realizable value to cost of sales. The costs attributed to units delivered under long-term commercial contracts and programs are based on the estimated average cost of all units expected to be produced and are determined under the learning curve concept which anticipates a predictable decrease in unit costs as tasks and production techniques become more efficient through repetition.

In accordance with industry practice, inventories include amounts relating to contracts and programs having production cycles longer than one year and a portion thereof will not be realized within one year.

* * * * * * *

NOTE 2—ACCOUNTS RECEIVABLE

The following tabulation shows the component elements of accounts receivable from long-term contracts and programs:

	1974	1973
	(000 omitted)	
U.S. Government:		
Amounts billed	$ 7,136	$ 6,532
Recoverable costs and accrued profit on progress completed—not billed	4,173	3,791
Unrecovered costs and estimated profits subject to future negotiation—not billed	1,468	1,735
	12,777	12,058
Commercial Customers:		
Amounts billed	1,937	3,442
Recoverable costs and accrued profit on units delivered—not billed	1,293	364
Retainage, due upon completion of contracts	2,441	2,279
Unrecovered costs and estimated profits subject to future negotiation—not billed	537	893
	$18,985	$19,036

The balances billed but not paid by customers pursuant to retainage provisions in construction contracts will be due upon completion of the contracts and acceptance by the owner. Based on the Company's experience with similar contracts in recent years, the retention balances at December 31, 1974 are expected to be collected as follows: $270,000 in 1975, $845,000 in 1976 and the balance in 1977.

Recoverable costs and accrued profit not billed comprise principally amounts of revenue recognized on contracts for which billings had not been presented to the contract owners because the amounts were not billable at balance sheet date. It is anticipated such unbilled amounts receivable from the U. S. Government at December 31, 1974 will be billed over the next 60 days as units are delivered. The unbilled accounts receivable applicable to commercial customers are billable upon completion of performance tests which are expected to be completed in September 1975.

Unrecovered costs and estimated profits subject to future negotiation, the principal amount of which is expected to be billed and collected within one year, consists of the following elements:

	1974	1973
	(000 omitted)	
U.S. Government Contracts:		
Excess of estimated or proposed over provisional price	$ 190	$ 157
Amounts claimed for incremental costs arising from customer occasioned contract delays	1,278	1,578
	1,468	1,735
Commercial Contracts:		
Unrecovered costs and estimated profit relating to work not specified in express contract provisions	537	893
	$2,005	$2,628

NOTE 3—INVENTORIES

Inventories and inventoried costs relating to long-term contracts and programs are classified as follows:

	December 31,	
	1974	1973
	(000 omitted)	
Finished goods	$3,562	$3,435
Inventoried costs relating to long-term contracts and programs, net of amounts attributed to revenues recognized to date	2,552	2,638
Work in process	738	947
Raw materials	453	383
Supplies	112	71
	7,417	7,474
Deduct progress payments related to long-term contracts and programs	1,139	1,217
	$6,278	$6,257

The following tabulation shows the cost elements included in inventoried costs related to long-term contracts:

	December 31,	
	1974	1973
	(000 omitted)	
Production costs of goods currently in process	$1,184	$ 960
Excess of production cost of delivered units over the estimated average cost of all units expected to be produced	647	893
Unrecovered costs subject to future negotiation	280	310
General and administrative costs	260	270
Initial tooling and other non-recurring costs	181	205
	$2,552	$2,638

The inventoried costs relating to long-term contracts and programs includes unrecovered costs of $280,000 and $310,000 at December 31, 1974 and 1973, respectively, which are subject to future determination through negotiation or other procedures not complete at balance sheet dates. Of such amounts, $260,000 and $280,000 are in respect to contracts

under which all goods have been delivered at December 31, 1974 and 1973, respectively. The unrecovered amount at December 31, 1973 consisted of three items, one of which was settled during 1974. The amount remaining at December 31, 1974 is represented principally by a claim asserted against a customer for amounts incurred as a result of faulty materials furnished by the customer which in turn caused delays in performance under the contract. In the opinion of management these costs will be recovered by contract modification or litigation. It is expected that the negotiations which are being conducted currently with the customer, will be successfully concluded during the next twelve months. If this expectation is not realized, the matter will be referred to the Armed Services Board of Contract Appeals, with the consequence that settlement could be delayed for an indeterminate period.

The actual per unit production cost of the NX-4C aircraft produced during the most recent fiscal year was less than the estimated average per unit cost of all units expected to be produced under the program. Prior to 1974, the Company's NX-4C commercial aircraft program was in the early high cost period. During the initial years of the program, the cost of units produced exceeded the sales price of the delivered units and the estimated average unit cost of all units to be produced under the program. At December 31, 1974, inventories included costs of $647,000 representing the excess of costs incurred over estimated average costs per aircraft for the 117 aircraft delivered through the year end. The estimated average unit cost is predicated on the assumption that 250 planes will be produced and that production costs (principally labor and materials) will decrease as the project matures and efficiencies associated with increased volume, improved production techniques and the performance of repetitive tasks (the learning curve concept) are realized. (Note: The amount by which the production costs of the equivalent finished units in process at the date of the latest balance sheet exceeds the cost of such units on the basis of the estimated average unit cost of all units expected to be produced under the program should be stated. Since, as stated above, the actual per unit production cost is currently less than the estimated average per unit cost of all units expected to be produced under the program, no such excess is assumed in this example.)

Recovery of the deferred production, initial tooling and related non-recurring costs is dependent on the number of aircraft ultimately sold and actual selling prices and production costs associated with future transactions. Sales significantly under estimates or costs significantly over estimates could result in the realization of substantial losses on the program in future years. Realization of approximately $421,000 of the gross commercial aircraft inventories at December 31, 1974 is dependent on receipt of future firm orders.

Based on studies made by and on behalf of the Company, management believes there exists for this aircraft a market for over 250 units, including deliveries to date, with production and deliveries continuing at a normal rate to at least 1980. At December 31, 1974, 117 aircraft had been delivered under the program, and the backlog included 64 firm unfilled orders and options for 43 units.

The aggregate amounts of general and administrative costs incurred during 1974 and 1973 were $2,251,000 and $2,238,000, respectively. As stated in Note 1, the Company allocates general and administrative costs to certain types of Government contracts. The amounts of general and administrative costs remaining in inventories at December 31, 1974 and 1973 are estimated at $260,000 and $270,000, respectively. Such estimates assume that costs have been removed from inventories on a basis proportional to the amounts of each cost element expected to be charged to cost of sales.

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RELEASE NO. 165

December 20, 1974

SECURITIES ACT OF 1933
Release No. 5550

SECURITIES EXCHANGE ACT OF 1934
Release No. 11147

Notice of Amendments to Require Increased Disclosure of Relationships Between Registrants and Their Independent Public Accountants

The Securities and Exchange Commission today adopted certain amendments of Form 8-K, Regulation S-X and Schedule 14A of the proxy rules. These amendments were originally proposed on October 11, 1974, in Securities Act Release No. 5534. Based on the comments received in response to that proposal, several modifications have been made which are discussed in this release.

One of the underpinnings of the Commission's administration of the disclosure requirements of the federal securities laws is its reliance on the reports of independent public accountants on the financial statements of registrants. These reports provide the assurance of an outside expert's examination and opinion, thereby substantially increasing the reliability of financial statements.

The decision that the Commission and investors should rely on independent public accountants for the audit of financial statements was made by Congress when it enacted the Securities Acts forty years ago, and in the judgment of the Commission this system has worked effectively in the interests of investors. The independence of these professionals both in fact and appearance is an essential ingredient in the system, and the Commission has taken a number of steps to strengthen this independence. The amendments adopted herein are a further effort in this direction.

In recent years, the Commission has described in several releases situations in which it concluded that the necessary independence did not exist due to economic or personal relationships between accountant and client. In this way, it assisted the accounting profession's own standard setting bodies in the creation of credible and useful standards of independence for the profession as a whole. This process is a continuing one.

In addition, the Commission, starting in 1971, has required specific disclosure in a timely Form 8-K filing of any change in principal accountants made by the registrant, including disclosure of any disagreement between the registrant and its principal accountant in the eighteen months prior to the change which could have required or did require mention in the accountant's report. This was designed to strengthen accountants' independence by discouraging the practice of changing accountants in order to obtain more favorable accounting treatment.

In 1972, in Accounting Series Release No. 123, the Commission urged registrants to create an audit committee of the outside members of the Board of Directors in order to provide for more effective communication between independent accountants and outside directors. It was believed that such a committee would lessen the accountants' direct reliance on management and would put them directly in touch with outside members of the Board whose performance was less specifically being reported on in financial statements, thus increasing the accountants' independence.

Finally, the Commission and its staff have for many years offered support to accountants in numerous conferences and in informal administrative determinations of what reporting procedures should be followed in particular factual circumstances. The Commission's general refusal to accept opinions qualified in regard to audit scope or accounting principle as satisfying the Acts' requirements for certified financial statements has also strengthened the accountants' independence.

The Commission believes that the necessary independence of accountants does exist.

It has noted with approval reports in which the accountants have evidenced their independence by bringing significant information to the attention of investors. For example, in one recent case an independent accountant reported that its client's accounting procedures, while acceptable under generally accepted accounting principles, were not those which the firm believed best reported financial results under the particular factual circumstances. In another case, an independent account while reporting on a five-year summary of earnings noted in its report that the accounting principles used to account for a transaction in an unaudited interim period subsequent to the five-year period were such that had the firm been required to report on this period an adverse opinion would have been required. After discussions with the staff in this case, the registrant ultimately revised the interim statements.

It is essential that both the fact and the appearance of independence be sustained so that the confidence of the investing public in the reliability of audited financial statements and the integrity of the public accounting profession will be maintained and enhanced. To this end, the Commission has concluded that it is desirable to increase the level of disclosure regarding relationships between independent accountants and their clients.

Accordingly, the Commission is adopting herewith a number of amendments to its forms and rules designed to enhance the accountant's independence by increasing disclosure of auditor-client relationships.

First, Item 12 of Form 8-K under which changes in accountants must currently be reported is amended to expand the disclosures required and to clarify the intent of the item. The changes made and the reasons therefor are as follows:

1. The resignation (or declination to stand for re-election after completion of the current audit) and dismissal of accountants would be reportable events as well as the engagement of a new accountant. In the past, when only the engagement of a new accountant triggered the reporting requirement, there was sometimes considerable delay in bringing significant disagreements to the attention of investors. Under the new rule, timely disclosure is required. This may mean on some occasions that two reports on Form 8-K will be required for a single change of accountants, the first on the resignation (or declination to stand for re-election after completion of the current audit) or dismissal of the previous accountant and the second where a new accountant is selected. In such a case, information filed in connection with the first report may be incorporated by reference in the second.

A special variant of resignation, declination to stand for re-election after completion of the current audit, was not recognized in Securities Act Release No. 5534 which proposed these amendments. It is specified as a trigger for reporting in the adopted amendments because of a recognition that, where an auditor declines to stand for re-election after completion of his current audit, such action is the substantive act of resignation, rather than the later time when his current engagement is terminated.

Changes in the independent accountant for a significant subsidiary on whom the principal accountant expressed reliance also become reportable events. The proposal did not restrict this modification of existing rules to a significant subsidiary and thus would have required reporting of changes which are minor in relation to the consolidated whole and of changes by non-controlled investee companies. For these purposes, significant subsidiary is as defined in Regulation S-X Rule 1-02, except that a non-incorporated segment such as a division which met the size tests of the definition would be included.

In some circumstances, a report would be required regarding an accountant who did not report on financial statements of the registrant. For example, where Accountant A reported on the financial statements of the prior year, Accountant B was engaged for the current year but was replaced by Accoun-

tant C before he completed any examination, reports on Form 8-K would be required with respect to the change from Accountant A to Accountant B and from Accountant B to Accountant C.

2. The item would require disclosure as to whether the principal accountants' reports for either of the past two years contained an adverse opinion or a disclaimer of opinion or was qualified as to uncertainty, audit scope or accounting principles. Based on comments received, the language was modified to make clear that "consistency" exceptions need not be reported in this item. This disclosure will assist users of Form 8-K to determine whether there were any items in the previous two years which were of such an unusual and material nature that disclosure was required in the accountants' report. Although such data are on file elsewhere in most cases, including them in the 8-K report will bring together in one place information which is relevant in the evaluation of auditor-client relationships.
3. The period prior to the date of the change of accountants for which disagreements of sufficient importance to warrant mention in the accountants' report if not resolved must be reported is extended from eighteen months to the period which includes the two most recent fiscal years and the subsequent interim period. The previous requirement was not sufficient to assure reporting of such disagreements in the previous two audits, and since two-year comparative statements are normally presented this seems the minimum period which should be covered.
4. The item is amended to clarify the intent of the present item which was to require a description of all disagreements, including those where the disagreement was resolved to the satisfaction of the accountant. This clarification was necessary as a result of the experience gained from analyzing 8-Ks filed in which no description was given of disagreements or in which a simple statement was made that there were no unresolved disagreements and staff follow-up was required to obtain the necessary information. Some commentators on Securities Act Release No. 5534 which proposed these amendments requirested clarification of whether disagreements at lower staff levels are requested to be reported. Disagreements contemplated by this rule occur at the decision-making level; i.e., between personnel of the registrant responsible for presentation of its financial statements and personnel of the accounting firm responsible for rendering its report.
5. The term "disagreements" should be interpreted broadly in responding to this item. For example, if an accountant resigned or was dismissed after advising the registrant that he had concluded that internal controls necessary to develop reliable statements did not exist, this would constitute a reportable disagreement in the event of a change of accountants. Similarly, if an accountant were to resign or be dismissed after informing the registrant that he had discovered facts which led him no longer to be able to rely on management representations or which made him unwilling to be associated with statements prepared by management, such situations would constitute reportable disagreements.
6. The item is amended to require that the registrant's statement as to whether any disagreements existed be included in the Form 8-K filing rather than in a separate letter attached to the filing and to require that copies of the accountant's letter be filed as an exhibit with all 8-K copies filed. These changes are intended to simplify the filing procedure and to clarify the Commission's intent that the registrant's description of disagreements, if any, and the accountant's concurrence or non-concurrence therewith be included in the Form 8-K (or attached as an exhibit). Under the existing rule, a few registrants have submitted letters separate from the Form 8-K filing with the result that the full disclo-

sure of any disagreement was not readily available to the public.

7. When a change in independent accountants occurs so that the accountant being replaced is aware that a Form 8-K should be filed reporting the event, he might well bring that reporting responsibility to the attention of the registrant. If he becomes aware that the required reporting has not been made, e.g., because he has not been requested to furnish a letter as required by Form 8-K, Item 12 (d), he should consider advising the registrant in writing of that reporting responsibility with a copy to the Commission.

Second, Regulation S-X is amended to require disclosure in a note to the financial statements of any material disagreement on any matter of accounting principles or practices or financial statement disclosure reported in Item 12 of Form 8-K within twenty-four months of the date of the most recent financial statements in a filing. This disclosure is believed necessary to put readers of the financial statements on notice that such a disagreement existed which could have significantly affected the statements.

In addition, this amendment requires footnote disclosure of any transactions or events occurring during the fiscal year in which the change of accountants took place or during the subsequent fiscal year which are similar to any transactions or events which gave rise to a reported disagreement and are differently accounted for. This would include cases in which a disagreement arose during the year of change and the same transaction or transactions which gave rise to the disagreement was accounted for in a different manner than that which the previous accountant concluded was necessary.

If such transactions which raise the same issues of accounting principle application or disclosure are material and are accounted for in a manner different from that which the former accountant apparently concluded was required, disclosure must be made of the effect on the financial statements if the accounting method specified by the former accountant had been followed. Also, if disclosure which the former accountant apparently concluded was required regarding such events or transactions has not been made elsewhere in the financial statements, it should be made in the footnote required by this rule. The proposal was modified to not require such disclosure where the method asserted by the former accountant ceases to be generally accepted because of standards subsequently issued. This disclosure will make investors aware of situations where alternative accounting approaches may be followed and are favored by at least one professional accountant, and the effect of such alternative approaches. In addition, it is believed that such disclosure requirements may have the effect of discouraging shifts in accountants simply to obtain approval of an alternative accounting approach. If registrants and their present independent accountants believe that the disclosure of the effect of applying the alternative accounting approach favored by the predecessor accountant would not be significant to investors in the circumstances, they may submit a statement to that effect to the staff which will consider a waiver of the rule.

Finally, a number of amendments are made to Item 8 of Schedule 14A of the proxy rules to require additional disclosures in the proxy statement of the relationships between issuers and independent public accountants. Since this disclosure is unlikely to be relevant to other solicitations, it is required only for annual meetings of securities holders or where financial statements are required pursuant to Item 15. These changes and the reasons therefor are as follows:

1. Disclosure of the principal accountant selected or to be recommended to shareholders for election, approval or ratification for the current year. This requirement is designed to make stockholders aware of the identity of the independent accountant of record for the current year, even in cases when the shareholders are not asked to take formal action to approve his selection. The Commission believes that such knowledge will enhance the stockholders' recognition of the role of the independent accountant.

2. Disclosure is required of the name of the principal accountant for the previous year if different from that selected or recommended for the current year or if no accountant has been selected for the current year. This disclosure is designed to inform the stockholder when a change in accountants has occurred and who the independent accountant of record is in cases where no action has been taken to select an accountant for the current year.
3. Disclosure of disagreements between accountant and issuer reported on a Form 8-K filed to report a change in accountant during the past year is required. The disclosure is designed to call disagreements to stockholders' attention so that they may be more fully informed of the relationships between accountant and issuer. Since any disagreement must by its nature have two sides, it seems desirable that both sides have an opportunity to review its description in the interests of obtaining a balanced and complete presentation. Accordingly, the issuer is required to submit the description included in the preliminary proxy material to the accountant, and if the accountant believes that the description is incorrect or incomplete he may include a brief statement, ordinarily expected not to exceed 200 words, in the proxy statement presenting his view of the disagreement. In recognition of valid comments received, the time for submitting such statement to the issuer was extended to ten days and provision for flexibility in the number of words was made.
4. Disclosure is required of whether or not representatives of the principal accountants for the current year and the most recently completed fiscal year are expected to be present at the stockholders' meeting with the opportunity to make a statement and available to respond to appropriate questions. The Commission believes that it is desirable for communication between stockholders and their independent accountants to be encouraged. While the principal communication is the accountant's report on financial statements, there may be some matters which the accountants wish to bring to the attention of stockholders and there may be questions which stockholders wish to address to the accountants. This disclosure will emphasize the existence of this opportunity for communication when it is available.
5. Disclosure is required of the existence and composition of the audit committee of the Board of Directors. The Commission has already expressed its judgment that audit committees made up of outside directors have significant benefits for a company and its shareholders (Accounting Series Release No. 123). This disclosure will make stockholders aware of the existence and composition of the committee. If no audit or similar committee exists, the disclosure of that fact is expected to highlight its absence.
6. The current requirement in Item 8 for disclosure of any financial interests of any accountant who is being selected or approved by stockholders of the issuer or certain other relationships which existed during the past three years is rescinded inasmuch as the accountant, who must be independent of the issuer, is precluded from having such relationships by the accounting profession's (and the Commission's) standards for independence of accountants.

The text of the amendments to Form 8-K, Regulation S-X and Schedule 14A of the proxy rules follows.

Form 8-K. Item 12 and EXHIBITS are revised as given below:

Item 12. Changes in Registrant's Certifying Accountant.

If an independent accountant who was previously engaged as the principal accountant to audit the registrant's financial statements resigns (or indicates he declines to stand for re-election after the completion of the current audit) or is dismissed as the registrant's principal accountant, or another independent accountant is engaged as principal accountant, or if an independent accountant on whom the principal accountant ex-

pressed reliance in his report regarding a significant subsidiary resigns (or formally indicates he declines to stand for re-election after the completion of the current audit) or is dismissed, or another independent accountant is engaged to audit that subsidiary:

(a) State the date of such resignation (or declination to stand for re-election), dismissal or engagement.

(b) State whether in connection with the audits of the two most recent fiscal years and any subsequent interim period preceding such resignation, dismissal or engagement there were any disagreements with the former accountant on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements if not resolved to the satisfaction of the former accountant would have caused him to make reference in connection with his report to the subject matter of the disagreement(s); also describe each such disagreement. The disagreements required to be reported in response to the preceding sentence include both those resolved to the former accountant's satisfaction and those not resolved to the former accountant's satisfaction. Disagreements contemplated by this rule are those which occur at the decision making level; i.e., between personnel of the registrant responsible for presentation of its financial statements and personnel of the accounting firm responsible for rendering its report.

(c) State whether the principal accountant's report on the financial statements for any of the past two years contained an adverse opinion or a disclaimer of opinion or was qualified as to uncertainty, audit scope, or accounting principles; also describe the nature of each such adverse opinion, disclaimer of opinion, or qualification.

(d) The registrant shall request the former accountant to furnish the registrant with a letter addressed to the Commission stating whether he agrees with the statements made by the registrant in response to this item and, if not, stating the respects in which he does not agree. The registrant shall file a copy of the former accountant's letter as an exhibit with all copies of the Form 8-K required to be filed pursuant to General Instructions F.

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EXHIBITS

Instruction 7. Letters from the independent accountants furnished pursuant to Item 12(d)

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Regulation S-X. A new rule designated as (s) is added to Rule 3-16 as given below.

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Rule 3-16(a) to (r) (No change)

(s). *Disagreements on accounting and financial disclosure matters.*—If, within the twenty-four months prior to the date of the most recent financial statements, a Form 8-K has been filed reporting a change of accountants and included in such filing there is a reported disagreement on any matter of accounting principles or practices or financial statement disclosure, and if such disagreement, if differently resolved, would have caused the financial statements to differ materially from those filed, state the existence and nature of the disagreement. In addition, if during the fiscal year in which the change in accountants took place or during the subsequent fiscal year there have been any transactions or events similar to those which involved a reported disagreement and if such transactions are material and were accounted for or disclosed in a manner different from that which the former accountants apparently concluded was required, state the effect on the financial statements if the method which the former accountant appar-

ently concluded was required had been followed. The effects on the financial statements need not be disclosed if the method asserted by the former accountant ceases to be generally accepted because of authoritative standards or interpretations subsequently issued.

* * * * *

Regulation 14A. Item 8 of Schedule 14A is revised as given below.

Schedule 14A. Information Required In Proxy Statement.

Item 8. Relationship with Independent Public Accountants

If the solicitation is made on behalf of management of the issuer and relates to an annual meeting of security holders at which directors are to be elected, or financial statements are included pursuant to Item 15, furnish the following information describing the issuer's relationship with its independent public accountants:

(a) The name of the principal accountant selected or being recommended to shareholders for election, approval or ratification for the current year. If no accountant has been selected or recommended, so state and briefly describe the reasons therefor.

(b) The name of the principal accountant for the fiscal year most recently completed if different from the accountant selected or recommended for the current year or if no accountant has yet been selected or recommended for the current year.

(c) If a change or changes in accountants have taken place since the date of the proxy statement for the most recent annual meeting of shareholders, and if in connection with such change(s) a disagreement between the accountant and issuer has been reported on Form 8-K or in the accountant's letter filed as an exhibit thereto, the disagreement shall be described. Prior to submitting preliminary proxy material to the Commission which contains or amends such description, the issuer shall furnish the description of the disagreement to any accountant with whom a disagreement has been reported. If that accountant believes that the description of the disagreement is incorrect or incomplete, he may include a brief statement, ordinarily expected not to exceed 200 words, in the proxy statement presenting his view of the disagreement. This statement shall be submitted to the issuer within ten business days of the date the accountant receives the issuer's description.

(d) The proxy statement shall indicate whether or not representatives of the principal accountants for the current year and for the most recently completed fiscal year are expected to be present at the stockholders' meeting with the opportunity to make a statement if they desire to do so and whether or not such representatives are expected to be available to respond to appropriate questions.

(e) If the issuer has an audit or similar committee of the Board of Directors, state the names of the members of the committee. If the Board of Directors has no audit or similar committee, so state.

* * * * *

The foregoing amendments are adopted pursuant to authority in Sections 6, 7, 8, 10 and 19(a) of the Securities Act of 1933; and Sections 12, 13, 15(d) and 23(a) of the Securities Exchange Act of 1934. The amendments to Form 8-K and to Regulation 14A shall be effective for Forms 8-K and proxy statements filed subsequent to January 31, 1975. The amendment of Regulation S-X shall be effective with respect to financial statements filed for periods beginning on or after January 1, 1975.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 166
December 23, 1974

SECURITIES ACT OF 1933
Release No. 5551

SECURITIES EXCHANGE ACT OF 1934
Release No. 11150

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 18723

Disclosure of Unusual Risks and Uncertainties in Financial Reporting

In recent months, the Commission has noted with considerable concern a number of situations in which significant and increasing business uncertainties have not been fully reflected in the financial reporting of registrants. These have included cases in which unique or special circumstances have arisen which affect an enterprise's ability to measure current results, cases in which changing economic circumstances have substantially changed the risk characteristics of certain assets and cases in which assumptions which underlie the use of certain accounting principles in certain situations have become subject to substantial uncertainty.

The Commission recognizes that a large number of estimates are required in the preparation of all financial statements. Management must estimate the economic life of assets, the magnitude of mineral resources, the outcome and timing of long-term contracting activities, the outcome of legal and regulatory matters, the collectibility of receivables and many others. Since investors are aware of the need for such estimates, in the normal case it is not necessary for management to point out that they have been made and to indicate that some uncertainty exists as a result. Indeed, such disclosure would amount to little more than "boiler plate" which would not be useful to investors.

On the other hand, when unusual circumstances arise or where there are significant changes in the degree of business uncertainty existing in a reporting entity, a registrant has the responsibility of communicating these items in its financial statements. It is not sufficient to assume that the numbers shown in conventional fashion on the face of the financial statements will adequately inform investors. The basic accounting model is by its very nature a single valued one in which a single best estimate is reflected in the face of the statements. While in most cases, this presentation effectively communicates business financial position and results of operations, under some conditions of major uncertainty it may not adequately inform investors of the realities of a business being reported. In such cases, registrants must consider the need for substantial and specific disclosure of such uncertainties and, in extreme cases, the need for deviation from the conventional reporting model. In addition, independent public accountants must consider the need for disclosure of such uncertainties in their report.

A number of examples of such uncertainties and the kinds of disclosures which may be appropriate are discussed below for illustrative purposes. This list is not intended to be all inclusive and could not be since changing conditions produce new uncertainties and resolve old ones on a continuing basis.

Loans and Loan Loss Reserves of Financial Institutions

In several industries, severe economic problems have developed in 1974. This has been particularly true in the real estate area where high interest rates, increasing con-

struction costs and difficulties in renting or selling completed projects have threatened the survival of many enterprises. Companies with substantial equity investments in or credit extensions to such enterprises have therefore had to face the problem of determining the value of such assets, and in most cases a very wide range of possible values exist depending upon various assumptions about the future.

Companies, such as real estate investment trusts, which find themselves in such a position should make disclosures beyond the actual amount of loan loss reserve provided to enable investors to obtain a more complete picture of uncertainties involved. For example, in addition to the disclosures required under Rules 12-42 and 12-43 of Regulation S-X, narrative disclosures might be made of the adequacy of any security interest held in terms of current realizable value, the amount of loans delinquent and the extent of the delinquencies, the concentration of the portfolio in particular markets and the economic conditions in those markets, the sensitivity of the portfolio to specific economic variables such as changing interest rates and local employment conditions and the extent to which income continues to be accrued on various assets in the portfolio. To the extent possible, these disclosures should be specific, not general. They should describe both positive and negative factors.

While the real estate industry has been a particular problem area, loan loss reserve problems of financial institutions are by no means limited to this area. Surveys of loan losses of banks, for example, have indicated that during the period 1969–1973, loan losses as a percentage of loans outstanding have doubled while the valuation portion of the reserve for loan losses has declined substantially. In addition, current economic conditions have resulted in a substantial increase in borrowers who are experiencing financial difficulties.

A significant factor contributing to the decline in reserves is apparently the sole reliance by some registrants on the minimum provision for loan losses resulting from applying regulatory formulae for minimum provisions described in the regulations of banking authorities. It should be emphasized that such formulae can only be viewed as a starting point in determining the necessary provisions to absorb future loan losees. As set forth in Regulation F of the Federal Reserve Board, an estimated amount for loan losses in excess of the minimum amount should be provided when judged appropriate. If, as may be the case with many registrants in 1974, the minimum provision results in a valuation reserve balance less than an amount adequate to reflect the risks in the year-end loan portfolio, registrants must provide the amount necessary to insure the adequacy of the reserve.

In addition to the adequacy of valuation reserves, it is important that financial institutions make appropriate financial statement disclosures to enable investors to understand the nature and current status of their portfolios. This should encompass a sufficient breakdown of assets to give the investor insight into investment policies, lending practices and portfolio concentration. Banks, for example, have generally disclosed "loans" as a single item in the balance sheet, even though the item frequently amounts to more than 50% of earning assets. In such cases, it would seem desirable to furnish in the balance sheet or the notes thereto an additional analysis of loan categories, perhaps such as that required by Schedule III of Form F-9 of Regulation F of the Federal Reserve Board.

Additional disclosures should also be considered in cases where there have been substantial changes in the risk characteristics of portfolios, even when increased provisions for losses have been made. Where, for example, loans which are considered doubtful as to collectibility have materially increased, or where there have been large increases in delinquencies, loans extended or renegotiated under adverse circumstances, or other evidences of changed risk, registrants should expand on normal disclosures to highlight such factors.

Marketable Securities

The substantial decline in the market value of common stocks which has occurred

in 1974 has resulted in many companies holding portfolios where the year-end market value is below cost and hence where the risk of investment loss has materially increased. Generally accepted accounting principles require that write downs to market be made by a charge in the income statement in cases where market declines are not due to a temporary condition. Registrants and their independent accountants must carefully review investment portfolios to determine whether evidence indicates that a provision for loss is necessary.

If registrants and their independent accountants conclude that no provision for loss is required in the case of a portfolio where market value is below cost at the balance sheet date, it is particularly important that full disclosure of the market decline and the potential for loss on the basis of year-end market values be made. In such case, consideration should be given to including disclosure on the face of the balance sheet (in the investment section) and the income statement (in the investment income section). In addition, comments on market value changes should be included in "Management's Discussion and Analysis of the Summary of Earnings" described in Accounting Series Release No. 159.

Declines in the market value of common stocks are particularly significant in the insurance industry. In this industry, current practice permits common stock portfolios to be carried on the balance sheet at market values with cost disclosed parenthetically even though gains and losses are reflected in the income statement on a realized basis. Under current market conditions, it would appear desirable for all insurance companies to consider adopting this approach.

By making these comments the Commission does not intend to prejudge the many complex accounting issues in connection with marketable securities which must be addressed in a systematic way by the Financial Accounting Standards Board.

Deferral of Fuel Costs by Public Utilities

During the past year, there have been substantial increases in the fuel costs of public utilities. In many cases, public utility commissions have permitted these increased costs to be passed on to users through a "fuel adjustment clause" under which increased costs paid in one period may be directly billed to users in a subsequent period. These costs have in some cases been deferred as assets by utilities and matched against revenues in the period when they are billed. While such an accounting approach may not be inappropriate in circumstances where a direct right of pass through exists, uncertainties exist in some cases as to whether public utility commissions will permit the recovery of these deferred costs at a time when full new rate schedules are adopted. In cases where public utility commission orders do not assure such recovery, registrants should make disclosure of the uncertainty as to recovery which may exist and the effect on the financial statements of a failure to recover these costs.

Cost of Raw Materials Where Price is Still Under Negotiation

During the past year, companies in the petroleum industry who source crude oil in foreign countries have had to deal with problems of unusual uncertainties. Because of uncompleted negotiations concerning the take over of ownership by foreign governments and because crude oil acquired in 1974 was expected to be subject to the price determinations of the finally negotiated agreement, such companies have had to estimate the cost of crude oil currently being used in reporting results.

Where such unusual circumstances exist and where changes in estimates would have a significant impact upon reported results, expanded disclosure should be provided to enable investors to appraise the magnitude of the risks involved. Such disclosure should be highlighted in presentations of financial information.

The disclosure should include a description of the unusual circumstances involved, a description of the types of assumptions made by management when preparing financial reports, and an indication of the sensitivity of current and prospective earnings to

changes in such assumptions caused either by changing circumstances or the final determination of the uncertainties involved.

It would be appropriate to set forth such narrative discussions as part of the statement of accounting policies, as a separate note to financial statements or by a parenthetical statement on the face of the statements.

Small Number of Projects with Dominant Effect on Results

In some circumstances, registrants are in a position where the outcome of one or a very small number of projects will have a dominant effect in determining the company's success or failure. These projects are frequently subject to substantial uncertainties. Examples are major aircraft projects by airframe manufacturers, major constructon projects by a contractor, or major mineral exploration projects by an extractive industries company. In each case, the individual project is of an extremely large size relative to the size of the company.

In such cases, estimates of future success may be necessary in order to present financial statements on a going concern basis, and the degree of that future success may have to be predicted to some explicit degree in order to present an income statement covering current operations. In a major aircraft project, for example, accounting for the present will require some estimate of the total number of units to be sold over the life of the project and the length of time over which those units will be sold, since aggregate costs must be spread over the units in the program. In addition, estimates must be made of changing levels of cost taking into account production experience (the learning curve) and inflationary effects.

While the Commission has recently amended its financial disclosure requirements (in Accounting Series Release No. 164) to obtain better disclosure of long-term contract activities in all cases, those situations in which one or a few estimates subject to substantial uncertainty will have a dominant effect must be additionally considered.

In such cases, disclosure of the sensitivity of results to estimates must be emphasized. This may be done in the face of the financial statements by modifying appropriate captions. Another possible approach to be considered in unusual circumstances is revising the basic format of conventional financial statements to reflect a range of outcomes. In addition, substantial footnote discussion of results under alternative assumptions should be considered.

The Commission believes that the most appropriate presentation in such cases will depend upon the facts of the particular case, but feels that it should emphasize the need for comprehensive and fully highlighted disclosure.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 167
December 24, 1974

SECURITIES EXCHANGE ACT OF 1934
Release No. 11153

Order Instituting Proceedings and Imposing Remedial Sanctions in the Matter of Westheimer, Fine, Berger & Co.

Westheimer, Fine, Berger & Co. ("WFB"), a partnership engaged in the practice of accounting, has made an offer of settlement solely for the purpose of disposing of issues raised with respect to it under Rule 2(e) of the Commission's Rules of Practice. Those

issues relate to WFB's right to appear and practice before the Commission. They arise out of the entry on November 14, 1974, of a consent judgment of permanent injunction against WFB in an action brought by the Commission.[1] The Commission's complaint in that action alleged, among other things, that WFB had violated or aided and abetted violations of Sections 10(b) and 13(a) of the Securities Exchange Act and Rules 10b-5 and 13a-1 thereunder by permitting its audit reports, including its qualified opinion, to accompany the financial statements of Realty Equities Corporation of New York ("Realty") for Realty's fiscal years ended March 31, 1971 and 1972. According to the complaint, those financial statements reported certain transactions involving Realty, Republic National Life Insurance Company and others as bona fide arms-length business transactions when such transactions were not so in fact. The complaint further alleged that the results of some of those transactions were not as reported in the aforementioned financial statements.

Without admitting or denying the allegations of the complaint, and solely for the purpose of settlement, WFB consented to a judgment of permanent injunction enjoining it from violating the above-cited provisions of the Exchange Act and the rules thereunder in connection with the purchase or sale of securities of Realty, any subsidiary thereof, or any other company which has or has had securities registered pursuant to the Securities or the Exchange Acts or for the securities of which there exists a public trading market and which, within two of the last preceding three fiscal years (a) derived more than 25% of its revenues or pre-tax net profit (loss) from the purchase, sale, trading, or other transactions involving the transfer of real estate properties or interests therein (other than personal residential units), and (b) recognized material (in relation to pre-tax profit (loss)) gains from the sale, or other disposition of interests in real estate properties (other than personal residential units) (i) in which the purchaser made no significant investment in the property or (ii) in which the seller has a continued involvement with the property sold.

In view of the permanent injunction, the Commission deems it necessary that proceedings be instituted against WFB pursuant to Rule 2(e) of the Commission's Rules of Practice with respect to its qualifications to appear and practice before the Commission.

Without admitting or denying the allegations of the Commission's complaint, and solely for the purpose of settlement, WFB has submitted an offer of settlement in which it consents to the entry of an order by the Commission pursuant to Rule 2(e), which provides that:

1. For at least one year from the date on which this order is entered, WFB will employ the services of a special consultant satisfactory to the Commission. Such person shall be available to WFB for consultation to the extent requested by that firm. In addition to any specific requests by WFB during the period of such consultant's retention, the consultant shall select for review and review, to the extent set forth below, the audits of approximately 15% of the publicly-held companies for which WFB serves as independent auditor.[2] The review to be conducted by the special consultant shall be performed after WFB has completed its audit work and formulated its proposed accountant's report on the financial statements which include the transaction and/or occurrence occasioning his review, but before WFB has rendered its report on such statements.
2. After the special consultant has completed his review with respect to the prescribed number of public companies,

[1] S.E.C. v. *Republic National Life Insurance Company, et al.*, S.D.N.Y., 74 Civ. 1097 (MP). See S.E.C. Litigation Release No. 6273 (March 8, 1974), 3 S.E.C. Docket 684.

[2] The audits which the special consultant may select for review shall be limited to those audits in which certain transactions and/or occurrences outside of the client company's ordinary course of business are material to the audit. His review shall be limited to the audit work performed, as reflected in the work papers, with respect to such transactions and/or occurrences and the accounting judgments made thereon.

he shall render a report to the Commission as to his findings concerning the adequacy of the audit work performed, as reflected in the work papers, with respect to the transactions and/or occurrences occasioning his review and concerning the reasonableness of the accounting judgments made thereon. The report shall include a description of the scope and nature of his review on which such findings were based and shall be furnished to the Commission not later than 90 days after the completion of the last review by the special consultant pursuant to paragraph 1 hereof.[3]

3. In addition, WFB shall adopt auditing procedures to determine whether its clients have entered into material transactions with related parties.[4] Within 90 days from the date of the entry of this order, WFB shall submit such proposed procedures to the Commission's Chief Accountant for his review and approval.
4. Should WFB merge into another public accounting firm engaged in practice before the Commission and which in terms of the number of its professional employees, including partners, is at least twice as large as WFB, the provisions of paragraphs 1, 2 and 3 herein above shall terminate on the date of such merger. As expeditiously as possible thereafter, the combined accounting firm shall apply its quality control standards to the audits to be performed on the financial statements of public companies that were formerly clients of WFB. Furthermore, within 90 days from the date of such merger the combined firm shall report to the Chief Accountant the status of the implementation of the application of such quality control standards to such clients. And within 180 days from the date of such merger the combined firm shall submit to the Chief Accountant a final report confirming that the quality control standards have been adopted for use in all audits of such clients.

After due consideration, the Commission has determined to accept the offer of settlement.

Accordingly, IT IS ORDERED that proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice be, and they hereby are, instituted against Westheimer, Fine, Berger & Co.; it is further

ORDERED that Westheimer, Fine, Berger & Co. be, and it is hereby is, censured; and it is further

ORDERED that Westheimer, Fine, Berger & Co. comply with all of the terms of the offer of settlement that the Commission has hereby accepted.

For the Commission, by the Office of Opinions and Review, pursuant to delegated authority.

GEORGE A. FITZSIMMONS
Secretary

[3] Such report shall not identify the clients involved in the special consultant's review. However, WFB shall retain in its files information as to such clients' identity. Should the Commission deem such information necessary, it will be made available to it.

[4] Among other things, such procedures shall include a definition of the circumstances in which transactions shall be deemed to be with related parties.

RELEASE NO. 168

January 13, 1975

SECURITIES EXCHANGE ACT OF 1934
Release No. 11176

Order Instituting Proceedings and Imposing Remedial Sanctions in the Matter of Benjamin Botwinick & Co. and Alvin I. Mindes

Benjamin Botwinick & Co. ("BB"), a firm of certified public accountants, and Alvin I. Mindes ("Mindes"), a certified public accountant and a partner in BB, have made an offer of settlement for the purpose of disposing of matters raised with respect to them under Rule 2(e) of the Commission's Rules of Practice. These matters arise out of the entry on January 8, 1975 of a consent judgment of permanent injunction against BB and Mindes in an action brought by the Commission.[1]

The Commission's complaint in that action alleged, among other things, that BB and Mindes violated and aided and abetted violations of Sections 10(b) and 13(a) of the Securities Exchange Act and the rules promulgated thereunder. The complaint alleges, *inter alia*, that BB and Mindes participated in the filing with the Commission of an annual report on Form 10-K for the fiscal year ended December 31, 1971 of Allegheny Beverage Corporation ("ABC"), which report contained consolidated financial statements of ABC certified by BB.

The complaint charged, *inter alia*, that in its consolidated statement of operations for the year ended December 31, 1971, ABC materially overstated net sales and net earnings by improperly accounting for sales of vending machines by its wholly-owned subsidiary, Valu Vend, Inc. ("VV"), because the sales transactions had not been substantially completed as of December 31, 1971, and the revenues reported as a result of such sales were substantially uncertain of collectibility. The complaint alleged that many of the sales were made in late 1971 to newly-formed corporate purchasers with nominal assets, the principals of which were inexperienced in the vending or soft drink business, had made nominal or no downpayments to VV, had nominal or no cash investment in the business venture, and had not personally guaranteed notes executed in conjunction with the sales of the machines. The complaint charged that ABC or subsidiaries made advance cash payments to several large purchasers of machines to enable the purchasers to commence business operations. The complaint further alleged that payment on the notes was dependent on the sale of beverage through the vending machines, that by the end of 1971 a material number of the machines reportedly sold had not been delivered and more than 75% of the machines were not on income-producing locations, and that moratoria on required note payments of up to six months were granted. Finally, it was alleged that by the time BB's audit of ABC was completed, ABC had been notified by a number of major purchasers of their inability to make timely installment payments and meet inflated beverage sales projections that had been used by ABC to induce purchases of vending machines.

The complaint also alleged that ABC's earnings were materially overstated by the improper capitalization of purported start-up costs and test-market costs, and that ABC's consolidated balance sheet materially overstated assets and retained earnings as a result of the improper accounting of sales of vending machines and purported start-up and test-market costs.

The complaint also alleged that the opinion of BB contained in the ABC annual report stated that "the Valu Vend, Inc. subsidiary in its inception year reported income from vending machine sales on the accrual

[1] *SEC* v. *Allegheny Beverage Corporation, et al.*, D.D.C. 932-73. See Litigation Release No. 6677 (January 13, 1975).

method," that "[n]otes receivable from such sales will be collected over a four year period from the date of the sale," and that "subject to the collection of the aforementioned notes receivable," the financial statements contained in the annual report present fairly the consolidated financial position and results of operations of ABC and subsidiaries as of and for the year ended December 31, 1971, and were prepared in conformity with generally accepted accounting principles.

The complaint alleged that the opinion of BB was materially false and misleading because ABC's financial statements were not prepared in conformity with generally accepted accounting principles and did not present fairly the consolidated financial position and results of operations of ABC and subsidiaries as of and for the year ended December 31, 1971.

Without admitting or denying the allegations of the complaint and solely for the purpose of settlement, BB and Mindes consented to a judgment of permanent injunction enjoining them from violating the above-cited provisions of the Exchange Act and the rules thereunder in connection with the purchase or sale of any securities.

In view of the permanent injunction, the Commission deems it necessary that proceedings be instituted against BB and Mindes pursuant to Rule 2(e) of its Rules of Practice with respect to their qualifications to appear and practice before the Commission. Without admitting or denying the allegations of the Commission's complaint and solely for the purpose of settlemment, BB and Mindes have submitted an offer of settlement in which they consent to the entry by the Commission, pursuant to Rule 2(e) of the Rules of Practice, of an order imposing the following sanctions.[2] After due consideration, the Commission has determined to accept the offer of settlement.

Accordingly, it is hereby ORDERED

1. That BB request the American Institute of Certified Public Accountants to designate one or two persons satisfactory to the Commission's Chief Accountant to review the auditing procedures (including the application of generally accepted accounting principles) of BB in connection with clients making filings with the Commission; that, in this connection, the designated reviewer or reviewers examine the working papers of audits of companies for fiscal years ending before February 28, 1975, and have the full scope and authority to communicate with the Commission's staff to ascertain its views and questions and to review, as they deem appropriate, the personnel and other records of BB, to the extent reasonable and necessary to determine whether the professional procedures and practices of BB are adequate; that at the conclusion of this review, and within 10 months from the date hereof, the reviewer or reviewers report conclusions to the Commission and make recommendations if needed to BB for improvements; that these proceedings remain open, and the Commission retain jurisdiction of the matter, to the extent reasonable and necessary to assure reasonable compliance with said recommendations; and that BB not accept engagements with any new clients for 10 months from the date hereof where the engagement is expected to involve auditing or accounting services in connection with filing of financial statements with, or submissions or certifications to, the Commission.
2. That Mindes complete a program of continuing professional education by attending courses or seminars for at least 100 hours in subjects relating to public accounting or auditing; that this continuing education extend over a period of not more than 10 months from the date hereof; that the courses or seminars attended must be acceptable to the Commission's Chief Accountant; and that upon completion, Mindes shall submit an affidavit certifying attendance at

[2] In connection with the offer of settlement, BB advises the Commission that it will resign as the public accountants for ABC on the completion of its audit for the year ended December 31, 1974, and that it will not accept any new engagements from ABC involving required filings, submissions or certifications with the Commission.

said 100 hours of continuing education.

3. That during the 10-month period referred to hereinabove, Mindes engage in no practice before the Commission as an accountant other than as an employee or consultant under supervision, and in no case act as and/or be a partner of BB.
4. That BB have a policy that, for a five-year period, each of its partners shall attend courses or seminars in subjects relating to public accounting or auditing to the extent of at least 40 hours per year.

It is further ORDERED that proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice be, and they hereby are, instituted against Benjamin Botwinick & Co. and Alvin I. Mindes; and it is further

ORDERED that Benjamin Botwinick & Co. and Alvin I. Mindes comply with all of the terms of the offer of settlement that the Commission has hereby accepted.

For the Commission, by the Office of Opinions and Review, pursuant to delegated authority.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 169

January 23, 1975

SECURITIES ACT OF 1933
Release No. 5558

SECURITIES EXCHANGE ACT OF 1934
Release No. 11198

Financial Disclosure Problems Relating to the Adoption of the Lifo Inventory Method

The Commission today authorized the issuance of the following exchange of correspondence between its Chief Accountant and the Internal Revenue Service relating to discussions held in regard to financial disclosure problems arising from the adoption of LIFO accounting by many registrants and the book-tax conformity requirements of the Internal Revenue Code.

Attachments
Letter to Internal Revenue Service, January 20, 1975
Letter from Internal Revenue Service, January 23, 1975

SECURITIES AND EXCHANGE COMMISSION,

WASHINGTON, D.C. 20549

January 20, 1975

MR. LAWRENCE B. GIBBS,
Assistant Commissioner (Technical)
Internal Revenue Service
Room 3042
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

DEAR MR. GIBBS:

As we discussed, this letter sets forth my

understanding of the solutions agreed upon to prevent possible conflicts between financial disclosure principles and Revenue Ruling 74-586.

The Commission's Accounting Series Release No. 159 requires a public company to include "Management's Discussion and Analysis of the Summary of Earnings" in filings with the Commission. The same analysis must be included in the annual report to stockholders, although its format may vary somewhat from that used in filings on Form 10-K or in registration statements. The purpose of requiring this analysis, which under the rules would include a statement explaining "changes in accounting principles or in the method of their application that have a material effect on net income as reported," is to provide investors with a summary in one place of the most significant elements of reported results.

In the case of companies which have changed to LIFO accounting for inventories, an explanation of the change and its effect is called for by Accounting Series Release No. 159. My understanding of our agreement on Accounting Series Release No. 159 reporting is that the Service would not terminate a LIFO election if the same language used in the financial statements footnote to disclose the effect of the change to LIFO is repeated in management's analysis of operations. This is true whether such analysis is included as a separate narrative or as a part of the president's letter. You are agreeable to this position because the change to LIFO would only be made where that method is preferable to the one previously used. Thus the description of the change would state the effect on income but would be written in a manner which conveys the message that a summary of operations using the LIFO method for the current year is more meaningful in understanding the company's results of operations.

A typical example relating to the impact on earnings might read as follows:

Footnote A: The company has changed its method of accounting for inventories to Last-in, First-out (LIFO) method. This was done because the rapid increase in prices during the year would result in an overstatement of profits if use of the First-in, First-out (FIFO) method were continued since inventories sold were replaced at substantially higher prices. The effect on reported earnings for the year was a decrease of $XXX,XXX, or $X.XX per share.

Excerpt from Management's Analysis of Summary of Earnings:

In order not to overstate reported profits as a result of inflation during the year, the company changed its method of accounting for inventory from First-in, First-out to Last-in, First-out. This was necessary because of the rapid increase in prices in 197X which caused inventories sold to be replaced at substantially higher prices. The effect of the change was to decrease reported earnings by $XXX,XXX, or $X.XX per share.

Your Rev. Proc. 73-37 has previously stated that a company which changed to LIFO may make any disclosure which is required by Accounting Principles Board Opinion No. 20 in its financial statements for the year of the change without causing the Service to terminate the LIFO election. I understand that consistent with this position and in recognition of new financial disclosure principles, the Service will amplify Rev. Proc. 73-37 to allow the disclosures required by Accounting Principles Board Opinion No. 28 and Financial Accounting Standards Board Statement No. 3 in addition to the disclosure required in Accounting Series Release No. 159. The amplified Revenue Procedure also would provide that the above disclosures could be made in news releases, etc., in the year of election.

We believe that Rev. Proc. 73-37 amplified as discussed above will satisfactorily solve the problem of permitting necessary disclosures in the year in which a change to LIFO is made. The disclosures required to be made under our present rules and the other authoritative sources cited above are limited to the income effects of the specific changes

made during the year and therefore would only cover any segment of an inventory for which a change was made. If part of the inventory was changed to LIFO in one year and another segment was changed in the next, the disclosures in the second year would only relate to the effect on overall earnings of the segment changed in that year and not to the effect of a different inventory method on the inventory previously changed to LIFO.

Rule 3-07 of Regulation S-X requires that the disclosure made in the year of change be repeated at any time the financial statements for that year are subsequently reported. Instructions to registration statements and annual reports filed with the Commission require a summary of operations which includes information or explanation of material significance, including accounting changes. Securities Exchange Act of 1934 Release No. 11079 requires that a five year summary of operations be included in the annual reports to shareholders. We understand that such a repetition of previously made disclosure will not cause conformity problems. Our rules and the relevant authoritative literature do not presently require that any disclosure be made of the effect of using an alternative calculation of cost of sales covering periods subsequent to the year in which the change to LIFO is made. We do encourage but do not require registrants to make disclosure of the pro-forma effect on income if the LIFO system had been used in the year prior to its adoption, but we understand that this disclosure would cause no conformity problems since the registrant was not using the LIFO method for tax purposes in such previous year.

We also considered Rev. Rul. 73-66 which was issued in part as a result of the 1972 amendments on Regulation S-X which require (in Rule 5-02-6(b)) that registrants using the LIFO method disclose "the excess of replacement or current cost over stated LIFO value" if material, either parenthetically in the balance sheet or in a note to the financial statements. The ruling presently provides that a footnote or parenthetical statement to the balance sheet could state the excess of FIFO over LIFO cost. We understand that the Service will amplify Rev. Rul. 73-66 so that the use of replacement or current cost (which normally would not differ significantly from FIFO) also would be permitted in this note or parenthetically in the financial statements.

Sincerely,

John C. Burton
Chief Accountant

INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
January 23, 1975.

MR. JOHN C. BURTON,
Chief Accountant
Securities and Exchange Commission
Washington, D.C. 20549

DEAR MR. BURTON:

I have received your letter dated January 20, 1975.

Your letter is consistent with my understanding and the position of the Internal Revenue Service as set forth in Revenue Procedure 75-10, 1975-7 I.R.B. dated February 18, 1975, and Rev. Rul. 75-50, 1975-7 I.R.B., to be announced today in Technical Information Releaseses, copies of which are enclosed for your information.

It is also my understanding that the above mentioned letter and this letter are being published concurrently by the Securities and Exchange Commission and the Internal Revenue Service today.

Sincerely yours,

Lawrence B. Gibbs
Assistant Commissioner (Technical)

Enclosures

RELEASE NO. 170

January 27, 1975

SECURITIES ACT OF 1933
Release No. 5562

SECURITIES EXCHANGE ACT OF 1934
Release No. 11210

Order Suspending Accountant from Appearance or Practice Before the Comission in the Matter of Tubber T. Okuda

On April 27, 1973, Tubber T. Okuda, an accountant, was permanently enjoined from violating the antifraud provisions of the Securities and the Securities Exchange Acts by the United States District Court for the Western District of Washington.[1] The court found that Okuda prepared two false and misleading financial statements for Northwest Pacific Enterprises, Inc., only one of which was certified. These statements were found to have been used to induce persons to purchase the securities of Northwest Pacific. In a memorandum in support of its successful motion for summary judgment, the Commission argued that (1) Okuda knew or should have known these financial statements were false and misleading in that they failed to disclose that principal assets (six ocean going vessels) were grossly overstated, and (2) Okuda failed to review sufficient competent evidentiary material to afford a reasonable basis for the expression of his opinion on the certified financial statement of Northwest. The injunction led to Okuda's temporary suspension from practice before the Commission. These proceedings were initiated at Okuda's request to determine whether or not that temporary suspension should be made permanent.[2]

The Commission has now determined to accept Okuda's offer of settlement. On the basis of that offer, it is

ORDERED that Tubber T. Okuda be, and he hereby is, permanently suspended from appearing or practicing before the Commission; but it is further

ORDERED that on and after September 20, 1976, Okuda shall have the full right to apply for reinstatement;[3] and it is further

ORDERED that any such application shall be granted, if supported by an adequate showing that:

(A) Okuda has familiarized himself with the registration and the disclosure provisions of the federal securitiees statutes and with the Commission's requirements with respect to accounting procedures, and

(B) Nothing has occurred during the suspension period that would be a basis for adverse action against Okuda under Rule 2(e).

For the Commission, by the Office of Opinions and Review, pursuant to delegated authority.

GEORGE A. FITZSIMMONS
Secretary

[1] *S.E.C.* v. *Northwest Pacific Enterprises, Inc.*, Civ. No. 518-72C2.

[2] See Rule 2(e) (3) (ii) and (iii) of the Rules of Practice.

[3] The temporary suspension order was entered on September 20, 1973.

RELEASE NO. 171

May 1, 1975

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 18963

Adoption of Revised Rule 26 Under the Public Utility Holding Company Act of 1935 and Rescission of the Uniform System of Accounts for Holding Companies

The Securities and Exchange Commission today announced the adoption of revised Rule 26 (17 CFR 250.26) under the Public Utility Holding Company Act of 1935, and the rescission of the uniform system of accounts for holding companies ("uniform system"). The purpose of the change is to facilitate adjustment of registered holding company accounts to generally accepted accounting standards.

The revision was noticed for comment January 23, 1975 (HCAR No. 18782, 6 S.E.C. Docket 169, 40 FR 5372). Six responses were received, all endorsing the change in substance.

(The text of the amendment of Rule 26 (17CFR250.26) is omitted.)

Statutory Basis

Section 15(a) of the Act authorizes the Commission to prescribe the records and accounts to be maintained and the periods during which they are to be retained for inspection and audit by every registered holding company and every subsidiary. Section 15(e) of the Act requires that only an accounting system approved by the Commission be used. And Rule 28 prohibits, with the exceptions stated therein, the use of financial statements inconsistent with the book accounts so maintained.

We hereby authorize, as a transitional measure, the adjustment of all accounts for the calendar year 1975 to conform to the new accounting system adopted in that year by any company subject to the rule, as though such system had been in effect since the beginning of 1975. We have already granted in Holding Company Act Release No. 18782, January 23, 1975, an exception from Rule 28, to permit companies which intend to adopt such accounting system in 1975 pursuant to the amended rule to publish financial statements for the year 1974 on the new basis. This exception is hereby renewed and extended to financial statements for the year 1975 or portions thereof.

Background and Purpose

We have determined that the uniform system, prescribed in 1936, has become obsolete in significant respects and that there is no longer a need for a single prescribed system of accounts for holding companies. The change will allow holding companies to take the initiative in developing accounting systems adapted to their particular requirements.

The rescission of the uniform system eliminates discrepancies which have developed since the uniform system was adopted between the accounts prescribed and generally accepted accounting principles. The principal effects are the use of the equity method of accounting for investments in subsidiaries in place of the cost method and the presentation of extraordinary gains and losses on the income statement, rather than in retained earnings.

Record Retention

The rule published herein differs from that proposed in that it adopts rather than rescinds the detailed schedule of record retention requirements which has been in effect since 1959. It should be noted that, under paragraph (g) of the revised Rule 26, references in that schedule to the uniform system of accounts now are to be read as references to Rule 26. We are aware that this schedule

needs some change and expect to publish an amendment for comment.

In reviewing the proposed rule in the light of the comments received, it became apparent that the substitution of proposed paragraph (c) for the existing specific instructions as to record retention created uncertainties and ambiguities which should be avoided. It would not be appropriate to defer action on the basic accounting change proposed for republication of record retention requirements, so it is necessary to retain the existing requirements until the procedures necessary for change can be completed.

Other Changes From the Rule as Proposed

Textual alterations have been made to clarify certain questions raised in the comments. The second sentence of paragraph (c)(2), which would have required that undistributed earnings of subsidiaries be segregated on the parent company's balance sheet, has been deleted. This conforms to our basic policy of leaving the form of financial statements to Regulation S-X. Although the legal restrictions on the use of that portion of the parent company's retained earnings will normally be material, that restriction will usually overlap with similar restrictions imposed by bond indentures or loan agreements, which are customarily described by footnote. A mandatory use of a balance sheet caption for one such restriction could complicate an already difficult problem of disclosure.

The final clause of paragraph (c)(3), which referred to a Section 12(c) application becoming effective under Rule 23, is deleted because such an application can become effective in more than one way.

Filing requirements, which originally appeared as subparagraph (b)(5), have been restated in a separate paragraph (b). Each existing registered holding company should identify the accounts to be used in its system as part of its Form U5S for 1974, due May 1, 1975, or by supplement thereto. A company electing to continue to use the old uniform system until January 1, 1976, should so state in that filing but must specify the accounts to be used in a supplement thereto filed by December 1, 1975. This conforms to the 30-day advance filing requirement for amendments.

This portion of the rule has been elaborated to make it clear that the filing need not be repeated each year and that copies of official charts of accounts, such as those promulgated by the Federal Power Commission, need not be filed.

Some companies subject to the rule may wish to adopt an official system used by their subsidiaries or associates, even though not required to do so. The rule permits this choice. Such companies are free to modify the system so selected. Any variation from an official system would, of course, preclude meeting the filing requirements by a simple reference. However, official systems are a matter of official notice and may be incorporated by reference in a filing, as long as the variations therefrom are unequivocally stated.

Concern has been expressed that paragraph (b)(9) of Rule 14 a-3 under the Securities Exchange Act of 1934 would require inclusion of the entire chart of accounts in the material which the issuer is required to furnish on request to its security holders. That rule specifies the conditions on which exhibits to such filings are to be furnished, and is fully adequate to cover the contingency.

Application of Rule 26

Rule 26 is coextensive with Section 15(a) of the Act and applies, except as expressly limited, to every registered holding company and every subsidiary thereof. The proposed text has been rearranged to segregate in paragraph (c) the provisions dealing with the equity method of accounting for investments in subsidiaries, which are inherently limited to such companies in a registered system as have a subsidiary.

The record retention requirements, now paragraph (d), apply only to registered holding companies which are not public utility companies. Such requirements for public utility companies, whether or not holding companies, are specified by the Federal

Power Commission or state commissions. We do not, at this time, see a need for additional requirements as to these companies.

"Subsidiary company" as used in this rule has the special meaning prescribed in Section 2(a)(8) of the Act, and includes any company regardless of form of organization in which 10% or more of the voting securities are directly or indirectly owned, controlled or held with power to vote by a holding company. The rule does not prohibit use of the equity method of accounting for investments in nonsubsidiaries. Its use for such investments would be governed by applicable accounting standards.

Rule 26 is adopted pursuant to authority conferred on the Commission by the Public Utility Holding Company Act of 1935, particularly Sections 15 and 20 thereof, and shall be effective forthwith.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 172

June 13, 1975

SECURITIES ACT OF 1933
Release No. 5590

SECURITIES EXCHANGE ACT OF 1934
Release No. 11470

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 19039

INVESTMENT COMPANY ACT OF 1940
Release No. 8819

Notice of Rescission of Guidelines Set Forth in Accounting Series Release No. 148 Pertaining to Classification of Short-Term Obligations Expected to be Refinanced

Accounting Series Release No. 148 (33-5436, 34-10493, 35-18168, IC-8082; November 13, 1973) set forth guidelines concerning the classification of commercial paper and short-term debt expected to be refinanced, as follows:

> "Commercial paper and other short-term debt should be classified as a current liability even though the issuer's intention is to roll over such debt at its maturity. The fact that an issuer has both financial strength and a past borrowing record such that sale of new paper appears reasonably assured does not constitute a basis for long-term classification, since the power to terminate the credit remains with the creditor. Only (1) when a borrower has a noncancelable binding agreement from a creditor to refinance the paper (or other short-term debt) and (2) when the refinancing extends the maturity date beyond one year or the current operating cycle of the business (whichever is longer) and (3) when the borrower's intention is to exercise this right, should borrowings under such an agreement be shown as a long-term liability (along with disclosure of the above facts)."

These guidelines are rescinded effective December 26, 1975 and financial statements filed with the Commission with balance sheets dated on or after that date shall follow the criteria set forth in the Statement of Financial Accounting Standards No. 6 ("Classification of Short-Term Obligations Expected to Be Refinanced—An Amendment of ARB No. 43, Chapter 3A") which was issued by the Financial Accounting Standards Board in June 1975. Earlier application of this new Standard in lieu of ASR No. 148 guidelines is encouraged.

By the Commission

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 173

July 2, 1975

SECURITIES EXCHANGE ACT OF 1934
Release No. 11517

Opinion and Order in a Proceeding Pursuant to Rule 2(e) of the Commission's Rules of Practice in the Matter of Peat, Marwick, Mitchell & Co.

Between February 1972 and March 1974 the Commission filed four civil injunctive complaints against Peat, Marwick, Mitchell & Co. ("PMM") relating to PMM's examinations of financial statements of National Student Marketing Corporation ("NSMC"), Talley Industries, Inc. ("Talley"), Penn Central Company ("Penn Central"), and Republic National Life Insurance Company ("Republic National"). In addition, the Commission has completed an investigation relating to Stirling Homex Corporation ("Stirling Homex") which has also raised questions concerning PMM's audit of this Company's financial statements.[1] In order to resolve these controversies, PMM has submitted an offer of settlement which is described in detail below, and which we have considered and determined to accept. As contemplated by the settlement offer, without admitting or denying any of the statements and conclusions set forth herein, PMM has agreed to the institution of this Rule 2(e) proceeding and the issuance of the order hereinafter set forth.[2]

The facts of these five matters, as they appear to the Commission, are set forth in some detail below, together with the Commission's views on the accounting and auditing lessons to be learned from them. The following highlights certain of the basic problems which have been noted by the Commission in these matters:

The first set of problems relate to the process of taking on a new audit engagement and planning for the first audit. Three of these cases involved initial audits.

In the *NSMC* case, there was inadequate communication between the predecessor auditor and PMM which resulted in PMM's being unaware of doubts which the predecessor auditor had as to the integrity of management. In the *Republic* case, PMM was aware of disagreements between their predecessors and Republic's management regarding disclosure of and accounting for investments in its major debtor, but PMM did not investigate these differences in sufficient depth. The Commission, in *Accounting Series Release No. 153*, already has expressed its view that the basic responsibilities of auditors require full communication between predecessors and successors. Another lesson appears in *NSMC* and *Stirling*, where the auditors accepted assertions by management concerning the special circumstances of the business involved although presentation of the supposed results presented unusual accounting and auditing problems. In considerable measure this occurred because the auditors were not sufficiently familiar with the business context to assess the representations of management. Auditors should be particularly careful when the client asserts that special circumstances require unusual accounting or auditing solutions and should either possess or avail themselves of sufficient industry knowledge to judge the sub-

[1] The first four matters have been the subject of injunctive actions brought by the Commission against the Companies involved, other persons and PMM. *SEC* v. *National Student Marketing Corp., et al.*, Civil Action No 225-72 (D.D.C.); *SEC* v. *Peat, Marwick, Mitchell & Co., instituted sub nom; SEC* v. *Talley Industries, Inc., et al.*, 73 Civ. 4603 (S.D.N.Y.); *SEC* v. *Republic National Life Insurance Co., et. al.*, 74 Civ. 1097 (S.D.N.Y.); *SEC* v. *Penn Central Co., et al.*, 74 Civ. 1125 (E.D. Pa.). The fifth matter has been the subject of an investigation of the company, other persons and PMM. This opinion, except incidentally, does not attempt to deal with the other persons involved in these various controversies.

[2] For purposes of this settlement and carrying out of any procedures contemplated herein, PMM has waived separation of functions between the staff and the Commission.

stance of the situation. In addition, in *Stirling* there was a division of ultimate authority for the engagement between two partners, one of whom operated out of an office far removed from the executive offices and the manufacturing facilities of Stirling, so that his ability to actively plan and supervise this difficult first audit was substantially reduced.

Another problem area highlighted by several of the cases is the need for emphasizing the importance of substance over form in determining accounting principles to be applied to particular transactions and situations. In addition to considering substance over form in particular transactions, it is important that the overall impression created by the financial statements be consistent with the business realities of the company's financial position and operations.

In the *Penn Central* case, PMM did not place sufficient emphasis on the economic substance of several transactions and hence permitted these transactions to be accounted for under principles which in our view were not applicable in the circumstances. More importantly, the inclusion of the sum of all these transactions in financial statements resulted in statements which, taken as a whole, did not communicate to the user the business realities of the company's financial position and operations.

We believe that an auditor must stand back from his resolution of particular accounting issues and assess the aggregate impact of the particular issues upon a reasonable investor's perception of the economic substance of the enterprise for which financial statements are being presented.

In several of these cases, serious problems arose in the application of percentage of completion accounting and its improper use to accelerate the recognition of revenue. Percentage of completion accounting is normally used in situations where the conventional approach of recognizing revenue at the point of sale and delivery would produce a misleading picture of business activity. This is normally the case where there are substantial projects lasting longer than a year, where ultimate sales are assured by contract and where reasonable estimates can be made of the cost to complete the project. In the *NSMC* case, no firm sales had been made and, in fact, the percentage of completion was measured by the estimated percentage of sales effort expended. In addition, "projects" were of short duration and cost estimates were uncertain. Similarly, in *Stirling*, sales contracts were dependent on obtaining financing which was highly uncertain, and the costs of completion were difficult to estimate.

These cases emphasize that the use of accounting principles must be evaluated in the light of their applicability to the facts of the particular case, and that professionals must exercise the greatest care and judgment in appraising their applicability. While management may initially select the principles to be followed, the independent accountant must be satisfied that in his professional judgment the principles selected are those which appropriately describe the business reality within the general framework of the accounting approach to economic measurement.

Finally, in most of these situations, the auditors accepted the representations of management without obtaining independent audit verification of the realities underlying transactions. While the Commission does not suggest that management representations are not a significant source of evidence, it is apparent that if the independent professionalism inherent in the auditor's role is to be maintained, evidence beyond these assertions must be obtained in significant audit areas.

In *Talley*, for instance, the auditors accepted management's estimates of contracts to be received despite the fact that Talley had to predict both total government contracts to be awarded and the company's expectations of its share of such total contracts. These largely subjective judgments were based on various forms of "soft" data and were not sufficient for the purpose of assuming future orders. They also accepted Talley's estimates of per unit cost reductions despite the fact that Talley's cost system was not capable of (and did not attempt to) monitor differences between estimated and actual cost figures.

The recognizing of revenue in the *NSMC* case depended in part on the firmness of the "contracts" with NSMC's customers. In that regard the auditors relied heavily on management's representations that oral contracts were not unusual and were sufficiently firm to be a basis for recognizing revenue. In the initial audit, they did not insist on written confirmations from customers.

In *Stirling* sales and income were recognized in connection with the manufacturing and installation of modular housing for local housing agencies although the agencies, themselves without funds, were dependent upon federal financing and binding commitments for such financing were absent. In the Commission's judgment, PMM accepted representations that documentation from the local agency constituted or was the practical equivalent of committed federal financing. Assignments of modules to specific contracts, ability to recover installation cost overruns and the status of particular projects were other areas where PMM largely relied upon management representations and did not perform appropriate audit steps.

* * * * *

The following is a description of the five cases.

NATIONAL STUDENT MARKETING CORPORATION

Prior to discussing PMM's role as independent auditors for National Student Marketing Corporation ("NSMC") reference should be made to the circumstances under which the firm was engaged. In April 1968, NSMC made a registered public offering of 30,000 shares of its common stock.[3] At the time of this registered stock offering, NSMC's independent auditors were Arthur Andersen & Co. and Covington & Burling was its outside counsel. In July of 1968, shortly before the close of NSMC's fiscal year, Covington & Burling resigned as counsel to NSMC and was succeeded by White & Case ("NSMC's outside counsel"). At approximately the same time, Arthur Andersen advised NSMC that it would not be available to undertake audit responsibilities for the fiscal year ending August 31, 1968. Arthur Andersen's decision to resign apparently came as a result of a series of events which led Arthur Andersen and Covington & Burling to question the reliability of information which they received fron NSMC's management.

Upon being requested by NSMC to accept the audit engagement, PMM's Washington office inquired of the managing partner of the local Arthur Andersen office as to whether there was any professional reason why PMM should not undertake to act as outside autitors for the company. This limited inquiry, which the Commission believes should have been viewed as including questions regarding management integrity, was answered in writing in the negative. PMM did not ask for the reasons why Arthur Andersen had resigned and Andersen did not supply any information in this regard.[4] The Commission believes that information pertaining to the integrity of management should be communicated between predecessor and successor auditors. The resulting failure of communication caused PMM to undertake this engagement at a distinct disadvantage. While the kind of information Arthur Andersen and Covington & Burling had did not necessarily go to the fundamental integrity of NSMC's management, it was nevertheless significant information which PMM should have sought more aggressively. The significance of the simultaneous changes of the independent auditors and outside counsel also should not have been overlooked. This additional information might have added significantly to the normal "healthy skepticism" with which the auditor approaches a professional engagement.

[3] NSMC's common stock was offered to the public at $6.00 per share. By September of 1968, the stock was selling at $70 per share, about 350 times the last reported audited earnings per share.

[4] Arthur Andersen acted on advice of counsel. We believe that at a minimum the fact that their response was limited by such advice should have been communicated.

PMM's August 31, 1968 Engagement—Accounting for Fixed Fee Programs

NSMC was organized in 1966 to engage in the development, marketing and implementation of various products and services of its own and of its clients to high school and college students. At this time, it maintained its executive offices in Washington, D. C.

The clients of NSMC were companies wishing to sell their products and services in the student market. NSMC designed youth-oriented advertising programs to fit the needs of individual clients and sold its ability to implement those programs by distributing various materials directly to the so-called youth market. Media used by NSMC in its youth marketing activities included campus poster advertising, handouts, direct mail, desk pads, college directories, newspaper insertions, films and product sampling. NSMC sold its services through account executives whose duties encompassed solicitation of prospective clients, explanation of NSMC's marketing capabilities and development and design of specific programs to meet clients' marketing objectives. Posters, handouts, samples and other promotional materials used in the marketing programs were often made and delivered to the NSMC distribution network by outside vendors and/or by the clients themselves. NSMC's distribution network consisted of part-time campus representatives employed by NSMC who worked on a commission basis.

NSMC's revenues were generated on either a commission or fixed fee basis, depending upon the nature of the program. An example of a commission program was the distribution of posters with tear-off coupons for a magazine subscription. The client would pay a fee to NSMC per subscription application coupon received. An example of a fixed fee type program was a direct mailing to a specific number of addresses for a flat fee. Fixed fee business first became significant for NSMC during the latter half of fiscal 1968.

As described to the auditors, NSMC's increased efforts to obtain clients for particular marketing programs on a fixed fee basis were centered on NSMC's recently expanded national sales operation centered in New York City. The company had hired several account executives whose efforts involved the creation of an overall marketing program—marketing strategy, media selection, art work, and the like—tailored to the needs of a particular client, its presentation to the client, possible revisions and a new presentation, and ultimately acceptance by the client. The programs were directed to the student market and thus were to be implemented at various seasons during the academic year. The program effort was the responsibility of the particular NSMC account executive who drew upon and supervised the various necessary talents of the New York office staff. As represented by NSMC's management, the only remaining functions after acceptance by the client were those of an essentially mechanical nature such as printing, mailing, placing posters, and the like, with their costs being susceptible to a reliable estimation. A substantial amount of firm commitments allegedly had been obtained for such fixed fee programs prior to August 31, 1968, and it was represented that the creative effort had thus been largely accomplished, although implementation of the programs and billings were to take place at a later date. It was explained by NSMC to the auditors that, as was a common practice in the industry, these commitments were for the most part not in written contract form.

When PMM commenced its examination of NSMC's financial statements for the fiscal year ended August 31, 1968, it became immediately clear that NSMC's internal accounting books and records were in very poor condition and that the journal entries were a month or two behind. By early October a preliminary profit and loss statement had been prepared by management which reflected a loss of approximately $220,000 for that year. It was at this time that the company's management, principally its chief executive officer, advised the auditors that its books and records did not include substantial amounts of revenues generated by NSMC's New York office through the sale of fixed fee programs. From the beginning of October to the middle of November, additional information was supplied to the auditors by NSMC

which purported to show substantial commitments which would result in income arising out of the operations of this aspect of NSMC's business. Approximately 96% of NSMC's consolidated earnings before income taxes and extraordinary items and forty percent of its assets resulted from the inclusion in NSMC's financial statements for 1968 of revenues, less the accrual of related costs, from these fixed fee programs described in the financial statements as "contracts in progress." In our view, both this accounting treatment and the auditing in respect thereof were inappropriate for several reasons. Of the $1.76 million in revenues from unbilled receivables appearing in NSMC's 1968 financial statements, only about $200,000 was covered by written contracts from NSMC's clients.[5] The rest was reported as "contracts in progress" but in fact consisted of what were said to be oral "commitments," the sole written evidence of whose existence consisted in most part of one page commitment reports of the NSMC account executives. All of these commitment reports from the account executives were dated in October, some six weeks after the close of the company's fiscal year. These reports gave no indication that the purported commitments existed on August 31, 1968. The auditors' work papers do not reflect that efforts were made to test whether they existed at August 31, 1968 or not.[6]

Revenue should be recorded on a percentage of completion basis only in circumstances where (1) the ultimate realization of the revenue is reasonably assured, (2) the completion of the contract requires a relatively long period of time, (3) the partial performance of the contract is a reasonable measure of business activity and (4) the cost of completion can be reasonably estimated. In our view, none of these criteria was met with respect to the accounting for fixed fee programs, and the application of the percentage of completion accounting method to these circumstances was inappropriate. In addition, the determination of percentage of completion on the basis of what, in our view, was only sales effort appears to us to be totally inconsistent with the basic principles underlying revenue recognition. Furthermore, the method used ignored all cost of implementing the program in computing the percentage of completion, although such costs were accrued. Moreover, the company relied only on its account executives for their estimates of the percentage of completion. Although the auditors claim to have tested these representations and estimates by the account executives, they did not document such testing in their work papers.[7]

The accounting method utilized for the fixed fee programs made no allowance for, and the financial statements made no reference to, guarantee provisions in a substantial number of the programs by which, in the event the response level did not reach a stated minimum, NSMC was obligated either to accept a reduced fee or to rerun the program at no cost to the client. Since NSMC had had no significant past experience with the fixed fee programs, its liability to make good on these guarantees could not accurately be estimated.

By way of summary, some measure of the inappropriateness of the percentage of completion accounting applied to the fixed fee programs in the company's 1968 financial statements may be gleaned from the fact that during its 1969 fiscal year the company wrote off over 75% of the $1.76 million in revenues ascribed to the fixed fee programs previously reported in the 1968 statements.[8]

[5] It was NSMC's practice not to enforce even written contracts if the client never ordered implementation. In fact, the written contracts which they did have in 1968 covering fixed fee programs included guarantees that a certain level of market performance would be achieved.

[6] See §338.02 of Statement on Auditing Standards No. 1 (AICPA) on the form, content and nature of working papers.

[7] It is worth noting in this connection that least one account executive testified that he believed that this percentage of completion represented NSMC's likelihood of getting the commitment from the client.

[8] As discussed below, no disclosure of these write-offs was made in subsequent financial statements until after the Commission began its investigation into NSMC's affairs.

In addition to the propriety of the accounting method is the question of appropriate auditing procedures with respect to fixed fee programs. Standard of Field Work No. 2 of Generally Accepted Auditing Standards requires the auditor to make "a proper study and evaluation of the existing internal control [of his client] as a basis for reliance thereon." The 1968 audit was PMM's first audit of NSMC. Pmm's work papers contain evidence that the audit was the beginning of adequate record keeping for the fixed fee programs.[9] In this respect, the workpapers themselves were the principal records from which the financial statements were prepared. In light of the fact that the auditors did not consider NSMC to have a reliable system of recordkeeping, nor an adequate system of internal control, and that NSMC had no substantial prior experience with fixed fee commitments, the extent of the auditors' reliance on information supplied by NSMC, we believe, was improper. For example, they accepted the percentages supplied by NSMC's account executives of the amount of work that had ostensibly been completed on any particular commitment, even though, to their knowledge, NSMC had no written instructions concerning how this was to be computed.[10] As noted earlier, although the auditors claimed to have examined the account executive's files to verify and test the percentage of completion figures utilized, such examination was not documented in the audit workpapers.

Moreover, the auditors did not obtain written confirmation from any of NSMC's clients. Company officers informed them that its clients, not having been asked to formalize in writing their acceptance of NSMC's programs in the first instance, did not expect to be called upon to do so at a later date and might well back off from doing business with NSMC if asked to do so. As a result, PMM did not send written confirmations. The auditors concluded that the existence of these commitments could be determined by telephone confirmation on a representative selection of the oral commitments and review of such written commitment as existed.[11] A number of the telephone calls were placed by NSMC's account executives and the auditors did not insist on proper audit controls for these oral confirmations. Although there may be very limited situations where telephonic confirmations can properly be utilized as an auditing technique, provided adequate controls are

[9] PMM's audit supervisor reported that NSMC's "accounting, bookkeeping and maintenance of files were almost forgotten. . . The net result is that our working papers represent the beginning of proper record keeping and accounting procedures for recording gross income on contracts."

[10] PMM's management letter to NSMC of January 2, 1969 urged that these procedures be strengthened considerably:

"Due to the nature of the activity of the company, sales are recorded when a client commitment is considered to exist. The amount of the sale recorded is based on the percentage of time incurred to the estimated time to be incurred by the employees in developing overall programs for the client. Because the time of these employees is extremely important in developing a systematic method of recording sales, it is imperative that the company adopt a policy whereby these employees report their time to the accounting department on a weekly or other timely basis, report in writing commitments obtained from clients, and estimates of time to complete committed contracts. In addition, preprinted forms should be used to obtain written confirmation of all client commitments.

"Working with Mr. Kurek and Mr. Davies, we have recently designed appropriate forms for use in the above connection. We urge that implementation of the recently established program be followed up very closely and that no wavering from the required procedures be permitted."

[11] For the fiscal year ended August 31, 1969, at the auditors' insistence NSMC recognized revenue only on fixed fee programs which were evidenced by a written letter of commitment by the client. These commitments were confirmed in writing by the auditors. Again the Commission believes that such commitments, even when confirmed in writing, should not have resulted in recognized income resulting from the application of the precentage of completion method, for the reasons previously specified for the year ended August 31, 1968. Following the institution of the Commission's investigation, the company adopted the completed contract method for the fiscal period ended December 31, 1969.

maintained,[12] in our view such a procedure was inappropriate for NSMC.[13]

NSMC's Proxy Statement

During the period from November 1968 to May 1969, NSMC acquired additional companies primarily through the issuance of its common shares. In the Spring of 1969, PMM was engaged to assist the company in consolidating unaudited figures as at February 28, 1968 to be used in a proxy statement to obtain authorization from its shareholders for the issuance of additional shares needed for its acquisition program.

Retroactive Adjustments. At about this time, the auditors were informed that an account executive of the company had been terminated for alleged unethical conduct and that a subsequent review of the accounts which this individual supervised disclosed that four particular client commitments for fixed fee programs which he had earlier reported had never in fact existed. These commitments involved gross sales of approximately $750,000 which amounted to approximately 43% of the fixed fee sales reported in the company's previously issued financial statements for the fiscal year ended August 31, 1968. Costs of some $540,000 had been accrued on these commitments, resulting in a net reduction on the company's income before taxes for the prior period of some $210,000. The auditors suggested that this income should be written off retroactive to August 31, 1968, and the company adopted this procedure.

About the same time that this retroactive write-off was being discussed with the company, PMM's tax department, which had been engaged in the preparation of the company's tax return, indicated that they believed that the provision for deferred taxes which appeared in NSMC's 1968 financial statements appeared to be in error as a result of certain net operating loss carryforwards which the company was reporting on its tax returns. After being apprised of this, members of PMM's audit staff eliminated a portion of the 1968 provision for deferred taxes in the amount of approximately $190,000, and a retroactive adjustment of this effect was made on the company's books as of August 31, 1968.[14]

Work on the proposed proxy statement was suspended to facilitate shareholder approval of several additional mergers that were then contemplated. When preparation of the proxy statement was renewed, PMM personnel considered the question of whether the retroactive adjustments to the 1968 audited statements should be disclosed in a footnote to the consolidated statement of earnings set forth in the proxy statement which was to reconcile the originally reported net sales and net earnings with the restated amounts resulting from pooled companies reflected retroactively.

The auditors took the position that the write-off of the previously erroneously reported client commitments and the extraordinary item which was a correction of the tax provision error, both retroactively applied to 1968, approximately cancelled each other out in their effect upon previously reported 1968 net income. The difference, amounting to approximately $21,000, was an amount deemed by the auditors to be immaterial. They felt that the size and character of NSMC had changed substantially through acquisitions since PMM's report on the previous year's audited statements had been released. While the August 1968 financial statements originally reported sales of $4.9 million and net income of $388,000, the proxy statement reflected sales for that year of $11.5 million and net income of $773,000, after giving effect to pooled companies re-

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[12] See, *e.g.*, AICPA Industry Audit Guide, Finance Companies, p. 105, 1973.

[13] See Section 331.01 of *Statement No. 1 on Auditing Standards:*

> "Confirmation of receivables and observation of inventories are generally accepted auditing procedures. The independent auditor who issues an opinion when he has not employed them must bear in mind that he has the burden of justifying the opinion expressed." The auditors did not satisfy this burden because no adequate documentation existed."

[14] PMM later determined that this adjustment was in error.

flected retroactively, as well as the retroactive contract and tax adjustments.

It is the Commission's view that what the auditors did had the effect of improperly netting extraordinary and ordinary items of income and that in any event, disclosure of both of these adjustments was required by paragraph 26 of *Opinion No. 9* of the Accounting Principles Board. None of these adjustments, moreover, were disclosed anywhere in the proxy statement filed with the Commission and disseminated to stockholders; rather, they were improperly subtracted from the amounts shown for sales and earnings of pooled companies acquired by NSMC after August 31, 1968 in the reconciliation footnote.

About the same time that they were informed of the four alleged nonexistent client commitments, the auditors were also informed that the company was writing off against the current year's operating income certain other fixed fee programs which had been included in the 1968 statements but were not being implemented for various reasons. Despite this adverse experience, the auditors took no steps to reexamine or otherwise take a fresh look at its 1968 audit or the procedures and principles utilized therein with respect to fixed fee programs, even though NSMC was utilizing the 1968 audited statements, which were being represented by NSMC to be true and correct, to acquire other companies.[15]

The Commission believes that these judgments were erroneous. The auditors were aware that the company was experiencing current difficulty with the implementation and realization of income from the fixed fee programs. Payments were not being received from these commitments in the ordinary course. Several of the commitments for which income was attributed in fiscal 1968 were being written off currently and the ultimate collectibility of a substantial number of other 1968 programs still on the company's books was, at this time, subject to serious question.

It is the Commission's view that disclosure of these very substantial write-offs was essential under the circumstances. The write-offs affected what was represented by NSMC to be its basic and unique line of business. The write-offs exposed the weakness of that part of the company's operations which was at the heart of its entire acquisition program.

The Nine Month Statements

The unaudited nine-month earnings statement included in the proxy statement was compiled by NSMC with PMM's assistance, using the same percentage of completion accounting theory as in the 1968 figures. However, by the time the proxy statement was issued, PMM knew not only that a material amount of the 1968 commitments never existed, but that throughout fiscal 1969 the company was writing off in current periods other commitment that had been recorded in the 1968 figures that were not implemented for one reason or another.

In compiling the nine-month financial statements for the period which ended May 31, 1969, in at least one instance the Firm refused to permit the inclusion of income from commitments where there was no evidence of a writing signed by the client. PMM determined to eliminate from the nine-month earnings statement a purported commitment from the Pontiac Division of General Motors Corporation in an amount of over $1 million because PMM was not satisfied with the written evidence supporting such commitment. However, NSMC substituted a commitment in a lesser amount from Eastern Airlines. This letter from the client supporting this commitment was produced in August 1969 at the printers by an NSMC official for the first time while preparation of the proxy statement was in process.

[15] Following the institution of the above injunctive action against PMM and others, the Commission referred the actions of PMM's engagement partner and audit supervisor to the Department of Justice. On January 17, 1974 an indictment was returned charging them with making and causing to be made false and misleading statements with respect to material facts in the NSMC proxy statement referred to herein. Judgments of conviction were entered against them on December 27, 1974. Those convictions are presently on appeal. *United States v. Natelli*, Docket No. 75-10004.

The appearance of this commitment letter followed what had been, in our view, a suspicious pattern of post-period discovery of income items by NSMC management. In October 1968, as noted above, following a trial balance which showed a loss, $1.7 million of client commitments was disclosed to PMM for inclusion in the revenues for the period ending August 31, 1968. Although a substantial portion of these commitments was written off the company's books during the six-month period ending February 28, 1969, these write-offs were replaced with the so-called Pontiac commitment in the amount of $1.2 million, which represented another material addition to NSMC earnings two months after the fiscal period had ended. Yet, despite this experience, PMM did not object to the recording of the Eastern commitment. While the Commission recognizes that PMM was engaged in a proxy review rather than an audit of these nine-month financial statements, nonetheless, we believe that under all the circumstances then known to PMM, the auditors should not have concurred in the decision to recognize income arising out of this commitment and should not have continued to be associated with the financial statements.

At the time the proxy statement was filed, NSMC and the auditors knew that of the $3,347,775 of unbilled accounts receivable recorded in the 18-month period ended February 28, 1969, some $2,055,523 (61%) had been written off,[16] an additional $310,972 (9%) was uncollectible or was to be written off and some $123,006 (4%) was inactive and the balance, some $858,274 (26%) had been billed or billed in part. None of these write-offs was separately disclosed. Despite the fact that the company had ostensibly changed its procedures for booking these commitments and that the size and character of the company had changed through acquisitions, fixed fee commitments still accounted for a significant portion of the company's business. Although this method of accounting had proven to be completely unreliable, revenues continued to be accrued in much the same fashion through August 31, 1969.

[16] Included in these amounts was the Pontiac commitment of $1.2 million.

PMM's Comfort Letter

The approval of the shareholders was solicited on the basis of NSMC's August 31, 1968 and May 31, 1969 financial statements. The proxy statement was filed with the Commission on September 30, 1969 and mailed to NSMC's shareholders. Among the matters noticed therein for action at a special shareholders meeting to be held on October 8, 1969 was the approval of a merger of NSMC with Interstate National Corporation ("Interstate"), a publicly owned company.

Substantially the same proxy statement was also mailed to Interstate's shareholders. The shareholders of both companies voted to approve the merger. Under the terms of the merger agreement, which was annexed to the proxy statement PMM was to deliver at the time of the closing, and before consummation of the merger, what is commonly called a "comfort letter," stating that:

"... on the basis of a limited review, but not an audit, of the latest available unaudited interim financial statements of NSMC and its subsidiaries, consultations with responsible officers of NSMC and other specified procedures and inquires (including all such procedures as they consider necessary under the circumstances in connection with such limited review), they have no reason to believe that the unaudited interim financial statements of NSMC as of May 31, 1969, and for the nine months then ended, were not prepared in accordance with accounting principles and practices consistent with accounting prin- the preparation of the August 31, 1968 audited financial statements or that any material adjustments of such unaudited interim financial statements are required for a fair presentation of the results of operations of NSMC and its subsidiaries or that during the period from May 31, 1969 to a specified date not more than five business days prior to the Effective Date there has been any material adverse change in the fi-

nancial position or results of operations of NSMC and its subsidiaries taken as a whole".

The closing date for the Interstate merger was scheduled for October 31, 1969. At this time, PMM's Washington office was in the midst of its audit engagement for the fiscal year ended August 31, 1969. In the course of this examination, the auditors determined that significant adjustments had to be made to NSMC's financial statements. Certain of these adjustments were determined to be applicable to the May 31, 1969 nine-month financial statements—a subject of the required comfort letter. The effect of the adjustments PMM considered applicable to the nine-month statements was to reduce net income as set forth in the proxy statement for the unaudited nine-month period from a $700,000 profit to a net loss of about $80,000.

In light of the fact that PMM would not be able to give the "comfort" required by the merger agreement, the Firm's Department of Professional Practice in New York City was consulted on October 31, 1969, the day of the closing. An unsigned draft of PMM's letter setting forth the adjustments considered by them to be necessary was provided to the New York office of NSMC's outside legal counsel, where the closing was to take place. Sometime on the afternoon of October 31, before the merger was consummated, PMM informed NSMC and its outside counsel by telephone that an additional paragraph would be added to the letter which would state that if certain necessary adjustments had been made at May 31, 1969, the unaudited consolidated statement of earnings for the period would have shown a net loss for the consolidated operations of the company and that the company as it existed on May 31, 1969 was expected to "break even" for the fiscal year.

At this time, PMM (which was consulting its own counsel as to what steps it should take) understood that the draft of its comfort letter, which it represented to be still incomplete, was being reviewed by representatives of both Interstate and NSMC and their respective outside legal counsel and that all parties would await the delivery of a signed, final copy of the comfort letter before consummating the merger.

Later the same afternoon PMM called NSMC's outside counsel to state that the firm was issuing a final version of the letter to which had been added a further paragraph expressing PMM's belief that the companies should consider submitting corrected financial information to the shareholders before proceeding with the merger. At this time, contrary to its prior understanding, PMM was informed that the merger had been consummated without awaiting the final text of PMM's letter.[17] PMM delivered a signed copy of the final version to the office of NSMC's outside counsel before the close of business on October 31, 1969. On the next business day, November 3, 1969, PMM mailed copies of its final signed letter to each member of the boards of directors of NSMC and Interstate (some of whom in both instances were outside directors) and NSMC's outside counsel which had represented NSMC at the closing and to the law firm representing Interstate at the closing.

PMM took no further action, believing that it had satisfied its professional obligations by manifesting its concern to management of NSMC and to the directors and attorneys of both companies, and having been advised by its own counsel that further disclosure might violate state laws and the AICPA Code of Professional Ethics relating to auditor-client confidentiality.

We recognize that the action taken by

[17] The comfort letter, after setting forth the basis on which it was issued and the adjustments PMM considered necessary, stated in part:

"Your attention is called, however, to the fact that if the aforementioned adjustments had been made at May 31, 1969, the unaudited consolidated statement of earnings of National Student Marketing Corporation would have shown a net loss of approximately $80,000. It is presently estimated that the consolidated operations of the company as it existed at May 31, 1969, will be approximately a break-even as to net earnings for the year ended August 31, 1969.

"In view of the above-mentioned facts, we believe the companies should consider submitting corrected interim unaudited financial information to the shareholders prior to proceeding with the closing."

PMM was considerable, especially in the face of what appeared to the Firm to be countervailing positions taken by two prominent law firms. PMM's letter communication to both boards of directors was appropriate and put them in a position to take necessary action. Nonetheless, we believe that independent auditors in such circumstances should insist on revised financial statements being sent to shareholders when they are professionally associated with such statements, whether audited or unaudited. Further, while we believe that primary responsibility rests with management and directors of public companies, where they refuse to resolicit shareholders, under these circumstances, we believe that independent public accountants have an obligation to notify the Commission. We believe that such action is protected by the policies underlying the federal securities laws against any complaint that state statutory or ethical confidentiality provisions had been violated.

1969 Financial Statements

On or about December 1, 1969, NSMC mailed to its shareholders and others, and filed with the Commission, its annual report containing audited consolidated financial statements for the fiscal years ended August 31, 1968 and 1969. Although the auditing procedures followed by PMM with respect to the 1969 statements represented a change from 1968 in that the fixed fee programs were confirmed in writing with NSMC's clients, accounting for the fixed fee programs continued to be on the same percentage of completion basis which the Commission, for the reasons stated above, concluded was inappropriate.

In addition, NSMC's 1969 financial statements reflected extraordinary gains in the amount of $370,000 from the sale of two subsidiaries. The transaction was described in Note 3 to the company's financial statements for the fiscal year ended August 31, 1969 as follows:

"Subsequent to August 31, 1969, closings were held with respect to the sale of all of the stock of Collegiate Advertising Ltd. and Compunjob, Inc., wholly-owned subsidiaries. The subsidiaries were sold to employees of the respective companies. As to Collegiate, the consideration received was $220,000 represented by five-year 8% personal notes, secured by 3,200 shares of the company's common stock, and as to Compujob, the consideration was $225,000, represented by one-year 5% personal notes secured by 4,500 shares of the company's stock. The employees who purchased Compujob had originally sold it to the company. In the opinion of counsel in both transactions negotiations and agreements of sale were in effect consummated prior to August 31, 1969, and title to the stock and all of the risks and benefits of ownership thereof passed to the purchasers on August 29, 1969."

The auditors were first informed of these transactions during their examination, well after the close of the fiscal year. Although PMM knew the closings of these transactions did not take place until November of 1969, it was represented to them that the basic terms had been agreed prior to August 31, 1969. PMM was further aware that the parties were considering several different methods of structuring the transactions and, indeed, had been shown several different forms of agreement with respect to the sales prior to the November closing. In the auditors' view, the structure of the transaction was more a purchaser's problem and the auditors' concern was to assure them that risks and benefits of ownership passed from NSMC to the purchasers prior to the end of the fiscal period in which the transaction was to be recorded. Accordingly, the auditors sought and received legal opinions on the issue of passage of title from the attorneys for the purchasers who, it was expected, would have had first hand knowledge of the relevant facts as participants in the negotiations. In addition, PMM sought and received confirmatory opinions from NSMC's outside legal counsel which stated that the effect upon NSMC and the purchasers of the two subsidiaries was "as if" ownership of the shares of the companies had been trans-

ferred thereunder prior to August 31, 1969.[18]

PMM was aware that each of these subsidiaries was operating at a substantial loss and that the purchasers were employees of NSMC. In order to alleviate their concern as to why the purchasers wanted to acquire what were in effect losing companies, they sought and received written representations from the three principal officers of NSMC confirming that there were no indemnification or repurchase commitments given to the purchasers.

We believe that the auditors placed far too great a reliance on the opinions of counsel and the representations of management with respect to these transactions. Although the auditors were misled, such deception does not relieve the auditors of their professional obligation to conduct their examination in accordance with generally accepted auditing standards ("GAAS"). As we said in a similar situation in *Accounting Series Release No. 153*, it appears that the auditors

> ". . . failed to fully appraise the significance of information known to [them] and to extend sufficiently [their] auditing procedures under conditions which called for great professional skepticism."

We believe the "sales" of these subsidiaries were, in fact, sham transactions.[19] We believe that if PMM had sufficiently extended its audit procedures it would have discovered that (1) in neither case had negotiations commenced until after the close of NSMC's fiscal year;[20] (2) in the case of one subsidiary, NSMC had, by various side agreements, agreed to assume *all* risks of ownership after "sale" and, with respect to the other subsidiary, NSMC had agreed to make various cash contributions and to guarantee a substantial bank line of credit after sale; and (3) in both cases the collateral to secure the notes had been given to the purchasers by officers of NSMC.[21]

TALLEY INDUSTRIES, INC.

This case arises out of a merger in May 1970 of Talley Industries, Inc. ("Talley"), a Mesa, Arizona based company engaged in the manufacture and distribution of various products, including products designed for the U.S. Armed Forces, with General Time Corporation ("General Time"). In connection with such merger, Talley's financial statements for the year ended March 31, 1969 (audited) and for the nine months ended December 31, 1969 (unaudited) were included in a joint proxy statement mailed on or about April 16, 1970 to shareholders of Talley and General Time. PMM had examined and issued a qualified report on the 1969 statements and consented to the inclusion of its report in the proxy statement. Immediately prior to the merger, PMM also had issued a comfort letter dated May 10, 1970 with respect to Talley's unaudited financial statements for the nine months ended December 31, 1969 which were contained in the proxy statement. Information obtained by the Commission in a non-public investigation indicates that the foregoing financial statements and comfort letter were materially false and misleading. In addition,

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[18] The engagement partner explained in a letter he wrote to NSMC's controller at the time that "we are agreeing to the transaction being recorded as of August 31, 1969 only in reliance upon legal opinion as to the passage of title and the propriety of recording the transactions at that date. Furthermore, as we expressed during said meeting and in other occasions, we will require adequate disclosure of the transaction and of our reliance on the opinion of White & Case in the notes and probably in our accountants' report."

[19] It should be noted that the promissory notes given by the purchasers clearly state that they are non-recourse notes involving no personal liability therefor on the purchasers' part.

[20] The minutes of the NSMC Executive Committee meetings reveal that negotiations for the disposition of these two subsidiaries had not been authorized until October 20, 1969.

[21] Another instance where we believe PMM should have extended its audit procedures to inquire further into the substantive nature of the transaction relates to the accounting for the acquisition by NSMC of Consultants for Market Isolation, Inc. This transaction, which was accounted for as a pooling of interest in NSMC's financial statements for the fiscal year ended August 31, 1969, involved the sale for a substantial purchase price (approximately $1,360,000 in NSMC stock) of a company which had little or no economic substance. In our view, this acquisition was a sham transaction entered into by NSMC and the sellers, who were employees and stockholders of NSMC, in order to avoid recording as expenses payments to which the sellers were entitled under a sales representative agreement they had previously entered into with NSMC.

we believe PMM's examination did not meet professional standards.

Talley's financial statements were computed on the basis of: (a) Talley's projections of amounts of sales and expectation of new defense contracts in future periods for significant portions of Talley's business at its Mesa, Arizona operations, and (b) Talley's estimates of future production cost savings. In fact, Talley had no reasonable basis for expecting receipt of new contracts for production of its products in the amounts it projected or for future production cost savings in the amounts it estimated.

In view of the foregoing, we believe that both Talley's March 31, 1969 and Talley 's December 31, 1969 financial statements improperly reflect inclusion in inventory of substantial costs in excess of those attributable to goods on hand at those dates ("excess costs"). The aggregate of excess costs amounted to $8.9 million at March 31, 1969 and substantially more at December 31, 1969. These excess costs (including those accumumated in 1969) were written off as of March 31, 1970 at the insistence of PMM.[22] To the extent that such excess costs were improperly included in inventory, cost of sales was understated and net income was overstated. The write-off of excess costs at the end of fiscal year 1970 was approximately $19 million before anticipated tax effect. In our view, under the circumstances present in this case, Talley should have reflected excess inventory costs in its profit and loss statements as incurred; the result of not having done so was to overstate Talley's earnings for the year ended March 31, 1969. If all of the excess costs had been written off as incurred, Talley's earnings for the year ended March 31, 1969 would have been $.74 per common share, compared to the reported figure of $1.71 per common share.

Talley's Accounting System

In 1969 Talley accounted for its cost of sales on a program basis ("program method") for fixed price U. S. Government contracts at its Mesa, Arizona operations. Similar products were grouped into a program. At fiscal year end (March 31, 1969) a gross profit ratio based on estimates was established and was used in the following manner: actual sales for the fiscal year were added to projected sales for the following year as determined by known backlog and projection by Talley's management of anticipated contracts and actual costs for the year's production were added to costs estimated by Talley's management to complete the sales projected for the following year. A gross profit ratio based on total estimated sales over total estimated costs was established and applied to the dollar amount of actual sales made in the audit year to determine the cost of sales for the year. Any costs incurred in the audit year in excess of the amount recognized as cost of sales in that year by this computation were carried forward as part of inventory. The gross profit ratio so determined, adjusted for actual manufacturing overhead, was used by Talley throughout the following fiscal year to compute cost of sales for unaudited interim periods.

In the financial statements examined by PMM for the fiscal year ended March 31, 1969, Talley had projected total sales for the year ending March 31, 1970 amounting to approximately $100 million, of which only approximately $24 million was backlog. Anticipated sales contracts were primarily for programs for pyrotechnics, starter cartridges, and bomb racks. Such treatment had the effect of including in Talley's Mesa inventory account at least $8.9 million of costs in excess of the projected total costs of contracts on hand as of March 31, 1969.

Talley's financial statements for the nine months ended December 31, 1969 (unaudited) showed nine months earnings computed on the same basis of projected sales and estimated production costs, which resulted in an overstatement of inventory and of earnings; however, such financial statements were based on:

(1) $100 million of projected sales for the Talley Mesa operation for the fiscal year ending March 31, 1970, when actual sales of only $18 million had been achieved for the nine months ended December 31, 1969, and it

[22] We note that PMM's insistence on the write-off was with the knowledge under the circumstances that such a write-off would most likely lead to the civil and Commission litigation which in fact ensued.

was evident that the projected sales level of $100 million for the fiscal year 1970 would not be achieved; and

(2) anticipated production cost savings which had not been achieved as of December 31, 1969.

Such projections were made by Talley without adequate substantiation and lacked sufficient documentation.

Talley's business at its Mesa operation was obtained as a result of government contracts awarded for defense products. Talley, in making projections of future sales, had to predict: (1) total dollar amount of future contracts for a particular product to be awarded by the defense agencies; and (2) the percentage of the total market for that product that Talley would be successful in capturing.

As to (1), although information was available concerning future contracts to be awarded in the form of Advanced Planning Procurement Information ("APPI") bulletins from the Armed Forces, and in some trade publications, projections were based largely on subjective judgments by management as to future government purchases. Reliance was not based solely on government accouncements, but also on a number of unofficial sources, such as reports from Talley's field representatives, conversations with other individuals in government and industry, and in-house estimates of the government's future purchasing plans. Complicating Talley's problems in making accurate sales projections was the fact that not all anticipated defense product requirements listed by APPIs or reported in other trade sources available to Talley materialized into formal requests for proposals or bits. In some instances, reductions by Congress in appropriations cancelled programs in which Talley had projected it would secure contracts. Moreover, delays in approval by Congress of the appropriations bills sometimes seriously undermined the accuracy of some of Talley's projections of future contracts to be awarded.

As to (2) above, *i.e.*, Talley's projections of its share of the total market for a product, the predictions were even more subjective than the judgments made in (1), because no official information was available as to an accurate determination of those manufacturers who would win bids. As to certain of these projections, Talley had to estimate, among other things, whether it would be the low bidder. As to certain others, Talley's judgment was based upon its belief that government had desired and/or would desire to have more than one source of supply.

Talley's production cost estimates of material, labor and overhead for the fiscal year 1970, used in computing Talley's cost of sales for its fiscal year ended March 31, 1969, were also made without adequate substantiation and lacked sufficient documentation. While the program method of accounting is acceptable in circumstances where contracts for future sales exist, or where the likelihood of future contracts may be documented with a substantial degree of assurance based on past experience or other factors, we do not believe that either of these conditions existed in this case.[23]

In view of what PMM realized was the crucial importance of the reliability and accuracy of Talley's projections of sales and estimates of production costs to a fair presentation of Talley's financial statements as a whole for the fiscal year ended March 31, 1969, we believe that the auditors relied too heavily upon the representations, projections and estimates made by Talley's management, and did not require sufficient documentation and evidential matter to enable them to review adequately the sales projections and cost estimates for reasonableness.

Accounting Controls and Use of Program Cost Method

A physical inventory of goods-on-hand and

[23] Based upon our experience with respect to corporate disclosure on defense and other long-term contracting activities, we expanded the rules set forth in Regulation S-X to call for disclosure of greater detail in certain critical areas, particularly with respect to the nature of costs accumulated in inventories, the effect of cost accumulation policies on costs of sales and the effect of revenue recognition practices on receivables and inventories. Such amendments to Regulation S-X were adopted in Accounting Series Release No. 164, effective with respect to financial statements for periods ending on or after December 9, 1974.

work-in-process was taken only once a year, at fiscal year-end, at Talley's Mesa operations, despite PMM's recommendation in 1968 to take inventory on a more frequent basis for selected programs.

No procedures or accounting steps were established by Talley or recommended by the auditors to adjust the cost of sales figures for interim periods on the basis of variances of actual sales and cost experience from the projections and estimates. Moreover, while information was available throughout the year on both actual sales and actual costs, their variance from projections and estimates was not computed as such by Talley and, in fact, Talley's management made no review of their impact on the validity of Talley's interim cost of sales figures.

The program cost method could be accepted for certain products with extended production cycles and large start-up costs and where there is a reasonable basis to expect the receipt of future or follow-on contracts. However, even assuming the predictability of such contracts, the use of estimates inherent in this sytem requires strong accounting controls with constant monitoring and the recording of variances between estimates and actual experience. However, Talley's cost system lacked the sophistication to monitor variances with respect to interim financial statements or, in any event, was not utilized by Talley to do so. Also, there was no documented evidence to substantiate the large amounts of start-up costs (such as research and development costs and tooling costs) expended by Talley to develop a major portion of its products.

In light of these facts, Talley should not have employed the program cost method for a major part of their programs such as starters and pyrotechnics. Of the $19 million in excess costs at March 31, 1970, $10.5 million was in the pyrotechnic program, $1.9 million in the starter program and $3.3 million in the bomb rack program.

Moreover, prior to April 16, 1970 when Talley mailed its proxy statement, it was known that Talley's actual sales for its Mesa operation for the nine months ended December 31, 1969 were only $18 million and it was then evident that the projected sales level of $100 million for the year ending March 31, 1970 would not be realized. Accordingly, even assuming, *arguendo*, that Talley had been justified in embarking on use of the program cost method, by the date of the proxy statement it should have become quite obvious to Talley that the projections utilized in the computation of current earnings had proved so inaccurate and unreliable that continued inclusion of excess costs in inventory was clearly improper.

The Role of PMM

PMM's report on Talley's financial statements for the year ended March 31, 1969 contained in the proxy statement is qualified as subject to the company's ability to obtain sufficient future contracts as referred to in Note 3. The relevant section of Note 3 states:

> "The Company bases its calculation of inventories and of cost of sales applicable to fixed price United States Government contracts on the costs (including administrative overhead) incurred and estimated to be incurred on the relative production programs. For the purpose of computing sales, these costs are prorated over the estimated total revenues for such programs. The estimates are based on actual contracts on hand and future contracts expected by management to be obtained. The resultant value of inventories on this basis at March 31, 1969 is approximately $8,900,000 in excess of the prorated cost of actual contracts on hand and such excess is believed to be larger at December 31, 1969 but management expects sufficient future contracts to be received to recover such excess."

Although the auditors' report on Talley's financial statements for the year ended March 31, 1969 included a "subject to" qualification with respect to Talley's ability to obtain future contracts, the notes to Talley's financial statements did not disclose:

(1) The dollar amount of future contracts ($100 million) which Talley's management was estimating would be obtained; and

(2) That recovery of the excess costs was also dependent upon Talley's realization of

its projections of material amounts of savings in production costs. Thus, the report did not have a qualification that Talley's ability to recover the excess costs was subject to its ability to perform contracts in a profitable manner.

While it was clear from Note 3 that the excess costs arose because Talley's costs to date exceeded costs allocated to goods completed, in our view the footnote lacked sufficient facts to permit an informed assessment of Talley's ability to recover the excess cost balance. Of great significance in this respect was the absence of disclosure of the amount of contracts its management was projecting for the Mesa operations, which projection for 1970 was $100 million or approximately four times Talley's previous year's actual sales, and which projection was used in computing Talley's 1969 earnings.

In August of 1969, PMM's senior on the Talley audit noted weaknesses regarding the accounting system utilized by Talley, stating in a draft letter to Talley management:

> "Our examination revealed that the estimated items used in the prior years' cost of sales computations were very inaccurate when they were compared to the actual results of operations for the current period. This inaccurate estimating is one of the reasons for the large discrepancy between book and physical inventory that presently exists. By overestimating future sales and underestimating future costs, prior years' sales have not been charged with their proper share of accumulated costs, causing a substantial amount of costs which are not supported by physical inventories, to be carried forward from year to year."

The draft letter further stated:

> ". . . Whenever possible, the use of estimates should be avoided. Such items as next year's overhead rate, future savings to be obtained from increased efficiency or improved procedures, or future selling prices and product mix should not have to be considered when determining the current year's costs of sales, since many of these items are not subject to reasonable estimation and tend to become guestimates which permit inaccurate and inconsistent financial reporting."

The PMM manager on the engagement (the senior's immediate supervisor) has testified that he discussed the projections with Talley officials and reviewed certain documentation from which he concluded that the projections were reasonable. However, it does not appear that such discussions were held with the Talley official who was responsible for the sales projections. Moreover, the manager did not document, as he should have, in PMM's workpapers in the Talley audit either such discussions or the scope of his review of the sales projections. The engagement partner disagreed with the senior on the audit with the result that the above draft letter (the substance of which was or should have been already known by Talley in any event) was not sent. The workpapers do not reflect this disagreement or the manner in which it was resolved.

PMM's Comfort Letter

On May 10, 1970, four days before the shareholders' meetings of Talley and of General Time, PMM issued a "cold comfort" letter to the directors of Talley which stated, in part:

> ". . . nothing has come to our attention which caused us to believe that . . . the aforementioned unaudited financial statements [for the nine months ended December 31, 1969] would require any material adjustments for a fair and reasonable presentation of the information shown." [24]

However, by the time the comfort letter was written, the auditors already knew the actual amount of sale ($24 million) for Talley's Mesa operations for the entire fiscal year. A PMM workpaper dated April 29, 1970

[24] The auditor's comfort letter stated that the auditors had conducted no examination of Talley's nine month financial statements and that such letter was based solely upon PMM's having read the unaudited financial statements and Talley's minutes of board of directors' and stockholders' meetings and PMM's discussions with Talley officials.

prepared in connection with its then annual examination of Talley's financial statements for Talley's March 31, 1970 fiscal year had scheduled both the $100 million projected sales and the $24.7 million actual sales for the Mesa operations. The auditors knew the importance of Talley's projections in Talley's cost of sales calculations for both fiscal year 1969 statements and the 1970 interim statements.[25] Knowing as it did by May 10, 1970 that actual sales had fallen far short of projected sales, the auditors should have insisted on amendment of the proxy materials, and, at a minimum, the comfort letter should have disclosed:

(1) that the actual sales for Talley's Mesa operations for the fiscal year ended March 31, 1970 were only $24.7 million;

(2) that computation of Talley's earnings for the nine months ended December 31, 1969 (unaudited) had been based on a $100 million projection of sales for the Mesa operations, which projection exceeded by a wide margin the actual sales of $24.7 million for the fiscal year ended March 31, 1970; and

(3) that a write-off of Talley's accumulated excess costs (included in inventory) would or might be necessary, such write-off resulting in material downward adjustment of earnings from those shown in Talley's financial statements for the nine months ended December 31, 1969 (unaudited), which financial statements had been included in the April 16, 1970 proxy statement furnished to shareholders of Talley and of General Time.

Prior to issuing the comfort letter for the information of the Board of Directors of General Time Corporation, PMM had had discussions with Talley management in which PMM inquired as to the status of the excess costs in inventory. The auditors were informed that, in the absence of a physical inventory as at December 31, 1969, Talley was not able to determine with accuracy the amount of the excess costs as of December 31, 1969. However, Talley's management estimated that the excess costs existing at March 31, 1969 had been substantially reduced and would be reduced to an immaterial amount by March 31, 1971. Talley's management further informed PMM it estimated that as a result of additional programs instituted after March 31, 1969, the aggregate amount of excess costs at December 31, 1969 and March 31, 1970 was somewhat greater than at March 31, 1969 but no more than $12 million in total (including the remainder of the excess costs existing at March 31, 1969). These representations by Talley's management were added to a letter which PMM was writing to the Commission. PMM had not verified such information nor did it represent that it had done so. In fact the estimates were unreliable and Talley's representations were incorrect. We believe that such use of PMM's name was inappropriate in these circumstances.

On May 14, 1970 Talley'a acquisition of General Time was effected. In early June 1970, subsequent to the merger, PMM discovered during its audit of Talley's 1970 fiscal year-end financial statements that the excess costs at March 31, 1970 were in fact approximately $16.5 million (an increase of approximately $7.6 million from the previous year). Moreover, most of these costs did not appear to PMM to relate to new programs instituted since March 31, 1969 contrary to the represntations previously made by Talley. In mid-June 1970, PMM informed Talley that it would be necessary to write off the $19 million of excess costs (discussed at page 364, *supra)* that had been accumulated in inventory.

Conclusion

In our view, the auditors' uncritical reliance on Talley management's unverified and undocumented representations as to future sales and costs was inappropriate because they related to such a material portion of its earnings for fiscal 1969.

While an opinion qualified as being subject

[25] Both Talley and PMM personnel have testified that, in their view, Talley did not need to obtain all of the $100 million of sales during fiscal 1970 (*i.e.*, in their view the sales could be obtained over more than one year) in order to justify the carrying of the excess costs in inventory. We do not disagree. However, in the circumstances we believe a further review was necessary.

to the outcome of a particular uncertainty is designed to communicate that uncertainty to readers of the report, it does not absolve the independent accountant of the responsibility for performing adequate audit tests and obtaining documentation in regard to the matter.

In this particular case, since Talley was using an estimate of future sales greater by several orders of magnitude than what the company had ever achieved on such products and an estimate of reduced future costs which was not supported by past experience in computing cost of sales for fiscal 1969, we believe, that absent substantial documented evidential support for Talley's sales projections and cost estimates, the auditors should not have accepted Talley's projections and estimates as a basis for even a qualified opinion.

Furthermore, since at a date six weeks after the close of the following fiscal year, the auditors' workpapers in the then ongoing examination of Talley's financial statements for its March 31, 1970 fiscal year showed that Talley had achieved less than 25% of the $100 million of sales which Talley had estimated would be achieved during that year and which Talley had used as a crucial element in estimating gross profit for 1969 and the first nine months of fiscal 1970, we believe that the auditors should not have issued a comfort letter in which they said that nothing had come to their attention which would cause them to believe that the financial statements would require any material adjustments.

We believe that in both the 1969 audit and the issuance of the comfort letter, PMM's professional performance in connection with the Talley engagement was deficient in terms of the standards of the accounting profession.

REPUBLIC NATIONAL LIFE INSURANCE COMPANY

PMM rendered unqualified audit reports on financial statements of Republic National Life Insurance Co. ("Republic") for the years 1970, 1971 and 1972. For the reasons set forth herein, the Commission believes that said statements were materially false and misleading in that they misrepresented the income and financial condition of Republic and failed to adequately diclose the nature and extent of transactions between Republic and Realty Equities Corporation of New York ("Realty") and Realty-related entities[26] during this period. Moreover, it is the Commission's view that PMM failed to apply auditing standards and procedures appropriate under circumstances which should have caused them to exercise a great degree of caution, particularly since during the time in question Realty was experiencing severe financial difficulties and the prior auditors already had identified some of the problems.

On May 10, 1971, PMM was engaged by Repulbic, a Texas life insurance company which then had about $10 billion of life insurance in force and over $400 million in net assets, to examine and report upon Republic's financial statements for the calendar years ending December 31, 1970 and December 31, 1971. Republic's prior independent auditor, Arthur Andersen & Co. ("Andersen"), had been terminated in late December 1970 and its 1970 financial statements previously had been issued in February 1971 without a report by an independent public accountant. They were accompanied by an "Actuarial Certification" signed by Neal N. Stanley, the company's actuary.

PMM rendered an unqualified opinion dated February 18, 1972, on Republic's 1970 and 1971 financial statements. PMM's report stated that:

> ". . . such financial statements present fairly the statutory financial position of Republic National Life Insurance Company at December 31, 1971 and 1970 and the results of its operations and the source and use of funds for the years then ended, in conformity with insurance accounting

[26] For purposes of this opinion, we consider transactions with Realty-related entities to include transactions with companies and individuals affiliated or associated with or otherwise related to Realty or involving assets or properties at one time owned or managed by or otherwise connected with Realty or which came to Republic in a transaction in which Realty participated.

principles prescribed or permitted under statutory authority applied on a consistent basis. Insurance accounting principles vary in some respects from generally accepted accounting principles (see Note 1 of notes to financial statements)."

PMM's report on Republic's 1972 financial statements, dated February 6, 1973, was also unqualified, and contained the same opinion concerning the statutory financial position of Republic National Life Insurance Company.[27]

We take issue with PMM's audits of Republic's financial statements only with respect to treatment of Republic's transactions with Realty and Realty-related entities in 1970, 1971, and 1972. For reasons stated hereafter, we believe that Republic's financial statements for 1970, 1971, and 1972 did not present fairly the financial position of Republic, the results of its operations and the source and use of funds during such periods. It should be noted that our views as to the issues of adequate disclosure and recognition of income in these financial statements of Republic do not turn on any distinctions between statutory insurance accounting practices and generally accepted accounting principles. Moreover, we believe PMM failed to gather sufficient competent evidential matter to determine the adequacy of the reserve for possible losses on mortgage loans and real estate for the years 1970, 1971 and 1972.

Republic's Realty-Related Investments

Beginning in January 1968, Republic made a series of investments in securities of Realty and First National Realty & Construction Corp. ("FNR"), a Realty-related entity, and made commitments to place and placed mortgages on real properties owned or operated by Realty and Realty-related entities. In addition, Realty and FNR purchased real properties from third parties who owned the properties subject to Republic mortgages. Many of the mortgages with Realty and FNR thus assumed had a history of late payments or other collection difficulties.

On August 3, 1970, the American Stock Exchange suspended trading in Realty's securities and Realty publicly announced an expected loss of $8.7 million for its fiscal year ended March 31, 1970. Shortly thereafter, Alexander Grant & Co., Realty's then auditors, disclaimed an opinion on Realty's consolidated financial statements for the fiscal year ended March 31, 1970, in part because of uncertainties as to Realty's ability to meet financing requirements with respect to substantial amounts of short-term indebtedness. Realty's financial difficulties continued throughout the ensuing period covered by the Republic financial statements discussed in this opinion.

As of September 30, 1970, Republic owned or was committed to purchase $24.6 million of stock, bonds and notes of Realty, FNR and other Realty-related entities. In addition, Republic had over $33 million in mortgage loans outstanding on real properties owned or managed by Realty or Realty-related entities. In view of Realty's financial difficulties, Republic was thus faced with a serious question as to its ability to recover in full its

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[27] On February 1, 1974 PMM withdrew its two reports on Republic's prior financial statements when, on the basis of PMM's ongoing examination of Republic's 1973 financial statements and information learned by PMM during the Commission's private investigation, it appeared to PMM that a substantially greater reserve, the amount of which was then still undetermined, for losses in Republic's investment portfolio would have to be established, and that the larger reserve would in part apply to earlier years since there was no basis for determining that all of these losses had been occasioned by events confined to 1973 alone. On February 4, 1974, PMM insisted that Republic issue a press release (revising a press release previously issued by Republic on that day) which stated that substantial adjustments to Republic's previously issued financial statements would be required and that such prior financial statements and PMM's reports thereon should no longer be relied upon until the necessary adjustments were made. PMM subsequently issued its report, dated April 12, 1974, on Republic's 1973 financial statements containing a substantial reduction of Republic's net gain from operations and net gain from operations per share as previously reported for 1970, 1971 and 1972. This April report stated that the financial statements had been prepared in accordance with statutory insurance accounting practices. In May 1974, PMM reported on Republic's financial statements on the basis of generally accepted accounting principles.

unsecured investment of $24.6 million. At this time, Republic apparently attempted to restructure its investments in a manner which gave the investments the appearance of greater security, by removing itself from the position of a substantial unsecured creditor of Realty. It thereafter engaged in a series of transactions with Realty which resulted in removing all of the bonds, notes and stock of Realty and FNR which Republic then owned in exchange for notes of four Realty-related entities which held assets purchased from Realty. These notes were subsequently exchanged for mortgage loans on real estate properties and real estate itself. In these transactions significant additional funds were invested by Republic, the great portion of which was returned to Republic to pay prior obligations of Realty and Realty-related entities to Republic and in the form of interest income.

At December 31, 1971, Republic's financial statements included $9 million of bonds and notes of Realty-related entities, mortgage loans outstanding of $56 million on properties owned or managed by, or in some other way connected with Realty or Realty-related entities and $31.5 million in real estate which had come to Republic as a result of Realty-related transactions.

Republic's problems with its Realty-related investments continued in 1972, and Republic invested significant additional funds in transactions with Realty and Realty-related entities. Republic's aggregate Realty and Realty-related investments, contrasted to Republic's total reported statutory assets, were approximately as follows at year end 1970, 1971 and 1972:

Year	Realty and Realty-related	% Total	Total Assets
1970	$ 56 million	20.2	$277 million
1971	$ 97 million	23.5	$412 million
1972	$110 million	24.6	$448 million

This aggregate amount of Republic's Realty and Realty-related investments was not disclosed in Republic's financial statements for 1970, 1971 and 1972 or in PMM's accountants' reports thereon. We believe that such information was material to Republic's financial statements, particularly since by September 1970 Realty was experiencing severe financial difficulties which continued throughout the period covered by PMM's 1971 and 1972 audits of Republic.

Nor did the financial statements or notes thereto or PMM's accountants' reports on such financial statements contain the material information that at least 30% of Republic's reported income in 1970 (31%), 1971 (42%), and 1972 (30%) resulted from Republic's Realty-related investments. Moreover, for reasons stated hereafter, such income should not have been recognized at all.

In our view, PMM's auditors should have insisted that Republic make adequate disclosure concerning such matters; failing that, disclosure of such matters should have been made in PMM's accountants' reports together with appropriately qualified opinions.

PMM's auditors had been aware of the significant transactions between Republic and Realty as a result of their own audit work. Additionally, prior to issuance of PMM's initial report (dated February 18, 1972) on Republic's financial statements the auditors had reviewed workpapers prepared by Andersen, Republic's prior auditors, and had reviewed a letter dated Nobember 6, 1970, addressed by Andersen to Republic's Board of Directors. The letter noted that as of September 30, 1970, Republic's investments and commitments in Realty and FNR totalled about $58 million, called to Republic's attention recently available information concerning Realty's financial difficulties and informed Republic that the ultimate recovery in full of Republic's investments in Realty and FNR as of September 30, 1970 was in doubt. In view of the above factors and the likelihood of material effects thereof on Republic's financial positions at December 31, 1970 and the results of Republic's operations for the year then ending, the letter set forth Andersen's belief that Republic's 1970 financial statements should include "complete and informative disclosure" of these matters. Examples of such disclosures included:

"Segregation within the balance sheet of all investments in Realty and affiliates."

"Information regarding commitments to Realty and affiliates together with appropriate description as to Realty's current financial condition."

"Information relating to all significant transactions between Republic and Realty or its affiliates. . . ."

Andersen's letter also stated:

"Republic has presently recorded approximately $2,000,000 of income from its investments in Realty and FNR during the nine months ended September 30, 1970. Although substantially all of such income has been collected in cash, it nevertheless has been offset by larger investments in Realty. Since realization of this income is dependent upon the ultimate recovery of Republic's investments in Realty and FNR, we do not believe current recognition of such income is appropriate."

In December 1970 Republic terminated Andersen's engagement as Republic's auditors, and Andersen did not audit the December 1970 transactions between Republic and Realty nor did they report upon Republic's financial statements for the year ended December 31, 1970.

In addition to the reserves discussed herein, Republic's 1970 and 1971 financial statements reported upon by PMM contained a Statement of Source and Use of Funds, not required under statutory life insurance accounting practices but insisted upon by the auditors as disclosure of investment portfolio difficulties experienced by Republic which in a "Note" at the end of the text thereof, stated:

"During the years ended December 31, 1971 and 1970 certain investments were exchanged for or converted to other investments. The details of such transactions (excluded from the above statement) are as follows:

	1971	1970
Bonds exchanged for real estate	$17,753,000	$—
Bonds exchanged for mortgage loans	1,200,000	—
Mortgage loans converted to real estate	19,302,928	2.350,395"

The following year, a "Note" to the Statement of Source and Use of Funds contained in Republic's 1972 financial statements stated as follows:

'During the years ended December 31, 1972 and 1971 certain investments were exchanged for or converted to other investments. The details of such transactions (excluded from the above statement) are as follows:

	1972	1971
Bonds exchanged for real estate	$—	$17,753,000
Bonds exchanged for mortgage loans	—	1,200,000
Mortgage loans converted to real estate	8,556,628	19,302,928"

However, neither Note explained that the "certain investments" referred to therein were Republic's Realty-related investments or the fact that these investments were related to a compnay experiencing severe financial difficulties.

PMM correctly identified in late 1971 the primary problem area in Republic's financial statements as being Republic's investment portfolio and more particularly, Republic's Realty-related investments.[28] While the auditors expanded the scope of their examination in an attempt to deal with this area and

[28] While PMM was able to identify this problem area as a result of its own examination, it should not have acquiesced in Republic's request that it complete its own field work before it reviewed the prior auditors' workpapers.

As it turned out, the information came so late that PMM's response was inadequate to the situation. As set forth in an earlier opinion, *In the Matter of Touche Ross & Co.*, ASR No. 153 (1974), it is important that successor auditors "obtain access to and carefully review the results of the predecessor's work." In our judgment, this includes a timely review which should be initiated by the successor auditor at the inception of the engagement. We believe this is necessary to assure an adequately planned audit program which would take into consideration those significant areas of controversy that may have been uncovered as a result of such review. Mortgage loans unrelated to Republic's Realty-related investments were the subject of conferences between Andersen and Republic. The conferences were recorded by Andersen in memoranda which were not seen by PMM. We think that all papers having a relationship to the successor auditor's responsibilities should be made available by the prior auditors.

insisted on establishment of a reserve for possible losses on mortgage loans and real estate of $7 million at December 31, 1971 (approximately $5 million of which was attributable to Realty-related investments) and $7 million at December 31, 1972 (all attributable to Realty-related investments), it failed to come to grips with the basic auditing questions.[29] PMM made a judgment that establishing the $7 million reserve for possible losses on mortgage loans and real estate essentially mooted the disclosure question. We believe, however, that judgment was not correct in light of the then known circumstances. In our view, the above-quoted notes and the establishment of the reserves was not an adequate substitute for disclosing Republic's relationship with Realty and the transactions they had engaged in. No specific explanation was given that some or all of the reserve was attributable in the judgment of the auditors to possible losses on Republic's Realty-related investments and Realty's name was not even mentioned in the financial statements or in PMM's reports thereon.

Although auditing of Republic's 1970 and 1971 financial statements was accomplished at the same time, PMM's examination of Republic's Realty-related investments focused on the investments which Republic had on its books at December 31, 1971 as a result of the numerous transactions between Republic and Realty in 1970 and 1971. Since these remaining investments were in great measure mortgage loans and real estate, PMM attempted to value the real estate and the collateral underlying the loans to determine whether Republic had sustained losses as a result of the 1970 and 1971 transactions. While this examination included consultations with Republic's management and a review of the appraisals, prepared by Members of the American Institute of Real Estate Appraisers, which Republic had on the properties in question, neither the appraisals nor PMM's examination sought to ascertain the purchase prices paid by Realty to third parties for these properties. These properties had been purchased by Realty and simultaneously sold or mortgaged to Republic at prices far in excess of what Realty had paid for them. Although PMM questioned the basis and validity of preparation of some of the appraisals (some of which were done on a "highest and best use" basis, assuming future development), it did not obtain sufficient evidence of the current value of the properties in question. As one example, in December 1971, Realty purchased a large tract of undeveloped land in the Adirondack region of New York State for $3,150,000 and Republic placed a $13,450,000 mortgage on this property at the same time. This was the largest mortgage on Republic's books at both December 31, 1971 and 1972. Also included in the 1972 financial statements was a $5 million leasehold mortgage to a Realty-related entity. This mortgage was secured by the leasehold interest in an aging industrial complex, the sole tenant of which had already given notice that it would not renew its lease. Also, the Commission's investigation revealed that this transaction was contrived by Republic and Realty so that the portion of the proceeds in the amount of $1.7 million of this loan could be used by Realty and Realty-related entities to pay Republic the principal and interest payments to become due on two previously existing loans which had been granted by Republic to Realty-related entities in late 1971. PMM's audit procedures during their 1972 audit did not reveal this design or alert them to all of the factors surrounding the making of this loan. Although PMM did raise questions concerning the source of funds for the $1.7 million principal and interest payments on the pre-existing loans, it did not learn that the new $5 million loan by Republic had been used for such purpose. Included in Republic's 1971 and 1972 financial statements were the results of several similar transactions. Considering the significant prior transactions between Republic and Realty and Realty's failing financial condition, we feel that PMM

[29] In addition to this reserve, a Mandatory Securities Valuation Reserve ("MSVR") applicable to possible losses on stocks and bonds but not on mortgages or real estate was provided in the amount of $4.5 million for 1971 and $5.8 million for 1972.

should have extended its audit procedures substantially more than it did in this area.

The result was that despite establishing a reserve of $7 million for possible losses on mortgage loans and real estate, Republic's Realty-related mortgage loans and real estate were substantially overvalued at December 31, 1971 and December 31, 1972.[30]

In this case, PMM was aware, or should have been aware, of the significance of these transactions with Realty and Realty-related entities. We consider it an auditors's duty to do more than just make a mechanical examination of the data underlying a particular transaction. The responsibility of the auditor also involves a duty to investigate the totality of the circumstances surrounding material transactions, individually and in the aggregate, and to seek out the significant information that affects evaluation and decisions. In the instant case, PMM should have examined the circumstances under which Realty and Realty-related entities acquired the properties being mortgaged to Republic and should have insisted upon receiving appraisals based upon current value. Had PMM conducted an appropriate audit, it should have discovered the unusual nature of these transactions and the need for more complete disclosure.

Many of these transactions between Republic and Realty and Realty-related entities were less than arm's length and many of the characteristics commonly found in what are usually referred to as "related party" transactions. It should be recognized that related party transactions are not limited to any particular type or classification. Rather, they can take an infinite number of forms including some of those engaged in by Republic and Realty-related entities. Auditors must be alert to these types of transactions, which frequently are the subject of one form of management deception or another. Auditors should be especially alert to these possibilities where there exists some ongoing relationship, such as existed between Republic and Realty.

PMM's Workpapers

As set forth above, we believe that Republic's financial statements significantly overstated the value of its Realty and Realty-related investments during the period covered by PMM's 1971 and 1972 audits. At the same time, Republic's reserve for possible losses on mortgage loans and real estate was significantly understated. The valuation of the investment portfolio was a crucial problem, and we believe that the inadequacies of PMM's 1971 and 1972 audits are reflected by the insufficient information in the workpapers as to the basis of calculations to support the adequacy of the $7 million reserve for possible losses on mortgage loans and real estate as at December 31, 1971 and 1972. The complications contained in the workpapers in support of the $7 million reserve as of the above dates, in our opinion, were not supported by sufficient evidential matter that would result in a conclusion that this account was fairly stated.

Income Recognition

In 1970, 1971 and 1972, Republic recognized substantial amounts of income which came largely out of the funds which Republic was advancing to Realty and Realty-related entities in those years. To the extent that PMM was aware that interest on many of Republic's Realty and Realty-related investments would not have been paid currently in the absence of such advances by Republic, serious questions should have been raised by PMM as to the propriety of recognizing such income on a current basis. PMM's determination that recognition of this income was not improper was based upon their attempt to value the Realty-related investments that Republic received. The auditors took the position that because possible losses on Republic's major Realty-related investments had been identified and provided for by the $7

[30] Republic concluded in its statutory financial statements for 1973, which were accompanied by PMM's report dated April 12, 1974, that the reserve for possible losses on mortgage loans and real estate at December 31, 1973 was $25,000,000 after reductions of the carrying value of certain assets aggregating $8.5 million and not recognizing as income amounts aggregating $11.8 million. The possible losses related principally to Republic's Realty-related transactions.

million reserve and the MSVR, that there was no basis for refusing to allow Republic to recognize income from such investments. This judgment, although having some theoretical support, was only as good as the valuation of the investments that Republic held. In our view of the circumstances in this case, the auditors did not sufficiently extend their audit procedures beyond their review of the appraisals referred to above to determine the adequacy of the collateral for the Realty-related mortgage loans and, in fact, such collateral was substantially overvalued. Accordingly, we believe that in these circumstances such income should not have been recognized. Where interest is not being paid currently, it may be appropriate under some unusual circumstances to recognize interest income currently on adequately collateralized loans, but such circumstances generally will be very exceptional.

PMM's Review Procedures

In late 1972, PMM instituted a procedure whereby all of its reports on audited financial statements issued after December 31, 1972 would be reviewed by a second partner prior to issuance, primarily to give additional assurance of compliance with PMM policy regarding the form and content of the report and the accompanying financial statements. Thus, the report dated February 6, 1973 with respect of Republic's 1972 financial statement was one of the first to be subject to this so-called pre-issuance or "cold" review procedure.[31]

As part of the procedure, the engagement partner was to prepare for the reviewer a memorandum regarding the potentially critical areas of the audit and an indication of the engagement partner's satisfaction with the audit in each of those areas. The procedure did not normally contemplate a review by the second partner of any of the underlying audit workpapers, nor did it place upon him any responsibility for the adequacy of the audit or the appropriateness of the financial statements and related disclosures—such responsibility remained with the engagement partner who conducted the audit.

In his memorandum in early 1973, the engagement partner for the Republic audit identified, as the "main problem" in the audit, Republic's investments in Realty-related entities. In this connection, he stated:

> "The main problem area from an audit standpoint is investments. This company has some real problems in mortgage loans, certain bonds and real estate owned, most of which arose through dealing with Realty Equities Corp. I not only reviewed the investment workpapers in detail but also reviewed the loan files on new loans this year, held lengthy discussions with VP-Investments regarding problems and solutions and personally directed the audit of investments."

The memorandum did not mention, nor did the second partner making the pre-issuance review learn, that Realty was in severe financial difficulties and that the prior auditors had raised a number of questions with respect to Realty-related investments.[32]

THE PENN CENTRAL COMPANY

On February 1, 1968 the Pennsylvania and the New York Central railroads merged and became the Penn Central Transportation Company ("PCTC" or "Transportation Co."). PMM became the auditors of the merged company and issued a report on the result of PCT on both a consolidated and a "company only" basis for 1968. During 1969, Penn Central Co., a holding company, was formed and acquired all of the stock of PCTC. For 1969, PMM issued a report on the results of Penn Central on a consolidated basis and PCTC on a "company only" basis.[33]

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[31] This pre-issuance review should not be confused with a different reviewing procedure of PMM referred to elsewhere herein as "SEC review", which related to the review of certain filings with the Commission.

[32] These questions are reflected in the prior auditor's letter quoted above. The engagement partner apparently did not describe the differences the prior auditors had with Republic because he thought he was confronted with a different situation.

[33] PMM's reports were dated March 7, 1969 and March 12, 1970, respectively. Both reports were qualified as to the failure to provide deferred income taxes and were otherwise unqualified.

On June 21, 1970, the Penn Central Transportation Co. filed a petition for reorganization under the bankruptcy laws. An investigation conducted by this Commission following the filing of the petition revealed that Penn Central management[34] had engaged in a program of concealing the deterioration of the company which occurred in the post-merger period and which led to the filing of the petition in reorganization. A detailed description of the transactions, events and activities preceding the filing of the petition is contained in the Commission's *Staff Report on the Financial Collapse of the Penn Central Company.*[35] Management's efforts involved misrepresentations as to the affairs, prospects, financial results, and value of assets of the Penn Central complex. The misrepresentations were made in many forms of communications to the investing public and shareholders.

While the financial statements upon which PMM reported did show a declining trend in 1969,[36] they substantially understated the magnitude of the real decline in the economic fortunes of Penn Central and did not reflect the case drains which led to the collapse of the railroad when PCTC could no longer borrow funds.

The financial statements did not adequately present the financial condition of Penn Central because the economic substance of several transactions was not properly reflected therein and because there was insufficient attention given to the overall condition of the Company and its operations.

The principal means by which Penn Central inflated financial results for 1969 included the failure to include charges arising out of Penn Central's ownership of Lehigh Valley Railroad Co., failure to reflect current maintenance expenses of the New York-New Haven and Hartford Railraod Co. as charges against income, the improper inclusion of income from large real estate transactions by Great Southwest Corp. and the improper inclusion of dividends from certain subsidiaries. In 1968 the financial results were inflated by the improper inclusion of profits from the exchange of certain equity interests in real property for the stock ownership in Madison Square Garden Corp., the improper inclusion of income of the purported dividend comprising the common stock of a wholly-owned subsidiary of Washington Terminal Corp., the failure to record properly expenses connected with mail and baggage handlers, charges arising out of Penn Central's ownership of Lehigh Valley Railroad Co. and Executive Jet Aviation and the inclusion of purported profits from certain real estate transactions of Great Southwest Corporation. By acquiescing in these improper accounting practices, PMM, in our view, permitted Penn Central to misstate its financial position and operating results for the years 1968 and 1969.

In some of the items discussed below, PMM's position is briefly described.

Washington Terminal Company

PCTC, in 1968, included as part of its operating income what they considered to be "dividend-in-kind" in the amount of $11,700,000 declared by Washington Terminal Company ("ETC") a 50% owned company carried on the cost basis by PCTC.[37] This income was

[34] Penn Central is used to identify the corporate complex in general without distinguishing the separate identities of Penn Central Co. or the Transportation Co. Penn Central Co. was essentially a holding company and neither it nor PCTC had a separate management.

[35] *The Financial Collapse of the Penn Central Company—Staff Report of the Securities and Exchange Commission to the Special Subcommittee on Investigations of the House Interstate and Foreign Commerce Committee, August 1972. U. S. Government Printing Office, Washington, D. C.*

[36] The consolidated results and the PCTC results were reported. Rail operations, which were most significant in appraising long run operating prospects, were not separately reported. The data are as follows:

	Penn Central consolidated earnings*	Penn Central Transportation operations*	(Loss) on rail operations*
Jan-Mar	($17)		
1970	$ 4	($63)	($101)
1969	$88	($56)	($193)
1968	$69	($ 5)	($142)
1967		$ 9	($ 86)

* In millions

[37] The other 50% owner of the stock of WTC was the Baltimore & Ohio Railroad Company.

reflected in the results from ordinary operations and was part of the consolidated earnings of Penn Central and also part of the Transportation Company's operating results for the year. There was no separate disclosure in the financial statements or in the notes thereto that informed the reader of the nature of this transaction or of its magnitude. Absent this recordation as dividend income, consolidated earnings would have amounted to $78,753,000 as opposed to the $90,273,000 reported; and, PCTC's loss from ordinary operations would have amounted to $14,473,000 as opposed to the reported loss of $2,773,000.

The "dividend-in-kind" which was declared to its parent company was in the form of 100% of the stock of a new company formed for the purpose of receiving an undivided one-half interest in real property and air rights over the Union Station in Washington, D. C.[38] Both before and after the transaction, Penn Central owned a 50% interest in the Union Station property.

The Union station property became the subject of an agreement with the United States Government for development of a Visitor's Center and the leasing by the National Park Service of such Center. The deed conveying legal title and an undivided one-half interest provided that WTC would continue to control the property during the period that the Visitor's Center was under construction.[39] The agreement provided that the National Park Service would lease the property for 25 years, after the owners had made significant alterations and improvements, which were expected to take two or three years. At the conclusion of the lease the property could be acquired by the National Park service for $1.

PCTC recorded the $11,700,000 as its determination of the value of the stock distribution received.[40] This amount was based on an appraisal of the underlying property and the air rights.

PPM states that:

Penn Central Transportation Company accounted for its investment in Washington Terminal Company on the cost basis, an acceptable method of accounting and the method most commonly followed in 1968. Since Penn Central Transportation Company accounted for its investment in Washington Terminal Company on the cost basis, in PMM's opinion any distributions from Washington Terminal Company necessarily were properly recorded in earnings when received; and since the distribution was a dividend-in-kind the proper method of recording it by Penn Central Transportation Company was at fair market value under then current accounting literature. In PMM's view, PCTC's obligations under the lease contract were fixed and accrued in its accounts, and therefore, there was no uncertainty with respect to the value of this dividend and income had to be recognized in 1968 when the dividend was received.

The Commission disagrees with PMM's position that all necessary elements were present to permit the recordation of income in 1968. In the Commission's view, this transaction was, in substance, a write-up of this asset on the books of the parent company. We believe that recognition by the Transportation Company of income in the amount of $11,700,000 in the form of a 100% stock distri-

[38] A similar dividend was paid in the form of 100% of the stock of a separate new company which was formed to receive B&O's 50% interest.

[39] The deed by which WTC conveyed (to the newly-formed corporation) the undivided one-half interest included the following reservation:

"Subject to the continued right of use, possession, operation and maintenance of the Union Station Building, concourse concession areas and related areas presently used for commercial operation by the Washington Terminal Co., its lessees, concessionaries, licensees, passengers, officers, employees, contractors, invitees, and visitors during the period of alteration and construction of the Visitor's center parking facility and new passenger station contemplated by Public Law 90-264 and until the taking of full occupancy by the United States of America pursuant to a lease covering the property herein described."

[40] McCandles Corporation had appraised the property and the air rights for the Baltimore & Ohio Railroad Co. at $27,000,000, so that based on that appraisal the value of a 50% was $13,500,000. The figure of $13,500,000 was reduced by PCTC to $11,700,000, to reflect its determination of the fixed cost of improvements and a discount for the period prior to commencement of rental payments.

bution was improper since in substance the position of the consolidated enterprise was unchanged with respect to the use, possession, operation, and maintenance of the underlying subject property after the receipt of the distribution. Generally accepted accounting principles do not permit recording a transaction based on form when its substance is materially different.

The substance of the December 18, 1968 agreement was a promise on the part of the United States Government to purchase certain property after significant construction and alterations had been made to transform such property into a National Visitor's Center. In the Commission's opinion, recognition of income to PCTC under the circumstances outlined herein was inappropriate until the seller of Union Station had substantially performed its obligations.

The Commission also believes that if income in this amount was recorded in 1968, separate disclosure should have been made.

Madison Square Garden Transaction

Penn Central entered into a transaction in 1968 which involved a nonmonetary exchange within its investment portfolio that resulted in the company recording a gain in the amount of $21 million. This gain was reflected in income from ordinary operations and was part of the consolidated earnings of Penn Central and also part of PCTC's operating results for that year. There was no separate disclosure in the financial statements or in the notes thereto that informed the reader of the nature or magnitude of this transaction. Absent this gain, Penn Central's consolidated earnings from ordinary operations would have amounted to $69,273,000 as opposed to the $90,273,000 reported, and PCTC's loss from ordinary operations would have amounted to $23,773,000 as opposed to the reported loss of $2,773,000.

This transaction represented the exchange of Penn Central's 25% interest in Madison Square Garden Center ("Center") and its 55% interest in the Penn Plaza office building for a 25% interest in Madison Square Garden Corporation ("Garden"). Before the transaction, Garden owned 25% of the Center, 20% of the office building, and real estate on which the former Madison Square Garden had stood, and other minor assets.[41] Penn Central, in its filing with the Commission describing the transaction, indicated that its purpose was

> "to concentrate and unify Penn Central's interests in the new Madison Square Garden Center and the office building—though the ownership of a substantial equity interest in Madison Square (Garden Corporation) which will be the beneficial owner and operator of those facilities." [42]

Penn Central, which received no cash, recorded the gain of $21 million on this transaction by valuing the Garden Stock received at $25.7 million (based on its average market price on the NYSE of $11.078 per share at the date of negotiations) and subtracting the $4.6 million carrying value of assets given up.[43]

It is PMM's position, as stated by it, that the exchange of PCTC's shareholdings and interest in two corporations (privately held) which owned and operated an office building and a sports center, for shares of stock in

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[41] Madison Square Garden Corp. was essentially a holding company whose major assets consisted of its interests in Madison Square Garden Center, which in turn had the exclusive right to the use of the franchise and player contracts of the New York Rangers and New York Knickerbockers, and the Penn Plaza office building venture. The group of companies comprising the Madison Square Garden Corporation also owned a professional ice skating show and other real estate. The Madison Square Garden Corporation common stock had registration rights under the exchange agreement.

[42] Source—Schedule 13 D filed by Penn Central Company received by the Commission April 1, 1969.

[43] This was based on an agreement dated December 18, 1968. On the same date, Garden and Penn Central also entered into another agreement whereby Garden had agreed to sell and Penn Central agreed to purchase at $11.078 per share up to 180, 538 shares of Garden's common stock. This sale and purchase agreement had the effect of continuing Penn Central's undertaking to loan funds to cover costs of construction of the 29-story office building that would be in excess of the construction loan. This was to be accomplished by Garden loaning the funds that it would receive from the sale of additional shares to Penn Central.

Penn Central originally had a 23% interest as a result of the transaction which was increased to 25% mainly through purchases under the stock purchase agreement.

Madison Square Garden Corporation, a diversified holding company with over 36,000 shareholders, whose shares were publicly traded, constituted a substantive exchange of distinctly different kinds of assets and, in accordance with accounting theory then in existence, was an exchange of assets to which gain or loss must have been recognized. If no recognition were made of the exchange, the 1968 financials would not have shown the true results of management's decisions in the handling of its stock ownership in Madison Square Garden Corporation. In PMM's opinion, PCTC realized a gain of its investment in 1968 as the financial statement properly showed.

It is the Commission's opinion that the transaction represented the substitution of an investment in one form for essentially the same investment in another form. There was no change in economic interests in Center, the principal asset involved, and Penn Central's intent, as stated by it, was clearly not to dispose of its economic interest in the facilities exchanged.

We believe that PMM failed to recognize that in substance there were not sufficiently significant changes from a business viewpoint to warrant the recording of income on this nonmonetary exchange. Furthermore, it is the Commission's view that PMM should have required separate disclosure of the nature and amount of this transaction.

Merger Reserve: Separation of Mail and Baggage Handlers

In 1968, Penn Central Transportation Company charged against a $117,000,000 merger reserve established in 1967, payments aggregating $4,672,000 made to certain mail and baggage handlers upon their separation from employment with PCTC.[44]

The Penn Central's predecessor railroads, the Pennsylvania and New York Central railroads, and their labor unions had entered into a Merger Protective Agreement, dated January 1, 1964, which provided that no one employed during the period from January 1, 1964 to the effective date of the merger would be terminated after January 1, 1964. A subsequent termination did not have to be merger related for the agreement to apply.

The $117,000,000 liability reserve which was established in 1967 was to provide only for wages to be paid to 5,600 employees who had been furloughed prior to the merger, but who, due to the Merger Protective Agreement, had to be recalled to service upon the consummation of the merger and had to be employed or paid thereafter until they left through natural attrition.[45]

Subsequent to the merger, Penn Central early in 1968 incurred a cost of $4,672,000 in separation payments to mail and baggage handlers made surplus as a result of curtailment of use of Penn Central's services by the U. S. Post Office Department. The basic accounting question faced by PMM was whether the payment of $4,672,000 made to the mail and baggage handlers, who had been separated from employment with PCTC, was chargeable to the reserve previously established, or chargeable to expenses for the period.

PMM seriously questioned the use of the liability reserve for the payments to the mail and baggage handlers which questions may have led management of PCTC to petititon the ICC for approval to charge this cost to the reserve for ICC accounting purposes.[46]

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[44] The $117 million reserve was the potential cost of recalled employees portion of an aggregate reserve totalling $275,421,985 for anticipated costs of the merger of Pennslyvania and New York Central railroads. The reserve was established in 1967 by the Pennsylvania Railroad Company with the approval of the Interstate Commerce Commission. It was established by making a charge to earnings in 1967 in the amount of $275,421,985 thereby reducing earnings in that year by that amount.

[45] There was another class of employees who were expected to be made surplus as a result of the merger. This group numbered about 7,800 employees and were to be made surplus as a result of consolidations, coordinations, elimination of facilities, and so forth. It was made up of employees who were working as of February 1, 1968, and were to be subsequently made surplus. All wages relating to such 7,800 employees were to be charged to current operations, no wages were to be charged to the liability reserve.

[46] By letter dated January 23, 1969, PMM advised Penn Central Company with respect to this charge, in part as follows:

"We have reviewed the facts concerning the separa-

By a letter to the ICC dated January 23, 1969, Penn Central argued that such costs should be charged to the merger reserve because the payments to the mail and baggage handlers were directly the result of the labor agreements incident to merger, that they were unproductive of merger savings, and that the reserve was adequate in total amount.

PMM reviewed the letter to the ICC before it was sent and in the letter referred to in Footnote 46 above stated that if the ICC "... in its judgment deems the separations to be merger related and the costs incident thereto chargeable against the reserve, we would no longer have a basis for objection to a charge against the Merger Reserve for this purpose."

By letter dated January 29, 1969, the ICC replied as follows:

> "This will advise that a majority of Division 2 in conference today voted to grant the letter request filed January 23, 1969, for authority to charge an amount of $4,672,000 expended during 1968 in connection with separation of mail and baggage handlers against the 'Merger Reserve' established in 1967."

In our view, the $4,672,000 in separation payments incurred during 1968 as a result of the curtailment in services of mail and baggage handlers did not come within the original merger reserve criteria. The original merger reserve was created to provide for charges for payments to employees who had been furloughed prior to the effectiveness of the merger. The mail and baggage handlers were not furloughed prior to the effectiveness of the merger.[47]

In the Commission's opinion, even though the ICC was willing to permit the charge to the reserve for ICC purposes, we believe such amounts should have been reflected as a period expense during the year ended December 31, 1968 in the financial statements of the company issued to the shareholders. The accounting rationale for setting up the original $117 million liability for the recall of surplus furloughed employees was that solely as a result of the effectiveness of the merger a liability had been created and the combined railroads had therefore suffered an expense (loss), unrelated to future operations that had to be recognized. This accounting rationale does not apply to the facts leading to the $4,672,000 in payments. The liability, and hence the expense, did not exist as of December 31, 1967 nor February 1, 1968. Nor was there a known contingent liability as of such dates. It is the Commission's view that PMM should have been more objective by resolving this issue independently of the ICC and that initial resistance of PMM to charging the reserve for these payments reflected the proper accounting and auditing posture.

Lehigh Valley Railroad Company

Prior to 1962, the then PRR, through subsidiaries, owned 44.4% of the outstanding shares of Lehigh Valley Railroad Company ("Lehigh Valley"). As a result of an exchange offer, PRR on February 28, 1963, became the record or beneifical owner of 89.9% of the stock and this was incrased to 97.3% in 1964.

Lehigh Valley remained a 97.3% owned subsidiary of PCTC at the time of the merger of the PRR and NYC Railroads. In 1968, the Lehigh Valley losses were $6 million, and in

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tion of these employees and the data supplied to us with respect to the costs, amounting to $4,672,000. It is our opinion that the Merger Reserve originally was not established to cover separations of this nature, and, accordingly, such costs would not constitute an appropriate charge against the reserve.

"'We understand that you intend to petition the Interstate Commerce Commission to review the facts concerning the separation of the mail and baggage handlers and to rule on the question of whether such separations are, in fact merger-related. We have reviewed the letter addressed to the Commission by Mr. Saunders. Under the circumstances, if the Commission in its judgment deems the separations to be merger-related and the costs incident thereto chargeable against the reserve, we would no longer have a basis for objection to a charge against the Merger Reserve for this purpose."

[47] Penn Central had attempted to make a case to PMM that these mail and baggage handlers actually were intended to be furloughed prior to the date of the merger and would have been but for some unforeseen events and administrative oversight, and had they been furloughed prior to that date and recalled thereafter, the payments would have been chargeable to the reserve.

1969 the losses were $5.1 million, before an extraordinary charge of $1.2 million. The footnotes to the 1968 and 1969 Financial Statements contained in the Annual Report to Shareholders separately disclosed these losses. The Lehigh Valley results, however, were not consolidated with Penn Central's results during these periods.[48] Management's reason for not consolidating the operation of Lehigh Valley was their position that Penn Central's ownership was temporary since the ICC had required that Lehigh Valley be offered for affiliation with another railroad system.[49] Penn Central apparently relied on that ICC ruling as the basis for nonconsolidation,[50] apparently drawing its accounting support for nonconsolidation from the criteria included in *Accounting Research Bulletin No. 51*.[51]

The Commission concluded, based upon its investigation that neither C&O/B&O nor N&W ever had any interest whatsoever in acquiring Lehigh Valley; further, in the course of the investigation a management representative flatly stated that no one wanted to acquire Lehigh Valley and that it was not worth anything. In the Commission's opinion, therefore, Penn Central's ownership in Lehigh Valley could not reasonably be said to have been temporary, and, further, a significant write-down in the investment was required.

The Commission's investigation also included information gathered from "Moody's Transportation Manual" and from filings made by Lehigh Valley and contained in the public dockets at the SEC. These sources of public information revealed, among other things, that for a 13-year period from 1957 through 1969, Lehigh Valley incurred consecutive annual losses; whereas for the 13-year period preceding 1957, Lehigh Valley had only two loss years. The trends as indicated in this published data, as well as the current amounts of advances being made to Lehigh Valley, clearly supported PMM's questioning management as to reasons why Penn Central's investment in Lehigh Valley should not be written down.

The audit workpapers of PMM for 1969 illustrate its awareness of the problem, the workpaper stating "Lehigh Valley—to be written down or reasons must be supplied." As a result, at the request of PMM, Penn Central made the following written representation to PMM in a letter dated March 12, 1970 concerning management's evaluation of this investment and their intention concerning its disposition.

> "One of the roads to which Lehigh Valley must be offered is the C&O and if the merger with the Norfolk and Western does not go through, the Lehigh Valley will have great strategic value to the C&O and we certainly should be able to come out well on our investment.
>
> "There are other alternatives we have in mind if this does not occur but it is too early and premature to determine to what extent, if any, an impairment may result in the investments."

PMM states that, in its opinion: (1) Lehigh Valley was properly not consolidated under the provisions of ARB No. 51; (2) that the

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[48] The operations of Lehigh Valley were not consolidated in prior years; however, the financial statements for those years were not examined by independent public accountants.

[49] As noted in the footnotes to the 1968 and 1969 financial statements contained in the Annual Reports to shareholders, Lehigh Valley was not included in consolidation because the Interstate Commerce Commission "has required [Lehigh Valley] to be offered for inclusion in another railroad system."

[50] The Interstate Commerce Commission, in approving the merger of the Pennsylvania and New York Central Railroads in 1966, required PCTC to use its best efforts to offer Lehigh Valley to the C&O/B&O or to the N&W Railroads for inclusion in one of those systems, or absent such affiliation, for PCTC to continue to keep Lehigh Valley operational and possibly be merged eventually into Penn Central.

[51] The pertinent section of ARB No. 51 reads as follows:

> "Consolidation policy: 2. The usual condition for a controlling financial interst is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly of over 50 percent of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. For example, a subsidiary should not be consolidated where control is likely to be temporary; or where it does not rest with the majority owners (as, for instance, where the subsidiary is in legal reorganization or in bankruptcy)."

carrying value of Lehigh was recoverable upon disposition; (3) that disclosure of the losses in 1968 and 1969 were clearly set out in footnotes to fully inform the reader; and (4) that the investment in and advances to Lehigh Valley were included in consolidated Penn Central investments and advances which in the aggregate had a market value well in excess of their carrying value. For all of the foregoing reasons, in PMM's view, not consolidating Lehigh Valley was appropriate and no write-down would have been required of this asset either in 1968 or 1969.

PMM further states that it was unaware that Penn Central was not reasonably likely to divest itself of Lehigh Valley in the foreseeable future and, therefore, accepted management's accounting rationale in this regard and also accepted its reasons as to why the investment in Lehigh Valley should not be written down.

It is our view that PMM's auditing procedures should have included its seeking adequate evidence to support management's written representation as to the likelihood of divestiture. In both 1968 and 1969 PMM should have insisted that management furnish evidence that they had made offers to the C&O/B&O and to N&W, or that they were going to do so within a specific time period. PMM should have satisfied itself by further inquiry as to whether management had evidence of any indications of interest from these two railroads or from any other potential acquirer. We believe that PMM should have insisted on additional representations describing the specific alternatives that management had in mind in order for PMM to satisfy itself whether it was too early to determine, to what extent, if any, an impairment of value existed or would result.

In our view, Penn Central's ownership of Lehigh Valley was not temporary within the meaning of ARB No. 51 and, therefore, the operating losses of Lehigh Valley should have been reflected through consolidation. Failing such treatment, PMM should have insisted that the investments in, and/or advances to Lehigh Valley be written down since, in addition to Lehigh Valley's recorded losses there was substantial evidence in the Commission's opinion, as early as 1968, that Penn Central could not readily expect to cover its loans and advances to Lehigh Valley.[52] It is our opinion that PMM should have more critically examined management's assurances given in support of their representations that Lehigh Valley could be disposed of to another railroad system and without incurring a loss.

Executive Jet Aviation

In 1965, as part of a diversification program, the Pennsylvania Railroad ("PRR"), began investing in an air taxi service, Executive Jet Aviation, Inc. ("EJA").[53] PRR looked upon the investment as a means of entering into the air transport and air cargo fields, even though it was aware that the Federal Aviation Act prohibited railroads from engaging in such activities. PRR, however, made the investments in the hope that it would be able to have the aeronautics laws changed to permit it to engage in the air cargo business.

In 1966 EJA applied to the Civil Aeronautics Board for approval of its acquisition of Johnson Flying Service, a supplemental air carrier. In connection with this application, a CAB examiner found that PRR controlled EJA in violation of aeronautics laws. Pursuant to this finding, PRR submitted a plan of financing and divestiture which contemplated continued investment in EHA by PRR. In December 1967, the CAB held the plan to be inadequate, and ordered a complete divestiture.

Up to 1966 PRR had advanced approxi-

[52] The investment and advances in Lehigh Valley by Penn Central at December 31, 1969 aggregated $49,493,-000. Of this amount, $23,025,000 was in capital stock, $4,125,000 in bonds, and $22,343,000 represented advances and other sums due. Of the latter amount, $16,-395,000 represented advances made in 1968 and 1969.

[53] In 1965, as part of its diversification program, PRR, through a wholly-owned subsidiary, American Contract Corp., acquired 655,960 shares of class B, nonvoting common stock of EJA at a cost of $327,980, representing a 58% interest in the company's combined class A and class B shares outstanding. American Contract's largest investment in EJA, however, was in the form of loans and advances. Between 1964 and 1969, loans totalling $21 million were made by American Contract with funds provided to it initially by PRR, and later by Pennco.

mately $14,000,000 to EJA. These advances continued at a rate of approximately $2.5 million a year during 1967, 1968 and 1969. In the last half of 1967, EJA embarked on a program of quietly acquiring interest in several foreign supplemental carriers. At the same time, Penn Central also was purportedly trying to find a buyer for its interest in EJA, although its desire to retain some sort of "buy-back" rights was making this more difficult.

In mid-1968 U. S. Steel Corp. and Burlington Industries, Inc. entered into a memorandum of understanding with Penn Central whereby they agreed to purchase Penn Central's equity and debt interest in EJA, subject to EJA's receiving CAB approval to acquire Johnson Flying Service. However, Burlington withdrew from the agreement in December 1968 and U. S. Steel followed.

On June 4, 1969, the CAB instituted proceedings to determine whether EJA and Penn Central had violated provisions of the Federal Aviation Act. In October 1969, the CAB issued a cease-and-desist order, to which Penn Central and EJA consented. In addition to levying fines against both, the order directed EJA to divest itself of control of foreign air carriers and Penn Central to divest itself of control of EJA.

EJA had sustained losses since it began operation.[54] EJA was unable to obtain outside financing unless Penn Central was willing to subordinate its investment. EJA's auditors, Lybrand, Ross Bros. & Montgomery (now Coopers & Lybrand), were unable to complete audits in 1968 and 1969 because of major problems. EJA's financial and operating condition was continuously adverse and, in the opinion of the Commission, the likelihood of Penn Central's recovery of its investments was highly unlikely.

Despite this situation, Penn Central's stated position, as reflected in a representation letter addressed to Peat, Marwick, Mitchell & Co., dated March 12, 1970 was as follows:

"Pursuant to order of the Civil Aeronautics Board we must dispose of our investment in Executive Jet Aviation by March 1, 1971. Consequently, we are at this time carrying on negotiations with a number of interested parties with a view of disposing of our holding just as soon as practicable. It is a complicated situation and consequently negotiations as between interested parties vary widely. We anticipate that our holding will be disposed of in the relatively near future but only at that time will it be possible to evaluate intelligently the consideration to be received for our investment. It is almost certain that we will receive various types of securities in exchange for our stock."

PMM states that in its opinion it was not unusual: (a) for a company the size of PCTC to invest approximately $21,000,000 in what amounted to an experiment for expansion and for the investee company to suffer losses during its initial years; and (b) for a company which had suffered losses still to be considered to have substantial value to another company thereby enabling the investor company to recoup its investment or incur only a minor loss upon sale, this being particularly true of a start-up company possessing operating rights. The investment in EJA of approximately $21,000,000 was among total investments and advances of Penn Central of $453,239,000 in 1968 and $535,711,000 in 1969. In PMM's opinion investments and advances to consolidated subsidiaries and miscellaneous investments are to be considered as a group in determining whether a write-down should be made. The total market value of the investments and advances, including EJA, was in excess of the carrying value, and, therefore, in PMM's view there was no reason to write down the group of investments nor to write down any individual investment. Moreover, PMM states that it did not believe that management's representation was unreasonable and considered that it would have been improper to require that the investment be written down by an arbitrary amount when, in PMM's opinion, an estimate of the loss, if any, was not determinable. EJA eventually was sold in 1970 at a considerable loss, but in PMM's view this loss is not a true measure of the loss, if any,

[54] 1965 loss: $992,000; 1966 loss: $2,214,000; 1967 loss: $869,000; 1968 loss: $3,830,000; 1969 loss: $4,101,000.

that would have been experienced had the sale occurred under normal circumstances prior to commencement of reorganization proceedings.

The Commission believes PMM did not go far enough in its examination to evaluate this asset. It was known to Penn Central and to PMM that EJA had been continually in need of operating funds; PMM was also aware of the CAB's order to Penn Central to divest itself of control of EJA, and it also knew of certain prior unsuccessful attempts by Penn Central to dispose of this investment. Under the circumstances described above, in the Commission's view the investment in EJA was seriously impaired and PMM should have viewed this investment differently from other Penn Central investments.

The Commission's investigation revealed that PMM was not furnished with financial statements of EJA. PMM, however, requested Penn Central management to represent to PMM its evaluation of Penn Central's position in this investment and its intention concerning the disposition of EJA.

Penn Central's March 12, 1970 reply to PMM made no mention of any possible loss in this investment.

The Commission feels that since PMM was aware of EJA's financial difficulties, it should have insisted that management of Penn Central require EJA to prepare financial statements for PMM's review, and also should have insisted that Penn Central include in its representation letter the number and identities of the parties interested in acquiring EJA. Further, PMM should also have insisted that this representation letter include the status of the various negotiations in support of management's statement that they had anticipated this investment would be disposed of in the relatively near future. In addition, PMM should have required management to represent to them the possible range of any gain or loss that could result from the nature and status of the negotiations with interested parties.

We believe that PMM should have expanded its auditing procedures in 1968 and 1969 to obtain the necessary competent evidential matter to enable it to conclude that this investment was fairly stated. In our opinion, based on all available evidence, it appears the loss in this investment should have been recognized in 1968 and 1969, and that PMM failed to exercise proper judgment in this regard.

Great Southwest Real Estate Activities

Great Southwest Corporation ("GSC") is a majority-owned (approximately 91%) real estate development subsidiary of Pennco, a subsidiary of PCTC, which is in turn a subsidiary of the Penn Central Company.[55] In 1968 and 1969 GSC management effected several income tax oriented syndications which were described as having included therein certain tax advantages to investors. These syndications resulted in large reported earnings by GSC and were reported to shareholders of GSC in its annual report to its shareholders and to the extent of Penn Central's ownership, they were also included in Penn Central's consolidated earnings and in PCTC's reported results of operations.[56]

At issue in this case were GSC's accounting treatment and financial reporting of three real estate transactions which were part of the 1968 and 1969 tax syndications. In one transaction in 1968 GSC sold a parcel of raw land known as the Bryant Ranch which was suitable for holding for subsequent sale or development and sale. In the other two transactions GSC sold in 1968 an operating amusement park known as Six Flags Over Georgia, and in 1969 an operating amusement park known as Six Flags Over Texas.

In December 1962, the Commission issued Accounting Series Release No. 95 ("ASR-95") to provide guidance in the application of generally accepted accounting principles to real estate transactions reported in financial statements to be included in documents filed

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[55] Pennsylvania Railroad Company, through Pennco, acquired the majority interest in GSC in the mid-1960's as part of the diversification program of PRR. For convenience, any reference to GSC includes Macco Corp., a 100% owned subsidiary of Pennco which was merged into GSC in March 1969.

[56] PMM was the auditor of GSC as well as Penn Central.

under the federal securities laws. In that release we stated:

> "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."

We also indicated, in that release, that mere formal compliance with the technical legal requirement of a sale is not necessarily sufficient to justify revenue recognition, and that the substance of a transaction is the controlling consideration. In our opinion, the real estate transaction in question in this case involved circumstances of the type discussed in ASR-95 and were governed by the principles set forth therein dictating that there be no recognition of profit.[57]

In 1968 GSC sold the Bryant Ranch for $31,000,000 to a limited partnership formed to purchase the land. GSC reported the transaction as a sale and recorded a profit in that year of $8,558,176 and deferred $827,833 as a reported profit in 1969. The purchaser made a cash payment of $6,000,000 of which $600,000 was assigned to principal and $5,400,000 to prepaid interest. A note for $30,400,000 at a 7% annual rate was given for the balance, and under the terms of the note no principal payments were to be paid for the first 15 years after the transaction through 1983. There was no personal liability on the note and as required by California law, the only recourse was against the land. During this 15-year period, interest in the flat amount of $1,000,000 per year (less than that called for by the 7% rate) was to be paid. After 1984, principal payment plus accrued as well as current interest payments were to be made over a five-year period to amortize the note. Among other aspects of the terms of the transaction, GSC was obligated under certain conditions to make certain improvements and also pay certain other costs.

In 1968, GSC sold its amusement park known as Six Flags Over Georgia for $22,980,157 and recorded a profit of $4,813,400 on the transaction. In the Georgia park transaction, the purchaser, a limited partnership, made a cash payment of $2,970,000 of which $1,500,000 was assigned to principal and $1,470,000 prepaid interest. The purchaser also gave a mortgage note for $21,000,000 at 7% interest. Principal payments in the amount of $700,000 yearly were to begin in 1975. In 1969, it sold its other amusement park known as Six Flags Over Texas for $40,000,000, and recorded a profit of $17,530,170 on the transaction. As to the Texas park, the purchaser, also a limited partnership, made a cash payment of $5,432,670 of which $1,500,000 was assigned to principal and $3,932,670 to prepaid interest. The purchaser also gave a mortgage note for $38,301,585. There were other aspects to the structure of these two transactions which included continuing exclusive management of the amusement parks by GSC as well as GSC's retention of certain risk of loss and opportunity for gain factors.[58] Except for a few differences both amusement park transactions were substantially similar.

In ASR-95, we stated that a prerequisite to revenue recognition is an effective exchange or conversion. The Commission finds that applying the text of ASR-95 to the Bryant Ranch transaction, there was not a sufficient conversion of either GSC's or the purchaser's interest in the property to justify treatment of the transaction as a sale; and despite the formal aspects of the transaction, GSC immediately after the sale had essentially the same type and degree of control as it had prior to the transaction.

The Commission finds that one of the aspects of an exchange missing from the amusement park transactions, but necessary for an effective economic conversion, was the transfer of control.

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[57] Pursuant to an administrative proceeding, *In the Matter of Great Southwest Corporation*, Securities Act Release No. 9934, dated January 15, 1973, brought under Section 15(c) (4) of the Securities Exchange Act of 1934 and consented to by GSC, the financial statements of GSC for 1968 and 1969 have been restated and new reports thereon have been issued by PMM. PMM maintained in these new reports that the original accounting for these transactions had been proper.

[58] Moreover, GSC could not be removed as general partner prior to 1997 except under certain limited circumstances.

The Commission finds that the other critical aspect of an exchange absent from the transactions was the transfer to the purchaser of the risk of loss and opportunity for gain. Upon the transfer of the amusement parks, GSC continued to have, in a functional sense, essentially the same type of degree of control over the business and management as it had before. GSC also continued to bear substantially all of the opportunity for gain. When the elements of control and retention of risk and opportunity for gain are considered together, it becomes apparent that GSC's position with respect to the amusement parks did not substantially change because of the sale transfers. As to these two transactions, the Commission believes that in economic terms, true exchanges did not take place, and therefore, it was not proper for financial reporting purposes to record the transactions as sales and recognize revenue thereon.[59]

PMM states that in 1968 and 1969 it was its opinion and still is that the three transactions mentioned above were *bona fide* sales and, in its view, met the criteria of ASR-95, which was an important consideration in PMM's decision that it was appropriate to recognize income on these transactions. PMM believes that these transactions involved substantial cash outlays by the purchasers and resulted in the transfer of the reward or burden of ownership from the seller to the buyer. It also believes that there was no continuing involvement on the part of the seller, except to make certain improvements on Bryant Ranch for which estimated costs were taken into account and to become the operator of the two amusement parks under a management contract with the purchasers. Moreover, aside from ASR-95, it is PMM's view that other then current accounting literature required that income be recognized in 1968 and 1969 when these transactions occurred.

In the Commission's opinion these three real estate transactions were structured by GSC with the concurrence of Penn Central's management in an unsuccessful attempt to meet the criteria contained in ASR-95. The Commission believes these transactions failed to meet the criteria of ASR-95 since, in substance, nothing happened from a business viewpoint to warrant the recording of sales and profits on these transactions. PMM should have recognized the attempts by management to structure transactions in a contrived manner to meet the technical criteria of existing accounting literature, when in the Commission's view, they did not. It is our opinion that PMM in its 1968 and 1969 audits of GSC and of Penn Central failed to exercise critical and independent judgment on this very important issue.

[59] See Securities Exchange Act Release No. 9934, *supra*, dated January 15, 1973, for the Commission's description and views of the three real estate transactions.

New York, New Haven and Hartford Railroad

As a condition of the merger of the Pennsylvania Railroad and the New York Central Railroad, substantially all of the properties and investments of the New York, New Haven and Hartford Railroad Company ("New Haven") were acquired by Penn Central as of December 31, 1968. In our view Penn Central in 1969 improperly accounted for New Haven maintenance costs thereby obscuring the true dimensions of New Haven's operating loss. As a result, there was a significant difference between the results of operations reported to the ICC and those reported to the public in 1969. Footnote 14 to the financial statements contained in the 1969 Annual Report to Shareholders discloses this difference.[60]

[60] Footnote 14 reads as follows:

"(1) Shares issued in December 1968 in connection with the acquisition of New Haven properties have been reflected in the accompanying financial statements at $41.125 per share, the average fair market value of the stock during the period of negotiation of the acquisition agreement; whereas the Commission [ICC] has ruled that such shares be valued at $87.50 per share, the value determined by the Commission [ICC]. The difference in purchase price has been reflected partly as a deferred credit of $23,077,000 and partly as additional paid-in capital of $21,284,000 in reports to the Commission [ICC]; whereas a liability of approximately $40,000,000 for rehabilitation and other costs assumed in connection with the acquisition of New Haven properties has been reflected in the accompanying [GAAP] financial statements, but not in

Penn Central asserted that the state of New Haven's equipment was very poor and had to be rehabilitated. On this basis, substantially all of the costs attributable to the upkeep of the road in 1969 were written off against a liability for rehabilitation cost established in connection with the purchase of the New Haven properties.

To charge the rehabilitation liability account with items chargeable as period expenses would be improper. As a result of making such charges Penn Central recorded total maintenance expenses in 1969 for New Haven which were significantly lower than those recorded by New Haven in the prior years.

Care must be taken to distinguish genuine rehabilitation charges from ordinary maintenance costs which may be incurred at about the same time. We believe that in this case insufficient attention was given to this distinction. The Commission is of the opinion that it would have been necessary to approximate the amount of expenditures deserving capitalization by comparing the total of maintenance and restoration costs incurred with the record of normal up keep incurred in prior years. The historical record of approximate expenditures by New Haven for normal maintenance and capitalization items, as compared with 1969, follows (in millions of dollars):[61]

	Expense	Capitalized	Total
1969	$ 1.6	$35.9	$37.5
1968	34.6	0.6	35.2
1967	33.5	1.3	34.8
1966	33.3	0.5	33.8
1965	31.7	4.7	36.5

As a result of the staff's investigation of this area, the Commission believes that the audit examination by PMM was not sufficient to come to a conclusion that the $1.6 million was all of the general maintenance and repair costs that were to be charged against 1969 earnings.

reports to the Commission [ICC]. In 1969, the net loss for the transportation company, as reported to shareholders, was $21,986,000 less than the loss reported to the Commission [ICC] because of charge-offs against the liability for rehabilitation and other costs."

[61] From information contained in "Verified Statement (No. 10) of Stanley G. Jordon, Bureau of Accounts, Interstate Commerce Commission, Docket No. 35291".

Trucking Company Dividends

In 1969, PCTC caused one of its trucking company subsidiaries, New York Central Transport Co. , to declare cash dividends of $12,000,000 to PCTC. PCTC also caused two other trucking companies to declare cash dividends in the aggregate of $2,000,000 to an intermediate subsidiary which then declared a dividend in a like amount to PCTC.

The Commission's investigation revealed that none of the trucking company subsidiaries had sufficient cash funds to meet these dividend declarations. As to the $12,000,000 in purported dividend payments from New York Central Transportation Co., PCTC instructed one of its banks to charge PCTC's account and credit the account at that bank of New York Central Transport Co. Simultaneously, New York Central Transport Co. instructed the same bank to charge its account for that amount and credit the account of PCTC. The bank followed the instructions.

At the time when PCTC was allegedly loaning funds to its subsidiary, PCTC did not have the necessary cash funds in that bank to cover the amounts transferred. New York Central Transport Co.'s books of account then reflected "advance payable" in the amount of $12,000,000 and its equity account was reduced by a like amount. While advances payable were substituted for equity belonging to the sole shareholder on the books of New York Central Transport Co., the Commission concludes that the end result, in effect, did not give the 100% stockholder (PCTC) entity anything more than it had before, and the $2,000,000 dividend payment by an intermediate subsidiary was the same, in practical effect as New York Central Transport dividend payment.

Notwithstanding the fact that these dividend declarations had no effect whatsoever on the consolidated earnings of Penn Central, the "company only" (PCTC) financial statements did include this dividend declaration in reported income.

PMM disclaims knowledge of the instructions given to the bank by PCTC or the New York Central Transport Co. However, PMM states that its view was, and is, that a subsidiary may make a dividend payment as long as it has accumulated earnings available for such dividend, even if no cash changes hands at the time and the parent company simultaneously or subsequently records advances to such subsidiary. With respect to intercompany transactions of this nature, it is PMM's opinion that such transactions are by their nature not arm's-length and that, therefore, in "company only" statements the important factor is disclosure. These dividends were included in a separate line item entitled "Dividends and interest—Consolidated Subsidiaries" which totalled $44,324,000 in the separate "company only" financial statements for 1969.

In the Commission's opinion, though PMM disclaims knowledge of the instructions given to the bank by PCTC or the New York Central Transport Co., PMM should have followed the procedure of tracing cash transfers in support of these transactions and, had it done so, it would have discovered the bank statements, and the bank's debit and credit memoranda accompanying such statements. This, in turn, would have led PMM to make further inquiry of management as to the factual circumstances underlying these transactions.

In the Commission's view, PMM's audit program should have been expanded in order to test intercompany transactions in greater depth. Such expanded testing was desirable since PCTC, the entity purportedly benefiting from this transactions, had it separate financial statements, which were reported on by PMM, included in the annual report furnished to shareholders by Penn Central.

In the Commission's view, since no cash changed hands and the dividend, though declared from retained earnings, was supported only by entries on the books of the bank, the subsidiary and the parent, and since cash funds were not available to support the entries of the bank or the companies, there was no basis for recognizing the dividend as income.

Conclusion

In this case, Penn Central management was engaged in an attempt to conceal the extent of the deterioration of the company. One of the elements in this program was the presentation of financial statements which did not reflect the adverse results of railroad operations and which minimized adverse trends in the total business. PMM should have understood what management was doing and, rather than acquiesce, should have resisted management's efforts.

Auditors should be alert for the kinds of warnings present in this case indicating that management seeks to conceal a deterioration in the affairs of the company.

One major warning given was management's effort to record income from transactions which were structured to give an appearance of being *bona fide* but which did not reflect a business or economic change which would justify the recording of income. The Washington Terminal dividend, the Madison Square Garden exchange, the trucking company dividends and the Great Southwest property sales illustrate this development.

In a period of crisis, management may structure transactions or seize upon opportunities which may serve as a vehicle for recording a gain in a particular period but which do not require that a company change its fundamental interest in the asset. Auditors must not allow their skepticism as to the essence of transactions to be undermined. Instead, auditors should increase their vigilance when the proposal of such transactions raises questions as to management's intentions and as to the condition of the company.

Attempts by management to shift expenses from current accounts to reserve accounts or to capital accounts is also a cautionary note to accountants. In the items above, PMM allowed Penn Central to shift expenses under highly unusual circumstances, as in the case of New Haven maintenance costs and the mail and baggage handlers.

Auditors also should be alert to the fact that where a company is experiencing a deterioration in its financial condition and results, it may seek to avoid writing down loss

operations or investments and might seek to keep the current losses from such operations out of the consolidated financial statements. The Lehigh Valley Railroad and the Executive Jet Aviation situation described above are illustrations of that kind of desire by management, which must be resisted by auditors. The time when write-downs may be most needed is when a company is deteriorating and it is that very time when management will be particularly likely to want to avoid write-downs and will be willing to make representations to auditors to avoid the write-downs or to avoid consolidation of loss operations.

Another element in attempts by management to conceal in the financial statements the deteriorating condition of a company is the timing of recording large transactions. Some of the transactions described above were rushed to completion in the final moments of the financial period. Although this is not always a sign of improper management conduct, auditors should pay particular attention to such last minute transactions where the results of the company are declining or at a breakeven point as to profit and loss as in the Penn Central situation.

When faced with the possibility that management may be attempting not to reveal major adverse business trends, auditors must recognize this and review accounting matters with a particularly critical outlook to make certain that the financial results do not obscure the adverse business trend. The accountant must be certain that the treatment of all items fully conforms with the applicable principles. Moreover, the accountant must not view the treatment of items as acceptable merely because the treatment might be fitted within an applicable principle, and innovative treatments which tend to increase reported earnings or decrease reported losses must be scrutinized with particular care.

In our opinion, PMM, in auditing these statements, failed to heed the warning signs outlined above to insist on the application of appropriate accounting principles in the circumstances and to require adequate disclosures. In the Commission's view the statements were not a fair presentation of business facts.

Many of these transactions were presented to the auditors with a variety of sophisticated justifications supporting management's accounting methods to be used in recording the transactions. The Commission believes that PMM viewed these justifications too narrowly and did not consider whether the justifications were applicable in the circumstances. We consider it an auditor's duty to insist on meaningful application of accounting principles and disclosures in order that the financial statements reflect the business reality of the enterprise.

STIRLING HOMEX

Stirling Homex Corporation ("Stirling Homex") was engaged in the business of manufacturing and selling completely installed modular dwelling units, ready for occupancy. The concept employed by Stirling Homex was hailed as revolutionary in that the corporation attempted to integrate the many phases of home construction on a fixed site. The modular units were manufactured at a plant, shipped to a site and thereafter assembled into multi-family dwelling units.

Initially, Stirling Homex operated on a relatively limited scale. During the Company's first full year of operations, the fiscal year ended July 31, 1969, approximately 61% of its revenues[62] were derived from sales to entities controlled by the principal stockholders of the Company. For the succeeding two fiscal years nearly all revenue was derived from sales to local housing authorities and other non-profit entities who depended on Federal Government funding to finance the purchase of Stirling Homex dwelling units.

Stirling Homex became a public corporation on February 19, 1970 through a public offering of 1,175,000 shares of common stock at $16.50 a share. On July 29, 1971 the Company made another public offering of 500,000 shares of cumulative preferred stock at $40 per share. In July 1972, the Company filed a petition under Chapter X of the Bankruptcy

[62] Total revenues for 1969 were $9,600,000.

Act. Thereafter the Commission began an investigation of the affairs of the Company.

Information obtained by the Commission in that investigation into the affairs and financial reporting of Stirling Homex for the period 1970 to 1972, indicates to us that a registration statement and certain reports issued by Stirling Homex and filed with the Commission included audited financial statements for the seven-month period ended February 28, 1971 and for the fiscal year ended July 31, 1971 which were false and misleading and did not present fairly the consolidated financial position and results of operation of the Company in conformity with generally accepted accounting principles.

The consolidated statements of income of Stirling Homex for the seven-month period ended February 28, 1971 included in the registration statement for the preferred stock[63] and the consolidated statements of income of Stirling Homex for the year ended July 31, 1971 contained in the Annual Report to Shareholders and Annual Report on Form 10-K for such fiscal year were false and misleading in that among other things:

all modular sales of $12,493,000 for the February 28, 1971 period and $25,292,600 out of total modular sales of $29,482,271 for the July 31, 1971 period were improperly recorded in that the purported sales were not supported by required financing commitments;

installation sales were overstated by approximately $3,723,000 out of a total reported installation sales of $5,137,000 for the February 28, 1971 period and $2,443,000 out of total installation sales of $7,200,000 for the July 31, 1971 period through the inclusion of sales from projects for which there were no commitments of financing and through Stirling Homex's improper reporting of approximately $1,000,000 as of February 28, 1971 and approximately $2,000,000 as of July 31, 1971 of excess installation costs as "cost overruns" reimbursable to the Company[64]; and

general administrative and other expenses were materially understated by approximately $832,000 as of February 28, 1971 and approximately $1,000,000 as of July 31, 1971, as a result of the improper capitalizing of such expenses. Additionally, certain other expenses and construction costs were improperly capitalized.

PMM examined and issued unqualified reports on these financial statements. Although it should be noted that it appears that officers and other representatives of Stirling Homex, as well as others, intentionally deceived PMM by misrepresentation and concealment of material information and even the creation of a forged or spurious document, our investigation causes us to believe that PMM's examinations were not conducted in accordance with generally accepted auditing standards and we believe, as is detailed within, that the accounting methods followed by Stirling Homex were not in accordance with generally accepted accounting principles.

Stirling Homex accounted for its sales by separating the manufacturing and installation functions and by recording sales and income on the manufacturing aspect of the transaction upon the supposed assignment of manufactured units to the requirements of a particular housing agency customer. This was supported by a commitment of funding which was supposedly evidenced by receipt of a letter of designation, feasibility letter or other similar document from the local agency. Stirling Homex treated the letters or other documents from the local agencies as the equivalent of a financing commitment, and PMM accepted this concept.

In determining whether there existed a

[63] Also included in the registration statement were unaudited financial statements for the nine-month period ended April 30, 1971. Such unaudited financial statements were false and misleading in that all modular sales of $18,183,000 for the April 30, 1971, period and approximately $4,656,000 out of the total installation sales of $6,382,000 for such period were improperly recorded.

[64] Had Stirling Homex not improperly capitalized these costs overruns from the installation portion of certain of its projects, it would have incurred substantial losses on completion of these projects.

commitment of Federal financing, PMM relied on representations of Stirling Homex management, the Company's supposed experts on government housing programs, an opinion of outside counsel furnished by management, apparent concurrence of other reputable organizations dealing with the Company, and the belief that local housing authorities would not enter into contracts for projects without reasonable assurance that funding would be available. In fact, as we think PMM should have understood, in almost all cases the letters or other documents were not a commitment for Federal financing and without Federal financing the revenue from the project was not assured.[65] The acceptance of these representations without further auditing work, particularly in the light of PMM's lack of experience in this area, resulted in improper recognition of sales revenues.

In summary, the Commission believes that the registration statement, reports and the financial statements contained therein portrayed Stirling Homex as a healthy, prosperous company with increasing sales and earnings when, in fact, that company was experiencing serious business problems and financial difficulties. Moreover, nearly all of Stirling Homex's sales and resulting accounts receivable were either improperly recorded or fictitious, and the Consolidated Balance Sheet included in the Annual Reports materially overstated assets by approximately $36,400,000 as a result of the inclusion in accounts receivable of sales from projects improperly recorded in the current and prior fiscal year.

Stirling Homex Revenue Recognition Policies

Stirling Homex contracted with its customers, primarily public housing authorities, to manufacture and install modular housing units resulting in a housing-development ready for occupancy. Modules were manufactured on an assembly line at Stirling Homex's manufacturing facility in Avon, New York. The modules were later to be shipped to a construction site where they would be assembled into two, three and four bedroom apartments. The apartments, in turn, would be assembled into larger structures consisting of two to five apartments, depending upon the requirements of an individualized site plan. The completed modules contained wall and floor coverings, drapery fixtures and all other necessary appurtenances in order to make the multi-module dwelling unit ready for occupancy when assembled.

The Company purported to follow a revenue recognition policy whereby revenue would be recognized on the sale of each module when manufacture of the module was completed and other events had occurred (including an irrevocable assignment of the modules to a specific contract and a firm commitment of funding for the project) which reasonably assured the ultimate collectibility of the sales price. For purposes of revenue recognition, Stirling Homex made an allocation of the contract price as between module manufacture and module installation segments and, upon the manufacture and assignment of modules to a contract, the Company normally recorded as modular manufacture sales approximately 55% of such total contract price. The accounts receivable resulting from the recording of sales upon completion of the manufacture of modules were carried on the books of Stirling Homex as unbilled (not invoiced to customers) receivables. The portion of the total contract price allocated by the Company to module installation was recognized on the percentage of completion basis as site preparation and installation work was performed.

During the period relevant here, Stirling Homex's customers consisted primarily of public housing authorities who looked to Federal government housing programs as sources of financing for their proposed projects. The programs involved were low rent housing programs under the turnkey program of the Department of Housing and

[65] Some projects went forward to completion. Others, and they were larger, did not. The lack of completion resulted from a number of factors, including neighborhood opposition to housing at particular sites and the inability of Stirling Homex to continue to obtain financing which led to its ultimate collapse.

Urban Development ("HUD") and a subsidized housing program under Section 236 of the National Housing Act administered by the Federal Housing Administration ("FHA"). In addition, Stirling Homex had one project under the rural housing program of the Farmers Home Administration ("Farmers Home") of the Department of Agriculture.

Most of Stirling Homex's projects in the period under consideration were under the HUD turnkey program. The initial step in this program, following the receipt of proposals including proposed prices from a number of applicants, was the issuance by a local housing authority ("LHA") of a letter of designation, designating an applicant, such as Stirling Homex, as the developer of a specified project subject to specified conditions. Subsequently, if the specified conditions were met, the letter of designation would be followed by a contract of sale between the LHA and the developer, countersigned by HUD to evidence its commitment to finance the project. Until HUD countersigned the contract of sale, there was no legally binding commitment of governmental funds by HUD. Stirling Homex, however, began to manufacture modules and recognize income with respect thereto prior to the countersigning of the contract of sale by HUD and in most cases recognized income upon receipt of a letter of designation.

Commencing in the last quarter of the 1971 fiscal year, Stirling Homex recognized revenues on modules manufactured in connection with three projects which were intended to be financed under the Section 236 program of the FHA. The initial step in this program was the issuance by the FHA of letters of feasibility. These letters, although indicating the FHA's determination that the project was economically feasible and evidencing an intent to participate in the projects upon the satisfaction of certain conditions, did not in fact represent a legally binding funding commitment.[66] Stirling Homex, however, began to manufacture modules and recognized income when a letter of feasibility was received.

The third governmental program involved was the rural housing program of Farmers Home Administration, a branch of the Department of Agriculture. The one project purportedly financed under this program was the Greater Gulf Coast Housing Development Corp. project in Mississippi which is discussed below. Since the only purported commitment on the part of Farmers Home was a forged or spurious document committing $15 million, it is unnecessary to discuss the normal operation of this program.[67]

While reviewing Stirling Homex's 1971 registration statement, the staff of the Commission's Division of Corporation Finance questioned the reasonableness of recognizing sales revenues in advance of the date on which the Company was able to validly invoice a customer.[68] The staff requested that Stirling Homex revise its financial statements to defer recognition of income to that point at which the amount recorded was validly billable to a customer.[69] Had Stirling

[66] In addition to representations by Stirling Homex that the feasibility letters were a commitment of financing, PMM relied upon an opinion of counsel experienced in FHA matters, furnished to them by Stirling Homex management, which stated that, "In the trade and within the FHA organization, the feasibility letter is considered a binding, firm and reliable document" and "In summary, it is our opinion that the feasibility letter may reasonably be treated for accounting purposes as a basis for recognition of projected projects." The auditors did not fully relate the existing facts to this opinion.

[67] The materiality of this one project to the financial statements of Stirling Homex is vividly illustrated by the fact that sales on this project represented in excess of 60% of all module sales for the seven month period reflected in Stirling Homex's 1971 registration statement.

[68] Stirling Homex's unbilled receivables grew rapidly. On December 31, 1969, unbilled receivables were $644,918. At the end of the 1970 fiscal year, unbilled receivables increased more than seven-fold to $4.6 million. By July 31, 1971, the unbilled receivables were to increase by over $25 million bringing the total to $29.5 million. This increase of unbilled receivables created a distorted balance sheet since the current assets were composed primarily of these unbilled receivables.

[69] The relevant paragraph from the June 30, 1971 letter of comment reads as follows: "It is noted that the number of modules installed through April 30, 1971 is far less than the number manufactured through the fiscal year ended July 31, 1970. It appears to the Division that the registrant's accounting practices recognize income too far in advance of the date of billing to

Homex complied with this request, its financial statements would have shown substantial losses from operations.

Instead, Stirling Homex requested a meeting with the Division of Corporation Finance to discuss its accounting practices. During this meeting,[70] and in a written statement submitted shortly after the meeting, Stirling Homex set forth its rationale for the allocation of the total contract price between the module manufacturing phase and the installation phase and represented that no sales were recognized with respect to module manufacturing unless the following five conditions were met:

"(1) The Company must be designated by the LHA non-profit sponsor or other agencies as the contractor for the project. This designation is supported by a formal commitment from the customer to the Company.

(2) The customer must have obtained and submitted evidence to the Company that a commitment of monies to fund the project has been obtained from the appropriate governmental agency under which the project has sponsorship.[71]

(3) The numbers and types of modules and the general site plan and improvements must be identified and be the subject of the agreement between the Company and its customers.

(4) The Company must assign the manufactured module to a specific project and physically identify the module as being assigned to and reserved exclusively for the specific project and customer. (This identification was to be physically attached at the earliest stage of the manufacture of the module.)

(5) The module must be completed and be ready for shipment to the customer."

In short, it was represented to the Commission by Stirling Homex that before income was recognized in connection with module manufacture all events had occurred which reasonalby assured the ultimate collectibility of the sales price properly allocable to such manufacture.

This representation was false and the Commission has concluded that with respect to virtually every project as to which the Company recognized income at the point of module manufacture, one or more of the five conditions stated above had not in fact been satisfied at the time of income recognition.

General site plans were rarely in existence at the time sales and income were recognized from the manufacture of the modules. Because irrevocable assignment of modules to a particular project was, in many instances, largely impossible until such site plans were developed, the purported assignment of modules to projects indicated in the computer runs and other records of the Company shown to PMM, was essentially a sham. In fact, the modules were maintained for the most part on an unsegregated basis and shifted and reassigned from project to project where the need arose.[72]

More importantly, in virtually every instance there did not exist a firm and legally binding commitment of Federal funds to finance the project. The non-profit entities (some of which were "shells") and the LHA's doing business with Stirling Homex did not have substantial funds of their own. The letter of designation and feasibility letters did not represent legally binding commitments of funds to purchase the projects and were subject to a number of stated conditions, such as selection and approval of a

customers. It is requested that the financial statements for the current year be revised to defer recognition of income at least to a point no sooner than the amount is validly billable to the customer."

[70] At this meeting, which is discussed *infra*, a PMM partner responsible for the Stirling Homex account made a number of statements regarding Stirling Homex's accounting practices which we believe to have been in error.

[71] In its submission, Stirling Homex falsely represented to the staff—as it had to PMM—that a letter of designation from an LHA under the turnkey program represented such a commitment.

[72] For example, on the RIT project, which Stirling Homex included in sales for the nine months period ended April 30, 1971, Stirling Homex "assigned" modules to the project for the purpose of recognizing income but they were not the type called for by the project. It was not until May, 1971 that the Company began manufacturing the appropriate modules.

site, satisfaction of various zoning and building code requirements and agreement on an ultimate contract price. In almost all cases there was no commitment of funding to finance the projects at the time income was recognized.

In constrast to its representations to PMM and the staff of the Commission, that these conditions would routinely be satisfied, the Company, in practice, experienced great difficulties in finding acceptable sites (because of local opposition to the projects and other political and social problems) and in obtaining the zoning and building code variances necessary for its projects. In some instances it also had difficulties in reaching agreement on the ultimate contract price.

Moreover, the Commission believes that the allocation of the contract price as between module manufacture and installation was arbitrary and did not accurately reflect either the relative costs of each segment of the total sales price nor the relative profitability of the two segments. In fact, the actual costs of installation in most of the projects completed by the Company substantially exceeded those portions of the applicable total contract prices that Stirling Homex allocated to the installation work—at least, when there is taken into consideration the cost overruns improperly classified by the Company as accounts receivable.

Stirling Homex's accounting policy with respect to the recognition of sales and income upon completion of the manufacture of modules, which permitted the Company to front-end and prematurely report sales and earnings, was not in accordance with generally accepted accounting principles.[73] Following the manufacture of a modular housing unit for sale to an LHA, Stirling Homex still owned the modules and bore the risk of a loss.

The Commission believes that the percentage of completion method of income recognition was inappropriate with respect to the installation portion of the projects[74] since, among other things, the total time required for manufacture of the modules, preparation of the site and installation of the modules did not require more than a few months—assuming site selection, funding approvals and other local approvals were in fact in hand—and, therefore, the contracts probably could not be properly considered as long term contracts.

Retention of PMM

Stirling Homex began to search for a new accounting firm in January of 1971 after encountering resistance to certain of its accounting practices on the part of Harris Kerr Forster and Company ("HKF"), its auditors for the fiscal year ended July 31, 1970.* Stirling Homex apparently contracted a number of accounting firms, including members of the so-called "big-eight." In late February of 1971, PMM was retained by Stirling Homex.

PMM was not aware of the approaches by the Company to other accounting firms or of the disagreements between HKF and the Company.[75] PMM was informed that the principal reason for the change in auditors was purportedly the Company's desire and that of its investment banker to obtain a "big eight" firm. PMM also asked KHF if there were any professional reason why PMM should not accept the engagement. In addition, PMM made inquiries concerning Stirling Homex and learned that the Com-

[73] In 1970, the Accounting Principles Board issued APB Statement No. 4 which stated the general view on income recognition as follows:

"Revenue is conventionally recognized at a specific point in the earning process of a business enterprise, usually when assets are sold or services are rendered. This conventional recognition is the basis of the pervasive measure of principle known as realization."

* * *

"Revenue is generally recognized when both the following conditions are met: (1) the earnings process is complete or virtually complete, and (2) an exchange has taken place."

[74] While there are some exceptions to this rule, the necessary criteria for such exceptions did not exist in this case. This method, as indicated above, differed from the method Stirling Homex utilized in connection with recording sales on the manufacture of the modules whereby Stirling Homex recorded sales and income upon the completion of the manufacture of the modules. See Accounting Research Bulletin No. 45.

[75] Although PMM reviewed HKF workpapers, they did not learn of questions raised by HKF regarding the income recognition policies of Stirling Homex which HKF had reported on in the prior years' financial statements.

pany had reputable outside directors, legal counsel and bankers.*

PMM was retained to perform an audit of Stirling Homex's financial statements for the seven months of the Stirling Homex fiscal year ended February 28, 1971. PMM was informed that such financial statements were to be included in their registration statement to be filed by Stirling Homex with the Commission. The account was assigned to a partner in PMM's Newark, New Jersey office. The audit work, however, for the Stirling Homex account was to be performed by the PMM staff located in Rochester, New York, working under the direciton of a PMM partner in that office.

PMM assigned an SEC reviewing partner from the New York office to the Stirling Homex audit who participated in several meetings where significant decisions were made concerning unresolved audit questions. However, the SEC reviewing partner was unfamiliar with the income recognition policies of Stirling Homex and the government housing programs being utilized by customers of Stirling Homex. He did not review the audit workpapers and, in connection with the February 28, 1971 audit, met only once with the other PMM auditors for face-to-face discussion of the audit.

The Financial Statements of Stirling Homex Reported on by PMM

There is set forth below analyses of specific aspects of PMM's audit of the Consolidated Financial Statements for the seven month period ended February 28, 1971 and for the twelve month period ended July 31, 1971. In the view of the Commission, these analyses demonstrate that in a number of respects PMM's conduct of the audits was not in accordance with generally accepted auditing standards.

In a number of important areas, PMM unduly relied on the representations and interpretations of Stirling Homex management, and on management-prepared schedules and workpapers. It appears that this reliance was due in part to the inexperience of the PMM personnel and their unfamiliarity with government housing programs, government contracting or construction companies. Many such management representations were intentionally false and misleading and constituted part of a deliberate effort by management of the Company to deceive PMM, among others, as to the true status of a number of significant affairs. However, in the Commission's view, PMM accepted uncritically the representations of Stirling Homex with respect to these matters and did not take those steps which were required under the circumstanacces in order to verify the accuracy of the Company's assertions.

Thus, PMM's personnel relied on management's representation that a letter of designation represented a firm commitment of financing for a HUD turnkey project. As discussed above, letters of designation did not constitute a commitment of government financing and, should not have been relied on for that purpose by PMM. Documentation evidencing a legally binding commitment of governmental financing rarely existed prior to the reporting of income by Stirling Homex.

In several instances Stirling Homex obtained from the LHA contracts of sale on which the required HUD signature evidencing that funds had been authorized and reserved for the purchase of the development was missing. Absent such signature, there was no assurance that the project was eligible for financial assistance, that the funds had been properly authorized or that funds had been reserved by the government and were available to effect payment and performance by the purchaser LHA.[76] Despite the fact that these documents should have been recognized as being incomplete, PMM's personnel relied on the oral representations of Stirling Homex management that in practical effect financing had been committed to these projects. In the Commission's view this reliance was improper.

Similarly, PMM's personnel relied on the

* See Accounting Series Release No. 174 issued today by the Commission with respect to the activities of HKF.

[76] In some cases, Stirling Homex did not actually have a letter of designation but only a preliminary, nonbinding letter of intent.

representations of management and an opinion of outside counsel expert in FHA matters furnished by management that letters of feasibility in practice represented financing commitments by the FHA. Although a feasibility letter was an important first step in obtaining FHA financing and indicated a strong interest in the project, feasibility letters in general, and the feasibility letters involved here in particular, were subject to specified conditions and, in the Commission's view, they did not represent a binding commitment of funds for the project for income recognition purposes.

The obtaining of a commitment of funding was an especially serious matter since the LHAs and other nonprofit entities doing business with Stirling Homex were without financial resources and any agreements they entered into with Stirling Homex required financial backing of the Federal government. However, the auditors did not adequately familiarize themselves with the governmental housing programs despite their lack of prior experience with these programs and did not contact any Federal agency in order to verify the existence of commitments to finance the housing projects involved. The auditors' assumption that the LHAs would not enter into agreements with Stirling Homex without reasonable assurance of government financing was, in the Commission's view, unwarranted.

PMM's peronnnel relied on management-prepared schedules and workpapers, including computer runs of module assignment to projects, without adequate independent verification of their accuracy. As it turned out such schedules were essentially meaningless unless a final site plan for the project existed. Such a site plan did not exist in many cases. They did not perform the extended audit steps which the Commission believes were called for with respect to the accounts receivable resulting from the improper and premature recording of module sales from periods preceding its engagement by Stirling Homex, carried on the books of Stirling Homex as unbilled accounts receivable.

In the Commission's opinion, the confirmation procedure used by PMM with respect to unbilled receivables was inadequate. The confirmations which were sent to the LHA's sought, for the most part only confirmation of the existence of a letter of designation or contract and the basic terms of the agreement, *i.e.*, the number of housing units and price. In the Commission's view, information on the status of the project should also have been sought from the LHA's and, although it was perhaps reasonable to assume that an LHA would not confirm a project unless governmental funding was in fact available, the confirmations should have specifically requested confirmation of a funding commitment.

The Commission also believes that the handling of the confirmations by the audit staff was faulty in that they failed to take extended audit steps to evaluate the significance of remarks written on certain of the confirmations or deviations from normal confirmation practices, such as, in one case, the return of a confirmation to the company rather than to the auditors.

February 28, 1971 Audit

Listed below is a schedule of projects for which Stirling Homex, in the Commission's view, improperly recorded sales during the seven months ended February 28, 1971.

	Module Sales	Percent Total Sales
Portland Project	$ 569,200	4.5
Rochester	1,200,400	9.5
Ithaca	721,600	5.7
Washington, D. C.	678,400	5.4
Mississippi GGC	7,916,000	62.8
Additional sales recognized on projects previously recorded in the 1970 fiscal year	2,522,400	12.1
	$12,608,000	100.0

(a) *Mississippi GGC Project*

This project accounted for 62.8% of the module revenue reported for the seven-month period ended February 28, 1971 and

represented over 44% of the total revenue reported for the period.

In December, 1970, Stirling Homex entered into a contract (subsequently amended) with the Mississippi Greater Gulf Coast Housing Development Corp. ("GGC"),[77] a non-profit corporation with no financial substance, for the construction of 800 modular units for $15,000,000 with the funding to be provided by the Farmers Home Administration, an agency of the Department of Agriculture ("Farmers Home").

As evidence of the financing commitment necessary for the inclusion of sales and earnings from this project in the financial statements, PMM's personnel relied on a letter to GGC from Farmers Home dated February 22, 1971 which purported to represent a commitment of government financing for $15 million.[78] This letter was a forged or spurious document on the stationery of Farmers Home.[79] GGC had neither a history of operations, nor any financial substance. Since there was no funding for the project, it should not have been included in sales.

The contract with GGC was subject to agreement on acceptable sites for the projects conditioned upon the approval of the appropriate governmental funding agency and the obtaining of financing from the appropriate governmental funding agency. No site plans or proposed site plans existed. No modules were ever shipped to Mississippi for this project, and the project was never built.

Because of the magnitude and effect on the Stirling Homex financial statements of the sales and earnings of this project, it should have been audited with greater care than PMM exercised.[80] PMM's personnel, without knowing even the general guidelines of the Farmers Home program, accepted their reading of the February 22, 1971 letter and the oral representations of Stirling Homex management at a meeting described below as a sufficient basis to conclude that there was a firm commitment of financing for this project.

On March 19, 1971, three PMM auditors, including the client partner and the SEC reviewing partner, visited the offices of Stirling Homex to discuss with Stirling Homex management problem areas of the audit then being conducted. Among the areas discussed was the absence of evidence of such financing.[81]

At this meeting the management of the Company submitted the $15 million commitment letter for the inspection of the PMM auditors. These auditors requested a copy of the letter for their files, but the management of the Company stated they could not provide one at that time, stating that there was "political reasons" for keeping the letter confidential until local announcements were made by the sponsor of the project. No copy of the letter was subsequently obtained, nor did the auditors make an abstract of its terms or attempt to verify the authenticity of the document through direct communication with the Farmers Home. There was no other documentary support in PMM's workpapers demonstrating a firm commitment of

[77] Although PMM was not aware of this fact, this group was formed at the behest of Stirling Homex solely because of the necessity to have such a corporate vehicle to ostensibly negotiate and contract with Federal agencies for the funding of housing projects.

[78] The limit of funding on any individual Farmers Home project is restricted by statue to $750,000. The Mississippi GGC contract provided that Mississippi GGC had the rights to assign its rights under the contract to one or more non-profit corporations subject to the approvals of the appropriate governmental funding agency involved.

[79] PMM did not know that the document was forged or spurious and it was presented to PMM as representing a commitment of funding by Farmers Home.

[80] The confirmation received by the auditors as of February 28, 1971 in connection with GGC confirmed "a contract dated February 28, 1971 providing for total development and construction cost of fifteen million dollars," whereas in fact the contract for which confirmation was being sought was dated December 28, 1970. Although this was treated as a clerical error (and the July 31, 1971 confirmation subsequently received referred to the appropriate contract date) and we do not suggest that this contract was not in fact validly executed, we nevertheless believe that under the circumstances further inquiry should have been made concerning the date of the contract.

[81] PMM's workpapers contain a notation by a PPM partner stating that absent such financing "the income recognition on the sale of the financed modules could be jeopardized."

financing necessary to justify recording the Mississippi GGC project in sales.

Under the GGC contract the non-profit group was responsible for obtaining 100% financing from a government agency. The financing provision was later modified and U. S. Shelter ("USS"), a wholly-owned subsidiary of Stirling Homex, was to arrange financing and receive a 2% financing fee ($300,000) upon acceptance of this provision by the GGC.

The financing fee of $300,000 was reflected in the Consolidated Statement of Income contained in Stirling Homex's 1971 registration statement. The footnotes to the financial statements disclose that this fee was earned under an agreement with a non-affiliated customer whereby USS had rendered certain services to the customer which included the obtaining of a commitment from a Federal agency for permanent financing of a housing project. This income was improperly recognized. This footnote is false and misleading in that although this agreement, as shown to PMM, was dated February 15, 1971, it was in fact signed in March— after the balance sheet date—and thus the non-affiliated customer had not retained USS's services as of the balance sheet date and as indicated above, USS had not obtained any commitment of permanent financing from a Federal agency nor rendered any other services to this customer.

Although PMM mailed a confirmation to GGC concerning this USS financing fee, the confirmation was not returned. PMM did receive, however, a letter from the GGC's attorney who stated that USS's proposed financing commitment to GGC on February 15, 1971 had been accepted by GGC, but that such fee was subject to certain terms and conditions of the agreement dated February 15, 1971 and that payment of the fee was to be deferred until the date of any loan closings. The letter did not state when the proposed financing agreement had been accepted by GGC.

The auditors had a copy of the February 15, 1971 agreement in their workpapers. They questioned the recognition of income by USS of this fee since there was no indication that USS had obtained any commitment for financing. To profide evidential matter to support this financing fee, PMM obtained from Stirling Homex a copy of an ambiguous letter from Stirling Homex's bank which, stated that the bank had approved an unsecured $15 million line of credit, but also stated that borrowing under the line was to be limited to $3 million outstanding at any one time. Despite the obvious ambiguity in the letter, the auditors did not confirm the commitment's existence or its terms with the bank.

(b) *Rochester, New York Project*

In late 1970, Stirling Homex submitted a proposal to the Rochester Housing Authority ("RHA") to develop a turnkey project of 91 units on four scattered sites for approximately $2.3 million. No contract or agreement was executed for this project. Stirling Homex recorded $1.2 million in modular sales on this project on the basis of a letter of designation from the RHA dated February 26, 1971. These sales constituted a material portion of total sales for the seven-month period.

PMM sent a letter to the RHA requesting confirmation that RHA had accepted Stirling Homex's proposal for the 91 units. The letter was returned to PMM marked correct with an attached copy of the letter of designation for 91 units that the RHA had sent to the Company.

The designation letter, while tentatively designating Stirling Homex as developer of the project, set forth a schedule of events and approvals including site approval by various authorities, negotiation of the ultimate price that would have to be effectuated prior to the execution of a firm contract of sale, and a commitment of Federal assistance in financing the purchase of the projects by the RHA. PMM also obtained from Stirling Homex a copy of a letter dated February 26, 1971 to the RHA from the Area Director of HUD which authorized the RHA to designate Stirling Homex as the turnkey developer of the project, subject to the RHA's letter of designation containing the phrase "subject to site approval by the City of Rochester."

The auditors established no procedures to monitor the accomplishment of the events outlined in the designation letter. The var-

ious problems of rezoning, adequate sewage systems, and local governmental approvals were never resolved. The proposed Rochester sites were found unacceptable by HUD and the project was never constructed.

There was no legally binding contract in effect between the RHA and HUD or other evidence of financial commitment for this project. Therefore, sales and income in this project should not have been recognized.

(c) Washington, D. C. Project

A proposal was made to the National Capital Housing Authority ("NCHA") in the fall of 1970, to develop this turnkey project which would consist of 51 dwelling units for a proposed purchase price of $1,217,640. No contract was obtained by Stirling Homex on this project at any time. For the seven month period ended February 28, 1971 Stirling Homex recorded modular sales of $678,400 for the project.

PMM work papers contain only three documents to support recognition of $678,400 of module revenues on this project. One document was a copy of an undated letter proposing two possible housing developments to the NCHA. Another was a letter dated February 26, 1971 from the NCHA to Stirling Homex informing the Company that it had been selected as the turnkey developer for a particular site and additionally informing the Company that approval by the community as well as by the Board of Directors of the District of Columbia Redevelopment Land Agency ("RLA") was required for the development.

The third letter from the RLA, also dated February 26, 1971, indicated that the RLA approved the selection of Stirling Homex as the developer of the site but that final approval could only be given after public hearings before the RLA's Board of Directors. No audit procedures were undertaken by the staff of PMM to determine whether the required approval was ever obtained for this development.

A letter, dated March 12, 1971, was sent to the NCHA by PMM requesting that they confirm the acceptance of the Company's proposal for a 51 dwelling unit housing development. This letter was returned to PMM signed by an official of the NCHA indicating the information was essentially correct. A typewritten note on the returned NCHA confirmation informed PMM that: "Before the proposal is finalized the Authority, RLA and the HUD Regional Office must review and approve construction and financial details." [82]

The Commission believes that, in the circumstances, there did not exist evidence of a commitment by NCHA to purchase the housing units, or a commitment by HUD to finance the project and this income should not have been recognized.

(d) *Portland, Main Project*

At the time of income recognition, there was no firm commitment of funding for this project although a subsequent commitment was later obtained in July of 1971 and the project was completed. PMM received from Stirling Homex a copy of a turnkey agreement dated January 28, 1971 entered into by Stirling Homex and the Portland Housing Authority ("PHA") for the sale of a 50 dwelling unit housing development for $1,280,662. Stirling Homex included in sales $569,200 from this project. There was no funding for this project identified in the space provided in the contract. Further, the agreement was not signed by HUD. Consequently, there was no evidence of a legally binding commitment of federal monies to fund the purchase of the project at the time of the completion of the audit field work.

As late as June 25, 1971 Stirling Homex, PHA and HUD were still negotiating over price and specifications for the project, and it was not until July 22, 1971 that a firm contract was executed by the PHA, HUD and Stirling Homex.

(e) *Ithaca, New York Project*

PMM obtained from the Company as evidence that a contract of sale existed a document dated March 3, 1971 by which the Ithaca Housing Authority ("IHA") contracted to purchase from Stirling Homex a completed housing development consisting of 54 dwelling units for $1,233,050. Although the development was to be purchased and funded

[82] In connection with the July 1971 audit, the confirmation return did not contain any such typewritten note.

under the turnkey program of HUD, no turnkey contract in the required HUD form was executed. There was no formal commitment of Federal funding as of the February 28, 1971 period although a formal commitment was subsequently obtained and the project was completed. Sales of $721,600 from this project were included—improperly in the Commission's view—for the February 28, 1971 period.

(f) *Accounts Receivable at February 28, 1971*

In addition to the newly recognized sales during the period under audit, Stirling Homex carried a substantial amount of accounts receivable and cost overruns on projects recorded as sales during the 1970 fiscal year, which were also audited by PMM during its audit of the seven-month period. Listed below are some of the projects and the amounts of the accounts receivable which the Commission believes were improperly recorded as of February 28, 1971:

Project	Accounts Receivable
Hillwood, Akron	$4,470,000[83]
Highland, Akron	3,352,020
Bridgeport Street, Worcester	329,500
Providence Road, Worcester	416,100
Bird and Pearl, Erie	1,283,000
Pittsburgh, Erie	444,400
Grandview, Erie	1,174,600
North Street, Worcester	469,000

All the above accounts receivable recorded on Stirling Homex's financial statements as of February 28, 1971 were recorded, although in several instances in substantially smaller amounts, during the 1970 fiscal year of Stirling Homex ended July 31, 1970. The delays in payments and progress on these projects had continued as of February 28, 1971 and should have prompted extended audit procedures.

With certain exceptions, these projects were in essentially the same posture as they were in the prior fiscal year in that there had been little installation work accomplished, no money collected and no formal commitment of funds by any government agency.[84] The terms of some of the agreements themselves, had expired, such as the 120 day completion clause. All of these projects were HUD turnkey projects. The supporting agreements were not executed by HUD and therefore not backed by a funding commitment.

During the audit, PMM's personnel learned that the proposed site for the Bridgeport project had to be abandoned. They received the following statement on a returned confirmation from the Worcester Housing Authority that referred to Stirling Homex's dealings with them on the Bridgeport project:

> "In July 1970 this Authority and Kabeth Properties, Inc. were in the process of negotiating a contract for the purchase of 25 units to be erected on Bridgport Street in Worcester, Massachusetts for the sum of approximately $563,350.00. Because of problems involving site location, the proposed site had to be abandoned. At the present time, the Authority is awaiting submission by Kabath Properties, Inc. of a set of contract documents for approximately the same number of units on a suitable site in Worcester, Massachusetts."

July 31, 1974 Audit

Listed below is a schedule of projects for which the Commission believes Stirling Homex improperly recorded sales during the fiscal year ended July 31, 1971:

[83] Stirling Homex recorded accounts receivable of $6,818,000 during this period on this project against which $2,348,000 was purportedly received by the Company, leaving a net receivable of $4,470,000. In fact the $2,348,000 which related to three other Akron projects was erroneously applied to this receivable and the figure should have been $6,818,000.

[84] The Providence Road, Bird & Pearl Street and North Street projects representing approximately $2,170,000 out of a total accounts reveivable figure at February 28, 1971 of $26,960,000 were paid for prior to July 31, 1971. However, cost overruns on the projects accumulated in excess of $326,000 upon completion.

	Module Sales	Percent Total Sales
Rochester	$1,200,400	4.1
Washington, D. C.	678,000	2.3
Mississippi GGC	8.520,000	28.9
St. Thomas, V. I.	1,360,000	4.6
St Croix, V. I.	1,360,000	4.6
Clay	1,951,000	6.6
Morgantown	2,418,000	8.2
Stanley Simon	6,282,500	21.3
Grandview	317,600	1.1
Hillwood	86,800	0.3
Highland	1,118,000	3.8
	$25,292,600	85.8
Total Sales	$29,482,271	

(a) *Virgin Islands Projects*

The documentation in PMM's workpapers for the two projects was identical and the contracting entity was the same, Quantum Development Corporation ("Quantum"), a non-profit corporation sponsoring the housing development pursuant to the FHA's Section 236 program.

The earliest dated contracts were purchase agreements executed September 22, 1970. The terms of purchase agreements called for the sale of 200 dwelling units for a total purchase price of $2,720,000 for each of the locations. Stirling Homex was to pay for the shipment of the modules to their respective locations and only to supervise their installation.

PMM's workpapers also contained a feasibility letter dated January 8, 1971 addressed to the Virgin Islands Foundation for Housing and Economic Development ("VIFHED") St. Croix, Virgin Islands. This letter had an expiration date of 30 days and had not been renewed. PMM's personnel did not know of any relationship between the VIPHED and Quantum, nor did they do any follow-up procedures to determine whether the feasibility letter had been renewed.

A second agreement between Quantum and Stirling Homex, dated June 1, 1971, was also in PMM's workpapers. This purchase agreement called for the purchase by Quantum of 100 dwelling units for a price of $1,360,000 for each of the two sites or a total of $2,720,000 for 200 dwelling units. According to the terms of this contract, payment was to be in the form of an irrevocable letter of credit to be issued by the First Pennsylvania Trust Company of Philadelphia. Other conditions set forth in the agreement were:

(1) Approval of the modules by the FHA;

(2) Payment was to be made on the issuance of an appropriate bill of lading; and

(3) The modules were to be constructed in accordance with the plans and specifications.

The workpapers of PMM indicate that reliance for the commitment to fund the project was placed on the expired feasibility letter and on oral representations by the Company that a bank letter of credit had been furnished to Stirling Homex. In fact, a letter of credit had not been obtained by Stirling Homex at the time of PMM's audit and neither this letter of credit nor other financing was subsequently obtained.

On July 31, 1971, PMM sent a confirmation to Quantum to confirm information concerning its contract with Stirling Homex dated September 22, 1970 of 400 dwelling units for $5,400,000 with the terms of payment 10% of the units upon approval and acceptance of plans and specifications by mortgagee and the balance upon acceptance of modules at the factory. The confirmation was returned marked incorrect and there was a letter attached which said there was a new contract dated June 1, 1971 for 200 dwelling units at $2,720,000. In addition, the letter indicated that 10% of the contract price was to be paid upon approval and acceptance of the plans by the mortgagee and the balance upon acceptance of the modules at Stirling Homex's plant.

Moreover, in a note to its workpapers in the July, 1971 audit, PMM indicated the following as to this project:

> "FHA financing being processed by the LHA there so Stirling does not keep up on their progress. Stirling and PMM are relying on the bank letter of credit for the credibility of financing monies."

(b) *Clay, New York Project*

This project involved an application with

FHA under a Section 236 program of 150 dwelling units for a total price of approximately $3.5 million. The applicant on the project for which Stirling Homex was to be the builder was Clay Development Corp. ("Clay"), a wholly-owned Stirling Homex subsidiary. Clay, in turn, had an agreement with a non-profit sponsor under which the project would be purchased by the sponsor upon completion. In the closing days of the 1971 fiscal year, Stirling Homex recorded about $2 million of modular sales on this project.

Sales were recognized on the basis of a feasibility letter dated July 30, 1971 from the FHA. The letter by its terms specified that its issuance was subject to receipt of an allocation of Federal funds. Further, the letter indicated that prior to the commencement of subsequent processing, a municipal tax abatement for the project would be required. Thus, the letter did not evidence a firm commitment of financing. Had they extended their audit procedures, the auditors could have discovered that no commitment of federal funds had been made.

Additionally the purported arrangement between Clay and the non-profit sponsor for the resale of the project was a sham.[85] Therefore the purported sale was only to Clay, a wholly-owned subsidiary of Stirling Homex. As such it should have been reflected in the financial statements as a sale to an affiliated company.

(c) *Morgantown, West Virginia Project*

This project involved an application with FHA under Section 236 for 200 units for a total price of approximately $4.3 million. During the fourth quarter of the 1971 fiscal year ended July 31, 1971, Stirling Homex recorded approximately $2.5 million of modular sales on this project, using as a basis for evidence of firm commitment of financing on the project a letter dated July 30, 1971 from the FHA to Aquarius Development Corp. ("Aquarius"), a wholly-owned subsidiary of Stirling Homex. The project was the result of a contract between Aquarius and a non-profit entity.

The letter, while cast in the form of a feasibility letter, was in fact merely an offer to Aquarius to submit a revised application for a feasibility letter. It was not a firm commitment of financing and the Commission believes should not have been relied on as evidence of such a commitment. The modules that were supposedly manufactured for this project were structurally unsuitable because they were over two feet short of the required length. This proposed project was later abandoned for this reason and because of inability to obtain financing.

Moreover, as in the case of the Clay project, the purported agreement to sell the project to a non-profit sponsor was a sham.

(d) *Stanley Simon Project*

In the 1971 fiscal year ended July 31, 1971 modular manufacturing sales of nearly $6.3 million were recorded on this project on the basis of an agreement dated April 23, 1971 between Stirling Homex and Stanley Simon and Associates ("Simon") acting on its behalf and behalf of limited partnerships to be formed in the future. The agreement provided for the purchase of 1,000 modules at $11,000 per module for a total price of $11,000,000. It called for a $25,000 down payment on each site with the projects to be financed conventionally rather than through government programs. Each site for the modules was to be approved by both parties. For the most part, there was no commitment of financing on the project and there was no assurance that Simon would be able to arrange such financing.[86] In early July, 1971 Stanley Simon and Stirling Homex began drafting a contract to cover the 1,000 module units pursuant to the terms set forth in the

[85] The non-profit sponsor for the project in fact had withdrawn at the time of the July 1971 audit. PMM was not aware of this fact.

[86] The only evidence that was submitted to PMM that any permanent financing had been obtained, was a commitment dated July 19, 1971 by the Dime Savings Bank of Williamsburg ("DSBW") to make a first mortgage loan in the amount of $825,000 for a 112 unit development to be constructed in Utica, New York. The commitment by the DSBW was short in the amount of $283,000 required to make up the full sale price ($1,232,000). As for the remaining module sales reported as attributable to the Simon contract, no revenues should have been recognized because of the lack of evidence of permanent financing.

April 23rd letter of understanding but this contract was never finalized.

During the July 31, 1971 audit, PMM's personnel realized that a firm commitment of financing was unavailable inasmuch as they specifically noted in their workpapers that financing for this project was "pending". The review notes compiled by the PMM audit manager indicate that as late as September 23, 1971, subsequent to the date of PMM's report, PMM should "obtain proof of 100% permanent financing."

A PMM partner was aware that financing was not commited for the sales recorded on the Simon project by the close of the 1971 fiscal year and not obtained during the audit period. He was not concerned with the absence of any firm commitment because he relied on the reputation of Simon personally and the fact that Simon was known to be a man of considerable wealth. The partner felt that this was sufficient reason to permit income recognition on the project.

(e) *Stirling Homex Accounts Receivable as of July 31, 1971*

Receivables associated with revenues recorded in fiscal 1970 on many of the projects discussed above were still carried as receivables at the end of fiscal 1971.[87] There is evidence in the PMM workpapers that there were substantial problems with respect to many of these projects. The Commission believes that PMM failed to take adequate audit steps to assess the significance of these problems, relying on optimistic representations of Stirling Homex management which were received in response to the auditors' inquiries.

Listed below are several examples:

(1) *Pittsburgh Project Receivable of $444,-000.* PMM was informed by Stirling Homex that HUD had expressed reservations about the project site and Stirling Homex had indicated it could substitute another site if necessary. There is no indication that PMM examined any correspondence or other documentary support for this statement by management.

(2) *Washington Project Receivable of $678,-400.* PMM was informed during the 1971 fiscal year audit of the substantial delays being experienced with respect to this project because of the necessity of obtaining numerous approvals.

(3) *Grandview, Erie Project Receivable of $1,269,600.* During the 1971 fiscal year this project was substituted for the 37th and Tuttle Street Project in Erie, Pennsylvania, on which sales were recorded during Stirling Homex's 1970 fiscal year pursuant to an agreement with the LHA. As noted in their workpapers, the auditors were aware of the "political and community entanglements" being experienced by Stirling Homex.

(4) *Bridgeport Project Receivable of $329,-500.* PMM knew that this receivable was troublesome because no new replacement site had been located for the previously abandoned site and any replacement site was subject to HUD's approval.

(5) *Mississippi GGC Receivable of $8,520,-400.* PMM learned during the 1971 fiscal year audit that Stirling Homex was making application and seeking approval for several sites through the Farmers Home. PMM learned that a $750,000 "prototype" project proposal for 50 out of the 800 units had not received final approval by the time the audit was being performed.[88] Moreover, the modules had not been shipped to Mississippi.

(6) *Hillwood Project Receivable of $7,240,-000.* This project, which had been carried as a receivable by Stirling Homex since October of 1969, had almost no site work accomplished and was encountering zoning problems. Stirling Homex had reduced the number of modules for this project. Despite the size and age of this proposed project PMM took no extended audit steps with respect thereto.

(7) *Highland Project Receivable of $3,352,-000.* At the close of the 1971 fiscal year of Stirling Homex, there had been no progress

[87] Approximately $36,400,000 of accounts receivable out of $37,850,000 total accounts receivable were improperly included as assets.

[88] In fact, by the time of the PMM audit, the project had been rejected by the Farmers Home. This was not known to PMM.

on this project even though it was a large receivable and had been recorded in the 1970 fiscal year of Stirling Homex. The project site had been switched from the Highland Street, Akron location to a completely different site in East Barberton, Ohio. The sales that had supposedly represented the Highland project were not reversed on this project but merely switched to the Barberton Project. However, in October of 1971, Stirling Homex entered into an entirely new contract of sale which was approved by HUD and the project was ultimately completed and paid for.

Cost Overruns on Stirling Homex Projects

By the close of its 1971 fiscal year, Stirling Homex had incurred over $1 million of cost overruns on various projects, which were carried on its books as receivables. Further, Stirling Homex carried an additional $1,000,000 of cost overruns as Contracts in Progress.[89] These cost overruns represented additional costs incurred by Stirling Homex in excess of that portion of the contract price allocated to installation sales, which additional costs had not been and were not reimbursable under the terms of the applicable contracts. The existence of these cost overruns was not properly accounted for in Stirling Homex's financial statements nor disclosed in the accompanying footnotes.

Despite the unusual nature and size of these cost overruns PMM did not undertake adequate audit steps in that it failed to obtain reliable support for their collectibility.

Subsequent Discovery of Improper Business Activities

After being shown Stirling Homex's Form 10-Q for the period ended October 30, 1971, PMM personnel learned that the $2,720,000 in modular sales for the Thomasville and St. Croix projects had been reversed, that the modules had been reassigned to another project and that these facts were not publicly known. The Company advised PMM that this was an unusual nonrecurring transaction occasioned by events which took place after July 31, 1971.

Even though PMM personnel knew of these reversals and their possible effect on the audited financial statement for the July 31, 1971 period, they failed to follow auditing procedures that should be complied with in such circumstances to determine whether these reversals required modification or withdrawal of PMM's report on the July 31, 1971 financial statements.[90]

During March of 1972, PMM objected to the Company's recognition of a very large amount of income on two newly begun projects involving private financing. As a consequence, income from these projects was not reflected in Stirling Homex's financial statements for the period and the Company reported a substantial loss from operations for the quarter.[91]

In May of 1972, PMM auditors were told by management that Stirling Homex's financial condition was deteriorating rapidly and that it would report a $20 million loss for the nine months ended April 30, 1972, including sub-

[89] Stirling Homex improperly classified as an asset certain costs and expenses amounting to approximately $832,000 for the seven months ended February 28, 1971 and $1 million for the fiscal year ended July 31, 1971 which related to the construction of a proposed Mississippi plant to be financed by a $5 million industrial bond offering. This classification permitted these amounts to be capitalized rather than expensed during the period in which they were incurred, and resulted in an overstatement of net income for said periods. PMM's acceptance of this classification was inappropriate in that reimbursement was unlikely under the terms of the trust indenture, a substantial portion of the expenses were general and administrative expenses, and the reimbursement of the $1 million in intangible expenses from the offering proceeds was highly unlikely since they represented 20% of the total proceeds. Stirling Homex incurred these cost overruns because of delays caused by Stirling Homex's premature manufacture of modules, which were in large part motivated by the Company's income recognition policies. These delays caused increased expense such as storage costs, module refurbishment, and dissatisfaction with the Stirling Homex product by some customers.

[90] See Statement on Auditing Standards 1 at Sections 561.01 ff. ("Subsequent Discovery of Facts Existing at the Date of the Auditor's Report").

[91] This announcement started the chain of events which led to the ultimate bankruptcy of the Company in July 1972.

stantial charges against income for the period resulting from a reductiion in the sales price of modules on certain projects upon which revenue had been recognized in prior fiscal periods, a provision for the repair and refurbishing of 10,000 uninstalled modules in storage areas of the company, a provision for estimated additional costs of construction on the Stanley Simon Project, a provision for doubtful accounts with respect to the cost overruns which were included in accounts receivable and a provision for various overrun costs incurred in connection with the construction of several projects.

The auditors were completely "dumbstruck" by this recital by Stirling Homex management. They failed to undertake any review or investigation to ascertain whether the newly discovered facts existed at the date of their report on Stirling Homex's financial statements. Due to the nature of these extraordinary charges, it should have been clear to them that the previous financial statements of Stirling Homex were seriously deficient.

Statements to the Commission Staff

On July 7, 1971 a meeting was held at the Commission in connection with the then pending registration statement of Stirling Homex to discuss the Division of Corporation Finance's letter of comments. Present at this meeting were representatives of Stirling Homex, its outside counsel, underwriters and partners of PMM.

The meeting began with a general discussion concerning the staff's letter of comments.[92] Then a more particularized discussion took place concerning Stirling Homex's income recognition policies, with the client partner of PMM asking whether the staff of the Commission desired Stirling Homex to recognize on the completed contract method. He questioned this method and stated that under the circumstances this method would not be in accord with generally accepted accounting principles.

The PMM partner stated that the real question was not a matter of mechanical application of accounting theory but rather at what point in time sales should be recognized and what event should have transpired prior to recognition. He then outlined four events that had occurred prior to recognition of income by Stirling Homex, which in effect, would remove any credit risk. The most important of these events that he outlined was that there was a commitment of permanent financing to purchase the project.

A number of statements by the partner were largely inaccurate. Very few of Stirling Homex's projects were covered by permanent financing. Had he made appropriate verification during the earlier audit period or prior to the Commission meeting, he would have known that these statements were not true.

The oral statements of the partner were subsequently confirmed in the supplemental submission submitted by Stirling Homex in July 1971. The purpose of this submission was to outline Stirling Homex income recognition policies for the staff of the Commission in an attempt to dissuade the staff from insisting on the completed contract method of income recognition.[93]

It contained numerous false statements, including misrepresentations concerning the turnkey and other government programs as utilized by Stirling Homex and the fact that Stirling Homex had fulfilled certain conditions precedent before including its projects in sales.

CONCLUSIONS

As illustrated above, the Commission be-

[92] One of the matters under discussion was a certain land sale. PMM originally advised Stirling Homex that the transaction as originally structured would not, in its opinion, qualify for income recognition but indicated that if the transaction were restructured to bring it within the real estate guidelines then being applied generally by PMM, income would properly be recorded. The transaction was then restructured along the lines advised by PMM, and PMM gave its opinion to Stirling Homex management that income could be recognized. During the meeting the Commission's Division of Corporation Finance indicated its disagreement with PMM's views and the sale was reversed.

[93] These elements are substantially the same elements discussed in connection with Stirling Homex's accounting methods. See discussion above.

lieves that PMM failed in a number of material respects to conduct the February 28, 1971 and July 31, 1971 audit engagements in accordance with generally accepted auditing standards.

Valuable lessons can be derived from PMM's conduct, which, if focused upon, will hopefully prevent similar occurrences in the future. The facts of this case suggest that for a new and unknown client, some independent investigation should be made of the company, its customers and methods of doing business. When a client extensively utilizes government programs and contracts, it is expected that the auditors will have a thorough and complete familiarity with the programs.

In addition, care should be given to the organization of the "audit team" so that responsibilities are clearly defined. With respect to the Stirling Homex audit, the presence of two partners operating out of different offices supervising the same audit work gave rise to a situation where important decisions were deferred and the division of responsibility was not clear. As a result, it was difficult to coordinate effective control over the audit and the decision making process with respect thereto. This situation permitted vacillation on major decisions which ultimately were never satisfactorily resolved by either partner.

During the audit of Stirling Homex, the SEC review by PMM's SEC reviewing partner was superficial although the audit was one where it had been determined that an "in depth" review was required.

A successor auditing firm should review the working papers of the predecessor auditors. Such review should cover critical audit areas and unusual accounting matters. It should also cover disagreements between the predecessor auditors and management, whether or not they are satisfactorily resolved, which relate to accounting principles, auditing procedures, and the predecessor's understanding regarding the reasons for the change of auditors. Further, successor auditors should always be alert to factors bearing on the integrity of management.

A major deficiency of the Stirling Homex audit was PMM's reliance on the unsupported, undocumented representations of management. An auditor should not rely solely on the representations of management, but satisfy themselves as to such matters by other means consistent with the circumstances of the particular transaction, such as independent documentary verification.

Auditors should be wary when sales and income are sought to be recognized on the basis of assumptions and projections as to future events necessary for the ultimate realization of such income. In this case, sales and income were recognized on government financial housing projects at an early stage in the processing of the projects and at a point where the essential commitment of government financing was not in existence and where the projects were still subject to a variety of conditions such as the politically explosive issue of site selection of low income housing. The auditors, in part because of their unfamilarity with government housing programs, accepted optimistic and in some cases deceitful representations of the company and others regarding the programs and projects in question. The Commission believes that in cases such as these where income recognition occurs well before the point at which the customer is normally billed, auditors should exercise a high degree of caution and skepticism.

Also we believe that auditors have a duty to disclose subsequently acquired information which existed at the date of the auditor's report and establishes that previously reported upon financial statements are materially false and misleading. On two occasions during the 1972 Stirling Homex fiscal year, PMM learned information, which if PMM had investigated as they should have, would have disclosed to PMM that earlier prepared financial statements of Stirling Homex were materially false.

Finally, it must be noted that the statements made by the PMM partner to the Commission staff in connection with discussions of the Stirling Homex registration statement constitute unacceptable professional behavior in practice before the Commission. Independent professional accountants should not act as advocates on behalf

of their clients before the Commission, especially when the accountant is making factual statements about a particular client's business which have not been verified. As the Commission recently stated:

> "The Commission and its staff do not and cannot investigate representations made to it, but must be able to rely on their completeness if this process is to work. The objectives of the securities laws can only be achieved when those professionals who practice before the Commission, both lawyers and accountants, act in a manner consistent with their responsibilities. Professionals involved in the disclosure process are in a very real sense the representatives of the investing public served by the Commission, and, as a result their dealings with the Commission and its staff must be permeated with candor and full disclosure. It cannot resemble an adversary relationship more appropriate to litigants in court, because the Commission is not an adverse party in this context. All who are familiar with the Commission's policies know that too much importance is attached to the word of the professional, to permit his or her word to become the subject of question. A professional's word is often the functional equivalent of his or her reputation. Conferences with the staff of the Commission serve a vital role in the administration of the securities laws, and such conferences are predicted, for the most part, upon full disclosure by the professionals involved. It must be understood by all who practice before the Commission, lawyers and accountants alike, that the Commission and its staff cannot tolerate less than full disclosure." [94]

* * *

CONCLUSION

As contemplated by PMM's offer of settlement, PMM has agreed to an investigation into the manner in which it conducts its audit practice with respect to clients whose financial statements, reported upon by PMM are filed with the Commission. That comprehensive examination is to be carried out by a committee whose compensation and expenses will be borne by PMM. Members of the committee will be agreed upon by PMM and the staff of the Commission. The nature and scope of the examination is outlined in a memorandum addressed to the committee which has been agreed upon by the Commission and PMM and which is annexed to the offer of settlement. It is contemplated that the examination can be completed and the report of the committee submitted to the Commission within approximately six months. PMM also has agreed to the entry of an order by the Commission requiring it to adopt and implement any reasonable recommendations the committee may make with respect to PMM's SEC audit practice and procedures.[95] The offer of settlement also contemplates that two annual reviews of PMM's audit practice, will be conducted in 1976 and 1977 at firm expense, and the results of these reviews will be reported to the Commission and PMM.[96]

PMM has agreed to the entry of an order by the Commission prohibiting it from accepting audit engagements for new SEC clients for the six-month period beginning on May 1, 1975 and terminating on October 31, 1975. During that period, with certain exceptions, PMM will not accept or negotiate for the acceptance of new SEC clients.[97] This six-

[94] See *In the Matter of Arthur Andersen*, ASR No. 157, Exchange Act Release No. 10906.

[95] In the event that PMM demonstrates to the satisfaction of the Commission that a recommendation of the committee is not reasonable or need not be implemented either in the form recommended or with reasonable modifications, then it has been agreed that such recommendation need not be adopted.

[96] Since it is contemplated by all concerned that this examination and two subsequent reviews are designed to serve the purposes embodied within Rule 407 of the Federal Rules of Evidence, the parties have agreed to an order which the court has entered requiring that the details of the examination and reviews, the working papers and other documentation other than the reports of the committee and the reviewers and the deliberations of the committee and reviewers are to be held confidential.

[97] For the six-month period from May 1, 1975 through October 31, 1975, PMM has not accepted and will not accept audit engagements from new audit clients which contemplate the issuance by PMM of an auditor's opin-

month restriction does not affect in any way PMM's ability to service its existing clients nor does it affect other aspects of PMM's practice such as tax and management consulting.

PMM has also agreed to the entry of final judgments of permanent injunction in each of the four injunctive actions the Commission has instituted against the firm. These injunctions, among other things, prohibit the firm from engaging in specified violations of the federal securities laws with respect to the financial statements of the companies that gave rise to these proceedings. One of the injunctions formalizes certain PMM procedures and requires that they be followed with respect to accepting new audit clients generally and special procedures when a new engagement follows a resignation by a predecessor auditor which has resulted in the filing of a Form 8-K with the Commission reflecting identified professional disagreements between the predecessor auditor and the client.

Further, PMM has agreed to revise and implement certain procedures with respect to (i) its existing preissuance review of reports by a second partner not otherwise associated with the engagement in that the second partner will evaluate the appropriateness of financial statement disclosures and the accountants' report relating to material discussed in the engagement partner's memorandum; that memorandum which will be prepared following a review of the working papers, and will identify and discuss the critical audit areas and unusual accounting matters encountered during the course of the audit; (ii) its existing review by a second partner of specified types of engagements which will include an in depth review of the appropriateness of judgments and the working papers in the critical audit areas and unusual accounting matters, and (iii) ascertaining that engagement partners or, if necessary, others associated with them are adequately informed with respect to any unusual or abnormal practices peculiar to the industry and circumstances involved in the engagement. PMM has also agreed to conduct a study of the use of the percentage of completion method of accounting and to establish guidelines in this area for its audit practice, which guidelines are to be applied in the conduct of its audits for fiscal years beginning on or after December 27, 1975. The procedures and the study and the implementation thereof, including the guidelines, are the subject of this order as set forth below.

In determining to accept PMM's settlement offer, we have taken into account the fact that these controversies relate to audit engagements for five clients out of a large number of audit engagements conducted by PMM over the years in question going back to 1968, and that, based upon information submitted by PMM and otherwise known to us, their overall audit practice appears to be conducted in a competent and professional manner. Moreover, we believe that the provisions of the settlement offer will provide PMM and the Commission with independent assurance of the quality of PMM's audit practice before the Commission. While the Commission continues to retain jurisdiction over this proceeding, this settlement resolves these existing disputes between PMM and the Commission.

For the foregoing reasons, it is hereby

ORDERED,

1. This proceeding under Rule 2(e) of the Commission's Rules of Practice is instituted. PMM's offer of settlement, dated June 5, 1975, is hereby accepted.

2. An investigation will be made of the

ion, in respect of financial statements which it is expected by PMM will be filed with the Commission within the next succeeding twelve-month period. Such limitation shall not include an audit client (i) in which a significant equity or debt interest is held or acquired by a present client of PMM, (ii) for which PMM has provided professional services since January 1, 1974 and prior to May 1, 1975, (iii) which is controlled by a foreign entity provided the financial statements of the client are not separately filed with the Commission, (iv) which is a client or a subsidiary or division of a client of a foreign affiliated firm of PMM, (v) which since July 1, 1974 and prior to May 1, 1975 has communicated with PMM concerning the possible engagement of PMM as its auditor (the Commission having been advised of the number of such instances), or (vi) if its acceptance by PMM as an audit client is approved in the particular circumstances by the Chief Accountant of the Commission.

manner in which the audit practice of PMM is conducted with respect to audit clients whose financial statements reported upon by PMM are filed with the Commission.

a. That examination will be carried out by a committee (the "Committee") whose compensation and expenses will be borne by PMM. The members of the Committee will be chosen by PMM from a list of persons acceptable to the staff of the Commission.

b. The joint understanding of the Commission and of PMM concerning the examination is outlined in a memorandum addressed to the Committee. The memorandum is Annex B to PMM's offer of settlement.

c. It is contemplated by the Commission and by PMM that the examination can be completed and the report of the Committee submitted within six months.

d. PMM will promptly take all steps reasonably necessary and appropriate to adopt and implement any reasonable recommendations the Committee may make with respect to the manner in which such audit practice is conducted, provided, however, that, if PMM demonstrates to the satisfaction of the Commission that a recommendation of the Committee is not reasonable or need not be implemented either in the form recommended or with reasonable modifications, such recommendation need not be adopted.

e. The contents of the investigation, the working papers and other documentation (except the Committee's report) and the deliberations of the Committee will be held confidential except from PMM and the Commission.

3. PMM will promptly take all steps reasonably necessary and appropriate to adopt and implement the procedures contained in Annex C to PMM's offer of settlement. PMM will notify the Chief Accountant of the Commission prior to any amendment of such procedures within the next five years.

4. PMM will conduct a study of the use of the percentage of completion method of accounting and establish guidelines in this area for its audit practice, which will be applied in the conduct of its audits for fiscal years beginning on or after December 27, 1975.

5. For the six-month period from May 1, 1975 through October 31, 1975, PMM has not accepted and will not accept audit engagements from new audit clients which contemplate the issuance by PMM of an auditor's opinion, in respect of financial statements which it is expected by PMM will be filed with the Commission within the next succeeding twelve-month period. Such limitation shall not include an audit client (i) in which a significant equity or debt interest is held or acquired by a present client of PMM, (ii) for which PMM has provided professional services since January 1, 1974 and prior to May 1, 1975, (iii) which is controlled by a foreign entity provided the financial statements of the client are not separately filed with the Commission, (iv) which is a client or a subsidiary or a division of a client of a foreign affiliated firm of PMM, (v) which since July 1, 1974 and prior to May 1, 1975 has communicated with PMM concerning the possible engagement of PMM as its auditor (the Commission having been advised of the number of such instances), or (vi) if its acceptance by PMM as an audit client is approved in the particular circumstances by the Chief Accountant of the Commission.

6. A review will be conducted in 1976 and in 1977 at PMM's expense of the matters considered under the AICPA program for the review of quality control procedures of multioffice firms and to determine whether PMM has taken all steps reasonably necessary and appropriate to adopt and implement the procedures described in Annex C to PMM's offer of settlement and any recommendation of the Committee (subject to the proviso stated in paragraph 2.d.).

a. Each review will be conducted by a panel operating under the AICPA program, or (if such a panel is not prepared to act) by the Committee or not less than three accountant members thereof, or (if the Committee or three of its members are not prepared to act) by a group of not less than three certified public accountants chosen by PMM from a list acceptable to the staff of the Commission.

b. The results of each review will be reported to the Commission and to PMM.

c. The contents of each review, the working papers, other documentation (except the re-

port of its results), and deliberations of the reviewers will be held confidential except from PMM and the Commission.

7. The Commission retains jurisdiction of this proceeding.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary.

RELEASE NO. 174

July 2, 1975

SECURITIES EXCHANGE ACT OF 1934
Release No. 11514

Opinion and Order instituting proceedings and imposing remedial sanctions in the Matter of Harris, Kerr, Forster & Co.

RULE 2(e) OPINION

I. INTRODUCTION

This opinion under Rule 2(e)(1) of the Commission's Rules of Practice (specifically, Section 201.2 (e)(1) (ii) and (iii) of Title 17, *Code of Federal Regulations*) arises out of the conduct of Harris, Kerr, Forster & Co. ("HKF"), a partnership of independent public accountants, in its audit engagement and unqualified report upon the financial statements of Stirling Homex Corporation ("Stirling Homex") for the fiscal year ended July 31, 1970.[1] These financial statements and HKF's unqualified report on them were included in Stirling Homex's (1) 1970 Form 10-K filed with the Commission; (2) 1970 Annual Report to Shareholders; (3) 1971 Registration Statement for offering of 500,000 shares of Stirling Homex cumulative convertible preferred stock;[2] (4) 1971 Form 10-K filed with the Commission, and (5) 1971 Annual Report to Shareholders. It is our opinion that these financial statements were false and misleading. While it is our opinion that HKF's execution of its 1970 Stirling Homex engagement was not performed in accordance with generally accepted auditing standards ("GAAS"), HKF appears to have been a victim of a deliberate scheme to defraud, including the misrepresentation and concealment of certain material facts, perpetrated by certain management and supervisory personnel of Stirling Homex and others.*

HKF has submitted to the Commission a waiver of the institution of formal administrative proceedings under Rule 2(e) (1) and has consented to the entry of an order con-

[1] §201.2(e) (1) provides as follows: The 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 the opportunity for hearing in the matter . . . (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws (15 U.S.C. secs. 77a to 80b-20), or the rules and regulations thereunder.

[2] HKF was not Stirling Homex's independent auditor at the time of the offering by Stirling Homex of its preferred stock. The independent auditing firm of Peat, Marwick, Mitchell & Co., which replaced HKF, reported on the financial statements of Stirling Homex and consolidated subsidiaries for the seven months ended February 28, 1971, the most current audited financial statements included in the 1971 Registration Statement of Stirling Homex. The conduct of the accounting firm of Peat, Marwick, Mitchell & Co., with respect to Stirling Homex is discussed in ASR Release No. 173 also issued by the Commission today.

* Today the Commission also announced the filing of a civil injunctive complaint in this matter entitled *Securities and Exchange Commission* v. *Stirling Homex Corporation, et al.* In addition, the Commission issued pursuant to Section 21(a) of the Securities Exchange Act of 1934 a "Report of Investigation in the Matter of Stirling Homex Corporation Relating to Activities of the Board of Directors of Stirling Homex Corporation.

taining certain findings, conclusions and remedial sanctions.

Under the terms of HKF's waiver and consent, HKF solely for the purpose of settlement of this matter, and without admitting or denying the Commission's findings of law, and without admitting or denying any fact except for the purpose of this settlement, consented, among other things, to the entry of an appropriate order.

After due consideration of the offer of consent, we have determined that it is appropriate and in the public interest to accept this consent.

II. BACKGROUND

Stirling Homex was in the business of manufacturing and installing modular dwelling units in low-to-moderate income housing developments under the sponsorship of a local public housing authority. During fiscal 1970, a rapid expansion in Stirling Homex's modular housing manufacturing capacity occurred. This expansion was accompanied by widespread publicity and a volatile stock price movement. During this period, Stirling Homex's management sought to maximize income in hopes of supporting and maintaining an inflated price/earnings ratio. Stirling Homex attempted to progress from a small construction company to a leader in the nascent modular housing industry.

Stirling Homex's reported sales of modular housing were $5.4 million in 1969 and $16.5 million in fiscal 1970. The apparent impetus to this revenue growth was the recognition of modular sales attributable to "turnkey" projects which, under certain conditions, qualified for financial assistance from the Department of Housing and Urban Development ("HUD"). Stirling Homex achieved these increased sales, in the Commission's view, through the improper recognition of revenues and realization of profits with respect to the manufacture and installation of modular dwelling units. In 1972, Stirling Homex was declared bankrupt.

III. 1970 AUDIT

A. HKF's Understanding of Stirling Homex's Business.

In its review of the turnkey contracts, HKF considered only the relationship between Stirling Homex and the local housing authorities ("LHAs"). HKF's concern centered around Stirling Homex's ability to perform under the contracts with the LHAs and not with the LHAs' ability to fulfill their financial obligations, nor with the commitment of financing by HUD. HKF, in the opinion of the Commission, did not fully understand the funding provisions applicable to Stirling Homex's operations under the HUD turnkey program and did not seek expert advice.

In addition, HKF did not determine whether financial responsibility existed on the part of Stirling Homex's customers to purchase the completed turnkey projects. In fact, the LHAs did not have the necessary financing to carry out these turnkey housing programs without massive HUD assistance.[3] Moreover, the terms of the turnkey contracts between Stirling Homex and the LHAs were specifically conditioned upon HUD's approval, which approval had not been obtained:

> "The approval of this Agreement by the Government signifies that the undertaking by the Purchaser of the acquisition of the property constitutes a project eligible for financial assistance under the Annual Contributions Contract[4] identified in Exhibit 'C'; that said Annual Contributions Contract has been properly authorized; that funds have been reserved by the Government and will be available to effect payment and performance by the Purchaser hereunder; and the Government approval of the terms and conditions hereof."

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[3] While Note 3 to the Company's financial statements for the fiscal year ended July 31, 1970 indicates that the housing projects purchased by the LHAs were Federally financed and because of this "no provisions for doubtful accounts was considered necessary," this footnote was misleading because it failed to disclose that no firm commitment for funding of any Stirling Homex project had been made by any Federal agency responsible for funding Stirling Homex's projects.

[4] The Annual Contributions Contract is the document whereby HUD guarantees a commitment of funds to the LHAs.

Revenues from these turnkey projects were included in sales during the 1970 fiscal year, although the required HUD approval was absent from most of the turnkey contracts. These contracts were available to, and were reviewed by, HKF and were maintained in HKF's workpapers. HKF did not consider HUD's approval necessary to the recognition of Stirling Homex revenues. HKF was aware of the existence of a large number of modules reflected in sales to LHAs under turnkey contracts which had not been installed on the project sites as at July 31, 1970. HKF was also aware that the turnkey contracts provided that the risk of loss remained with Stirling Homex until the project was completed and contained no provision for payment until such time. In the Commission's view, the recognition of revenue under these circumstances was inappropriate.

B. HKF Procedures Employed on Stirling Homex Projects

Toward the end of fiscal 1970, HKF established certain criteria pertaining to turnkey contracts that had to exist before HKF would acquiesce to revenue recognition by Stirling Homex on the modules manufactured and assigned to specific projects. These criteria were established by HKF because it wanted reasonable assurance that the turnkey contracts would, in fact, be completed by Stirling Homex. HKF made the judgment that the LHAs would meet their financial obligations when a certificate of occupancy was issued.

Therefore, during the period, HKF required that the following criteria be met by Stirling Homex in order to recognize revenue on the projects: (1) Stirling Homex own or "control" the land upon which the project was to be constructed; (2) any of the following: (i) construction on the project site; or (ii) possession of a building permit; or (iii) reasonable assurance that a building permit would be forthcoming; and (3) in certain instances, modules be turned over to a common carrier.

The focus of these elements was unfortunate because it turned on Stirling Homex's ability to perform under the turnkey contracts and not upon the ability of the LHAs to pay. However, the LHAs' ability to pay was totally dependent on the commitment of HUD financing and, as previously indicated, this was not adequately considered by HKF.[5]

C. Projects

1. General Discussion

During fiscal 1970, Stirling Homex improperly recognized revenue of approximately $3.7 million on 8 turnkey projects,[6] located in Erie, Pennsylvania; Worcester, Massachusetts; and Sanford, Maine. None of the contracts for these projects had been countersigned by HUD as at July 31, 1970, as required by the contracts and the applicable HUD guidelines.

At no time did HKF make inquiry regarding the existence of HUD funding. This lack of inquiry, in the opinion of the Commission, did not meet the requirements of GAAS.[7]

2. Worcester, Massachusetts, Project

Stirling Homex executed four contracts with the Worcester Housing Authority in July of 1970, in the closing days of the 1970 fiscal year. These contracts involved four separate projects to be financed under the HUD turnkey program. These contracts accounted for over $1 million in sales improperly recognized in fiscal 1970.

The Worcester contracts do not contain any HUD approval. None existed. The engagement senior indicated this in HKF's

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[5] Almost no documentary evidence exists in HKF's workpapers demonstrating a commitment for financing by HUD to support income recognition by Stirling Homex on its turnkey projects.

[6] In addition, two Akron, Ohio projects, Hillwood and Highland, on which Stirling Homex recognized revenue of $6,900,000, were being processed under the turnkey program. HKF did not determine whether the Akron Metropolitan Housing Authority had HUD approval for these projects, though such approval was required by the terms of these agreements. In fact, no such HUD approval existed.

[7] The third standard of Auditing Field Work requires the examination of sufficient evidential matter as a predicate for the expression of the auditor's opinion. The third general standard of auditing requires "due professional care" in the performance of an engagement. (See *Statement on Auditing Standards No. 1*, published by the AICPA.) In the Commission's opinion, HKF's conduct, in this instance, fell below these minimal standards.

workpapers prepared during the 1970 audit of Stirling Homex:

> It was apparent from conversations that HUD is the financier of the Worcester developments. My question is that if HUD has not yet approved said contracts what will happen if such approval is not given . . . . Who would pay for the developments[?] I would say that HUD's approval could not be obtained until the following comes to pass (none of which happened until September or October).

Yet Stirling Homex recognized revenue and income on these Worcester projects. The required HUD approval in some instances never occurred, and in others occurred well after the close of the 1970 fiscal year. Moreover, HKF's own revenue recognition criteria were not satisfied in one instance. One project site had been rejected by the zoning board as unacceptable and no new replacement site was ever found. Thus, Stirling Homex neither owned nor controlled the land on this project. The HKF workpapers indicate that HKF was aware that the modules assigned to the Worcester projects (assignment to a project was the basis for revenue recognition) were being stored at locations other than the project sites.

As late as September 1970, the HKF engagement audit senior visually inspected the four Worcester project sites and found that two of the sites were only vacant lots. The third site had been rejected by the City of Worcester zoning board,[8] and the fourth was approximately 95% complete.

3. Erie, Pennsylvania, Projects

Stirling Homex entered into three contracts with the Housing Authority of the City of Erie on the very last business day of fiscal 1970. These agreements covered three projects to be financed under the HUD turnkey program and accounted for approximately $1.7 million in revenues recognized in fiscal 1970. As was the case with the Worcester projects, there was no evidence of a HUD financing commitment, and in fact, none existed.

4. Notes to 1970 Financial Statements

Footnote 3 to the Stirling Homex fiscal 1970 financial statements, captioned, "Receivables and Unbilled Amounts on Contracts," states the following:

> The Company enters into various modular housing sale contracts with local housing authorities. These contracts contain an allocation of the sales price as between modular units, site development and installation, land and other reimbursables. The terms of certain sales contracts ("Turnkey") provide for payment and transfer of title upon completion and receipt of all approvals necessary for occupancy.
>
> The Company records sale of modular units after they have been manufactured and assigned to specific contracts.
>
> The notes and accounts receivable from affiliated companies represent sales to companies in which certain officers and directors of the Company or members of their immediate families have an equity interest.
>
> The Company's sales to local housing authorities are for Federally financed housing projects which qualify for financial assistance from the Department of Housing and Urban Development. Due to the nature of these sales, no provision for doubtful accounts is considered necessary.

This note contained inaccurate and misleading statements in that the turnkey contracts entered into by Stirling Homex did not provide for an allocation of the sales price between modular and installation portions, although Stirling Homex submitted its proposals on such a basis. In order to obtain the

[8] The HKF workpapers indicate that the senior on the audit learned the following, ". . . the *Bridgeport* Street *project* was *killed* due to local opposition to developing a low income project. He [Stirling Homex's legal representative in Worcester] says presently there are four sites under consideration as substitutes for the Bridgeport Street project, the selection of a final site is still open. I raised the possibility that since these matters are subject to public hearings (as evidenced by local newspaper reports on Providence and North Street), *a substitute site may never be found. Therefore,* I can see *no basis* under our present thinking for *including Bridgeport Streets in sales.*" (Emphasis added.) HKF uncritically accepted Stirling Homex's recognition of income on the Bridgeport street project because of assurances by the Worcester Housing Authority and Stirling Homex that a substitute site would be found.

concurrence of the LHAs with the allocation, HKF suggested to Stirling Homex during its 1970 fiscal year audit that Stirling Homex have the LHAs execute addenda to the turnkey contracts which would provide for a breakdown of modular and installation sales. However, Stirling Homex refused to submit the addenda to the local housing authorities for their signatures.

Once HKF determined that Stirling Homex would not submit the addenda to the LHAs for their signatures, HKF decided on an alternative approach. In this regard, HKF sent two confirmation letters to the local housing authority on each project. One confirmation requested a verification of information regarding its contracts with Stirling Homex, including the date of contract, a breakdown of the total sales price between modular and installation sales, the terms of payment, and the number of dwelling units received by the housing authority through July 31, 1970. The second confirmation requested a verification of the amount of apartment dwelling units completed and assigned by Stirling Homex to a project with the particular local housing authority, as well as the amount billed by Stirling Homex through July 31, 1970.

By structuring the confirmations in this fashion, HKF was attempting to confirm the information contained in the Stirling Homex addendum. However, HKF did not receive a signed confirmation from all of the housing authorities verifying such information; rather, certain of the housing authorities referred HKF back to the contracts for confirmation of the contract terms themselves. HKF's attempt to confirm the breakdown of the total sales price and the dollar amount and number of modules completed and assigned to a project, the Commission believes, was inappropriate.

Further, the last paragraph of Footnote 3 set forth above leaves the impression that HUD funds had been committed to the projects and thus there was no necessity for an allowance for doubtful accounts. In fact, there were no Federal funds committed to these projects. Additionally, during the course of its audit engagement, HKF did not concern itself with this question.

5. Conclusion

In the Commission's opinion, HKF's audit was not performed in accordance with generally accepted auditing standards in that, among other things, it failed to acquire and examine sufficient competent evidential material concerning firm commitments of HUD financing to the projects.

In accepting HKF's offer of settlement, the Commission has considered the fact that HKF has not previously been subject to disciplinary or enforcement proceedings instituted by the Commission, that the conduct occurred in 1970, that HKF was subsequently terminated by Stirling Homex because of disagreements with Stirling Homex over matters of accounting principles[9] and that HKF was the victim of a deliberate scheme to defraud. Further, the Commission has considered the professional conduct of HKF with respect to transactions and events that occurred after HKF issued its report on Stirling Homex's 1970 financial statements, especially HKF's insistence that Stirling Homex give full and complete disclosure in its 1971 Registration Statement concerning two transactions that were recognized in income in financial statements that HKF was not reporting upon and at a time when HKF was no longer serving as independent auditor for Stirling Homex.

In view of the above findings, the Commission concludes that HKF's audit of Stirling Homex's 1970 financial statements was not conducted in accordance with generally accepted auditing standards.

* * * * *

Under the terms of its offer of settlement, Harris, Kerr, Forster & Company, without admitting or denying the Commission's findings, and solely for the purpose of settlement, consented to the entry of an order embodying the following sanctions.

[9] Accounting Series Release No. 165, adopted December 20, 1974, after HKF was terminated by Stirling Homex, would, in circumstances such as these, require disclosure of the substance of the disagreements between the independent public accountant and the registrant.

Accordingly, IT IS ORDERED that proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice be, and they hereby are, instituted against Harris, Kerr, Forster & Company, and Harris, Kerr, Forster & Company hereby is censured by the Commission.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 175
July 10, 1975

SECURITIES ACT OF 1933
Release No. 5596

SECURITIES EXCHANGE ACT OF 1934
Release No. 11529

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 19083

INVESTMENT COMPANY ACT OF 1940
Release No. 8848

Notice of Adoption of Amendments to Rule 4-02 of Regulation S-X Relating to Consolidated Financial Statements

The Commission today adopted an amendment of Rule 4-02(e) of Regulation S-X relating to separate statements of subsidiaries included in consolidated financial statements. The amendment clarifies the requirements for separate statements of consolidated subsidiaries engaged in certain financial activities. Revision of the rule was originally proposed on December 11, 1974.[1] Consideration of comments has resulted in revisions of the proposal so that the rule now being adopted will be more understandable and easier to work with.

The December 1974 release observed that the proposed amendment resulted from our experience in examining financial statements filed by registrants and also from current economic and financial developments. At that time we noted concern over developments in banking and other regulated financial businesses in which there is regulation for the interests of depositors and insureds apart from the interest of stockholders. The need for disclosure of information concerning subsidiaries in these highly leveraged areas is no less necessary today.

The revisions to the proposed amendments of Rule 4-02(e) are as follows:

The provision of subparagraph (e)(2) requiring financial statements for a registrant's nonsignificant subsidiaries when the investment in them exceeds 10 percent of total assets on registrant's balance sheet has been transferred to paragraph (e). The remainder of subparagraph (e) (2) has been eliminated since it provided for omission of nonsignificant subsidiaries whose exclusion generally would be appropriate because of lack of materiality. The former subparagraph (e) (3) has been renumbered (e) (2) but is otherwise unchanged.

[1] Securities Act Release No. 5548, Securities Exchange Act Release No. 11132, Public Utility Holding Company Act Release No. 18705, Investment Company Act Release No. 8612.

The inclusion of leasing as part of the finance line of business has been modified to include subsidiaries engaged in finance leasing and to exclude subsidiaries with only nonfinancing leases.

The proposed subparagraph 4-02(e) (1) provided for exclusion of supporting statements of a consolidated significant subsidiary or of a significant group of subsidiaries if their assets, sales and income each exceed 90 percent of the corresponding amounts on the consolidated statements. In response to several comments these provisions have been revised so that in making this test average consolidated income (or loss) may be substituted for the current year's income (or loss). This is comparable to a provision in the definition of significant subsidiary in Rule 1-02 of Regulation S-X.

Under the rule one or more sets of financial statements may be required in support of the basic consolidated statements, and under certain unusual circumstances as many as four separate sets of statements may be needed.[2] While this requirement may appear to place an onerous burden on a registrant, it is a reflection of the involved and complicated nature of business and is necessary to provide the investor with sufficient information on which to base investment decisions. In its project on "Financial Reporting for Segments of a Business Enterprise," the Financial Accounting Standards Board is considering the reporting problems of diversified companies including the matter of disclosure of information about different segments. Rule 4-02 will be reconsidered when the FASB issues a statement on this subject.

The following is the text of Rule 4-02(e) as revised:

(e) Separate financial statements shall be presented for each significant consolidated subsidiary or each group of consolidated subsidiaries which in the aggregate meets the tests of a significant subsidiary engaged in the business of life insurance, fire and casualty insurance, securities broker-dealer, finance (which group includes similar activities such as factoring, mortgage banking and leasing, exclusive of subsidiaries with only nonfinancing leases), savings and loan or banking (including all subsidiaries of banks), and for all nonsignificant consolidated subsidiaries not otherwise included in groups above, combined when registrant's investment (including current and not current advances) in all such subsidiaries exceeds 10 percent of total assets on registrant's balance sheet. Notwithstanding the foregoing requirement, separate financial statements may be omitted:

(1) For a consolidated subsidiary or group of consolidated subsidiaries in the same business if the registrant's and registrant's other subsidiaries proportionate share (based on their equity interests) of (i) total assets (after intercompany eliminations), (ii) total sales and revenues (after intercompany eliminations), and (iii) income (or loss) before income taxes and extraordinary items of such subsidiary or group of subsidiaries each exceeds 90 percent of the corresponding amounts on the consolidated financial statements. If the proportionate share of income (or loss) under (iii) above and the corresponding amount on the consolidated financial statements are not both income or both loss, then separate financial statements may not be omitted. If the average income before income taxes and extraordinary items on the consolidated financial statements for the last five fiscal years is less than such consolidated income on the most recent annual financial statements or if the average consolidated loss for the last five years is less than such consolidated loss on the most recent annual financial statements, then such average amounts may be substituted in the determination under (iii) above.

(2) For a consolidated subsidiary or group of consolidated subsidiaries in the same business if in excess of 90 percent of their sales and revenues are derived from registrant and registrant's other subsidiaries.

The foregoing amendments are adopted pursuant to Sections 6, 7, 8, 10 and 19(a) of

[2] For example, a holding company with bank and finance company subsidiaries might have to present the following sets of financial statements: (1) consolidated statements; (2) parent company statements; (3) combined statements of bank subsidiaries; and (4) combined statements of finance company subsidiaries.

the Securities Act of 1933; Sections 12, 13, 15(d) and 23(a) of the Securities Exchange Act of 1934; Sections 5(b), 14 and 20(a) of the Public Utility Holding Company Act of 1935; and Sections 8, 30, 31(c) and 38(a) of the Investment Company Act of 1940. The amendments shall be effective with respect to financial statements filed with the Commission subsequent to September 30, 1975.

By the Commission.

GEORGE A. FITZSIMMONS,
Secretary.

RELEASE NO. 176
July 22, 1975

SECURITIES EXCHANGE ACT OF 1934
Release No. 11543

Findings and Order imposing remedial sanctions in the Matter of Hertz, Herson & Co.

These are proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice to determine whether Hertz, Herson & Company ("Hertz, Herson"), a partnership engaged in the practice of accounting, should be denied the privilege of appearing or practicing before the Commission.

Respondent, without admitting or denying any of the Commission's findings and solely for the purpose of settlement, has submitted an offer of settlement in which Respondent consents to the institution of proceedings under Rule 2(e) of the Commission 's Rules of Practice and to the entry of an order containing certain findings and remedial sanctions as set forth below.

1. For the fiscal year ended August 31, 1971, Drew National Corporation ("DN") and its then approximately 80%-owned subsidiary, Drew National Leasing Corporation ("DNL"), issued false and misleading financial statements. Respondent, independent accountants for DN and DNL, rendered unqualified opinions with respect to those financial statements.[1]

2. DNL was engaged in the business of equipment leasing. At the fiscal year ended August 31, 1971, there were at least two million dollars of leases on which there were delinquent lease payments out of a total lease portfolio of approximately twelve million dollars. During 1971, DNL wrote off $134,000 against the allowance for doubtful accounts (which had an opening credit balance of $131,000) and charged income by an additional provision of $193,000, bringing the allowance for doubtful accounts to $190,000 at August 31, 1971.

3. The provision and allowance were inadequate under the circumstances since a significant portion of the leases were uncollectible, for among other reasons, the leases were seriously delinquent and the value of the underlying collateral was insufficient. This was particularly true since the condition of many of the leases which were delinquent in 1970 deteriorated further during 1971. In addition, DNL continued to recognize reve-

[1] The Commission has instituted and simultaneously settled legal proceedings against DN, DNL, and certain of their officers and directors, *Securities and Exchange Commission* v. *Drew National Corp., et al.* (DDC 75-1141). The Commission's complaint in that action alleges, *inter alia*, that DN's and DNL's financial statements for the years 1970 and 1971 were false and misleading because inadequate allowances and provisions were made for DNL's doubtful lease receivables. The complaint alleges that by the end of fiscal year 1970, many lease receivables were delinquent and otherwise doubtful of collection.

In the conduct of its audit for 1970, Respondent relied to a great extent upon management's representations as to the collectibility of delinquent leases, the value of the collateral and reliability of third party guarantors. While the delinquencies were less serious and material in 1970 than in 1971, the Commission believes that a more diligent audit might have uncovered the problems.

nues on these leases. As a consequence, DNL's 1971 financial statements materially understated net loss and were false and misleading.

4. In connection with the audit of DNL's 1971 financial statements, Respondent, in many instances, relied upon the representations of DNL's management as to the collectibility of, and the status of collection efforts with respect to, the lease receivables. In the performance of the audit, Respondent failed to use due professional care in that it did not sufficiently extend its audit tests by obtaining and examining adequate, competent evidential matter to determine the veracity of management's representations. In other instances, documentation was available which was not properly evaluated.

Thus, Respondent failed to appraise the significance of information known to it and to extend sufficiently its auditing procedures in circumstances calling for professional skepticism.

While the adequacy of an allowance for doubtful accounts is inevitably a matter of judgment and no one precise amount is appropriate in each situation, auditors have an obligation to bring together as much relevant information in this connection as is necessary so that a reasonable judgment can be made. In this case, the auditors failed to accumulate sufficient information. Furthermore, they formed a judgment on the information obtained which clearly fell outside the realm of reasonableness.

5. As a result of the inclusion of a provision for doubtful accounts more appropriate for an earlier year, DNL's 1972 financial statements, concerning which Respondent rendered an unqualified opinion, *ipso facto* were false and misleading in that the company's net loss was materially overstated.

6. To the extent that they incorporated approximately 80% of DNL's understated net loss of 1971 and overstated net loss for 1972, DN's financial statements for 1971 and 1972, concerning which Respondent rendered unqualified opinions, were false and misleading.

After due consideration, the Commission has determined to accept the offer of settlement. In arriving at its determination, the Commission considered the fact that Respondent, in order to insure that it performs its audits in accordance with generally accepted auditing standards, has agreed to the review described in the order.

Accordingly, IT IS ORDERED that proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice be, and they hereby are, instituted against Respondent.

IT IS FURTHER ORDERED that, upon the terms and conditions provided in the offer of settlement, Respondent consents to the entry by the Commission of an order which provides that:

1. Respondent shall employ as consultants, two certified public accountants who are satisfactory to the Chief Accountant of the Commission to review and evaluate the auditing procedures and professional practice of Respondent in connection with its audits of publicly-held companies. The review shall be limited to the audit work performed, the elements of quality control and the audit procedures employed by the firm as reflected in the relevant working papers and to an analysis of the application of generally accepted accounting principles. The consultants may communicate with the Commission's staff to ascertain its views. The review shall be performed after Hertz, Herson has completed said audits, but in no event shall the review commence later than two weeks from the date the consultants are retained.

2. At the conclusion of the review and evaluation, but in no event later than eight weeks[2] from the date of this order, the consultants shall report their conclusions to the Office of the Chief Accountant of the Commission and shall make recommendations, if needed, to Respondent for improvements.[3] Respondent shall have a reasonable opportunity to reply in writing to the review and evaluation results to the staff of the Commission, and to institute any recommended changes.

3. Respondent represents and undertakes

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[2] A reasonable extension of time may be granted at the discretion of the Chief Accountant of the Commission.

[3] Such report shall not identify the clients involved in the review.

not to accept engagements with any new public clients from date of entry of the Commission's Order until one month after the submission by the consultants to the Commission of their report where the engagement is expected to involve filings with, or submissions or certifications to, the Commission.

4. The Commission shall retain jurisdiction of this matter pending final receipt of the report referred to above, and thereafter for the taking of appropriate action, if necessary, for any purposes relevant to this order or the report, after notice and an opportunity for an evidenciary hearing.

After due consideration, the Commission has determined to accept the offer of settlement.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary.

RELEASE NO. 177
September 10, 1975

SECURITIES ACT OF 1933
Release No. 5611

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 19162

SECURITIES EXCHANGE ACT OF 1934
Release No. 11641

Notice of Adoption of Amendments to Form 10-Q and Regulation S-X Regarding Interim Financial Reporting

A. General Statement

In Securities Act Releases No. 5549 and No. 5579, the Commission proposed alternative methods of increasing disclosure of interim results by registrants. More than 700 letters of comments have been received in response to these proposals. In addition, the Commission held public hearings on the proposals and heard testimony from 14 witnesses. The Commission has given careful consideration to all comments and to the evidence received in the public hearings. It has now determined to adopt certain of the proposals, to modify others and propose revised rules for further comment and to withdraw other proposals, all as discussed below. The proposals for revised rules are contained in Securities Act Release No. 5612 dated September 10, 1975.

Adoption of Amendments to Regulation S-X

The Commission has determined to adopt, substantially as proposed, a new rule [Rule 3-16(t)] which will require disclosure of selected quarterly financial data in notes to annual financial statements of certain registrants. In making this determination, the Commission has concluded that footnote disclosure of net sales, gross profit, income before extraordinary items and cumulative effect of a change in accounting, per share data based upon such income, and net income for each quarter within the two most recent fiscal years and any subsequent fiscal period for which income statements are presented, is appropriate for the protection of investors in the case of large companies whose shares are actively traded. The Commission believes that the greatest investor need for these data exists in the case of such companies whose activities are most closely followed by analysts and investors. Accordingly, registrants whose shares are not actively traded or whose size is below certain limits have been exempted from this rule at the present time. In making this judgment the Commission also recognized that the

costs of such disclosure would be relatively a greater burden to smaller companies. Nevertheless, the Commission urges registrants who are exempt from the rule to consider the desirability of including such data in their annual reports. The exemption applies to all registrants who do not meet the following criteria:

A.1. The registrant has securities registered pursuant to Section 12(b) of the Exchange Act; or

2. The registrant has securities registered pursuant to Section 12(g) of the Exchange Act that are quoted on the National Association of Securities Dealers Automated Quotation System and these securities meet the Regulation T requirements for continued inclusion on the list of OTC margin stock; and

B. The registrant and consolidated subsidiaries had income after taxes but before extraordinary items and cumulative effect of a change in accounting of $250,000 for each of the last three fiscal years or had total assets at the last fiscal year end of $200,000,000 or more.

The Commission believes that such disclosures will materially assist investors in understanding the pattern of corporate activities throughout a fiscal period and it feels that such an understanding is important if financial statements are to serve their objective of allowing investors to develop reasonable expectations about the future prospects of enterprises in which they are investing or considering investment.[1] Presentation of such quarterly data will supply information about the trend of business operations over segments of time which are sufficiently short to reflect business turning points. Annual periods may obscure such turning points and may reflect a pattern of stability and growth which is not consistent with business reality. In addition, quarterly data will reflect seasonal patterns which are of significance to an investor's understanding of the business operations of a reporting entity.

Numerous commentators took issue with the Commission's view that the footnote information proposed to be required by the proposals and adopted herein was necessary for investors. They suggested that interim results are materially affected by random events, that short period estimates are by their nature imprecise and that putting such data into annual financial statements will mislead by lending them an appearance of reliability which cannot in fact exist. In addition, numerous respondents suggested that if the Commission did believe that quarterly data should be presented to investors at the end of the year, this could best be achieved by including the quarterly data in management's analysis of the summary of operations or elsewhere in the annual report, but not in the notes to financial statements.

The Commission has concluded that it should not amend its proposal in response to these comments. While it recognizes that random events can materially affect quarterly results, it believes that Section (3) of Rule 3-16(t), which requires disclosure in the note of any unusual items occurring in any quarter disclosed, will enable investors to ascertain the effect of such items and hence not be misled. It also recognizes that short period estimates are imprecise, and it emphasized in Securities Act Release No. 5549 that it was not proposing any change in the traditional accounting practice of making the best estimate practicable at the time the estimate must be made, and then reflecting subsequent adjustments in the estimate in subsequent periods as the need became apparent. Estimates are a necessary part of all financial reporting, and since registrants have had many years experience in making the estimates required in quarterly reporting and investors have had equivalent experience in using the reports encompassing these estimates, the Commission is not prepared to conclude that including quarterly data in a footnote to the financial statements will create an impression of reliability which will mislead investors. In addition, Section (3) of Rule 3-16(t) requires the disclosure of the aggregate effect and the nature of year end or other adjustments which are material to the results of each quarter presented. This disclosure will permit investors to determine

[1] See the report of the Trueblood Committee appointed by the American Institute of Certified Public Accountants to study the objectives of financial statements.

the nature and effect of substantial changes in estimates.

The Commission also does not agree that the required disclosure should only be made outside the financial statements. In general, it believes that significant financial disclosures about business operations during a period should be included in the financial statements for that period. The burden is therefore on those who believe that significant financial data should be outside the financial statements to demonstrate the reason for its exclusion. Commentators did not offer any compelling reasons to support their position in this regard. Accordingly, the Commission believes that it is appropriate to require disclosure in the notes to financial statements of those companies in which there is the most substantial public investor interest.

Involvement of Independent Public Accountants

The inclusion of interim data in the footnotes to annual financial statements necessarily will associate the independent public accountant with these data in some fashion. In its initial proposal in Securities Act Release No. 5549, the Commission indicated that it was not prepared to have these data labeled "unaudited." After receiving many comments and estimates of cost which suggested that an audit of interim data would be very costly to registrants, the Commission published an additional set of proposals (in Securities Act Release No. 5579) which would permit this note to be labeled "unaudited" and at the same time would set forth as an amendment to Rule 2-02 of Regulation S-X a set of limited review procedures which auditors would be expected to follow when they were associated with a set of financial statements which included such an unaudited footnote.

After careful consideration of costs and benefits of auditor involvement, the Commission has determined to permit the required note to be identified as "unaudited." Even though this note will not be audited, independent accountants will be associated with such a note when they report on financial statements which include such a note. The Commission does not believe it is appropriate for independent accountants to be subjected to unknown responsibilities in connection with their association with this note. Accordingly, the Commission is proposing, in Securities Act Release No. 5612, dated this date, a slightly amended set of review and reporting procedures which the Commission believes will satisfactorily set forth its expectation as to the responsibilities of independent accountants who report on financial statements filed with it which include such a note. The Commission plans to adopt final standards for auditors' reports which spell out these expectations prior to the effective date of the amendment to Rule 3-16 adopted hereby.

The Commission notes, however, that the subject of auditor involvement with interim financial data has been under active consideration by the Auditing Standards Executive Committee of the American Institute of CPAs (AudSEC). It also notes that historically the Commission has not been required to set forth the standards and procedures which underlie an independent public accountant's report because the public accounting profession has developed appropriate standards and procedures to provide protection to the investing public who rely upon such reports.

The Commission believes that it is preferable to continue its past policy of permitting the accounting profession to determine the auditing standards and procedures underlying accountant's reports as long as this policy is consistent with the interests of investors. Accordingly, it urges AudSEC to continue its study of auditor involvement with interim financial data in the light of the Commission's determination that certain interim data shall be included in annual financial statements of certain registrants in a note labeled "unaudited" and the Commission's further determination that auditor association with these data will necessarily occur and the responsibilities for such association must be satisfactorily defined. If AudSEC adopts a Statement on Auditing Standards prior to December 10, 1975 which sets forth the standards and procedures to be followed by independent accountants in

connection with the data in the unaudited note required by Rule 3-16(t), and the Commission is satisfied that these standards and procedures adequately protect the interests of investors, it is the intention of the Commission to withdraw the proposed sections of Rule 2-02(e) which set forth specific procedures of review and reporting and to indicate that the AudSEC statement identifies the "appropriate professional standards and procedures" presumed to have been followed by the reporting independent public accountant under Rule 2-02(e).

The Commission received many comments on the subject of auditor involvement, nearly all of which raised questions as to whether the benefits of such involvement would warrant the cost. The Commission has considered these comments with great care since it believes that it should not lightly impose additional costs on registrants and that the benefits of new requirements to present and prospective investors should outweigh any additional costs involved. Since the benefits of the increased involvement of independent accountants in interim reporting are not subject to quantification, and the measurement of costs includes many variables which are highly uncertain, the weighing of costs and benefits will inevitably require the exercise of subjective judgments rather than arithmetical computations.

In its releases proposing increased auditor involvement, the Commission specifically invited comments on the cost of its proposals to registrants. Many responses were received, but relatively few indicated that the respondent had undertaken any systematic research into the costs involved. Those that did report a systematic study of costs reported that the costs would vary depending on the nature of the registrant, but the most common estimates indicated that a quarterly review following the procedures set forth in the proposal would cost between 5% and 25% of the current annual audit fee. In the Commission's hearings, several of those making such estimates were asked whether the studies took into account any savings in year-end audit time which might result from quarterly reviews and they responded that no such savings had been included. In addition, several witnesses stated that current auditing procedures frequently included analytical reviews of results of time periods within the year in searching for unusual items which would require additional auditing steps, even though these reviews did not focus specifically on quarterly periods.

The Commission believes that as reviews of quarterly information become a regular part of the audit examination of public companies, auditors will revise the timing of their audit examinations so that they will perform procedures related to the testing of internal controls and the analytical review of internal financial reports on a regular basis throughout the year. In addition, programs encompassing regular analytical review should increase the efficiency of auditors in finding and focusing promptly on potentially troublesome areas in the audit. The Commission believes, therefore, that many of the costs included in the studies reported to the Commission will not prove to be incremental costs but will reduce the cost of the year-end audit examination. In addition, it is the Commission's view that many of the costs will be of a one time rather than a continuing nature since audit programs and corporate control systems will be improved promptly to keep costs at a minimum. The Commission does not suggest that the cost of auditor involvement in quarterly data will be trivial, but it does believe that some of the higher estimates supplied to it will not prove to be correct.

The benefits resulting from such increased costs cannot be quantified, but the Commission is satisfied that they will be substantial. While the new rules will not mandate the timely involvement of the independent accountant with quarterly reports, the Commission believes that it is likely that such involvement will occur so that management will be less likely to face the necessity of revising quarterly data at the time year-end statements are published. Either timely or retrospective involvement should increase the care and attention devoted to quarterly reports which will increase the likelihood that management will discover needed adjustments on a timely basis. In addition, management may be able to identify problem

areas more promptly so that unusual charges and credits are not made so frequently in the last month of a fiscal year. Finally, the involvement of independent accountants will add the expertise of professional accountants with wide experience in reporting problems to the quarterly reporting process. This should improve individual company reporting and direct greater professional attention to the general problems of interim reporting.

The Commission has brought a number of enforcement actions involving quarterly reports and it has observed other cases where quarterly reports have required correction. In addition, it has noted the preponderance of Form 8-K filings covering unusual charges and credits to income being made late in the year. While these are not suggested to be evidence of systematic abuse in quarterly reporting, they do indicate that deficiencies exist. Although auditor involvement will not prevent all deficiencies, the Commission does believe that it will enhance the reliability of interim reports and reduce the likelihood of abuse. In the final analysis, however, the benefits of auditor involvement in quarterly data are expected primarily to result from improvement in the quality of interim reporting and the annual auditing process and only secondarily from the prevention of specific abuses currently perceived.

After appraising the costs and benefits, the Commission has determined that the benefits of mandatory involvement of independent accountants in quarterly data on the basis set forth in the rules adopted hereby substantially outweigh the costs thereof and that such involvement is required in the interests of investors.

In exempting certain registrants from these rules, the Commission has noted that the cost of auditor involvement will fall with the greatest relative severity on smaller registrants in which public investor interest is not of great magnitude. In these cases, the Commission believes that it is less clear that the benefits of auditor involvement with interim data outweigh the costs. Accordingly, it has not required such involvement for such registrants at the present time, although it will continue to study the question as it evaluates the experience gained from the rules adopted hereby.

Effective Date of Amendments to Regulation S-X

Because quarterly data have not previously been included in financial statements for a year and because the Commission recognizes that specific implementation of auditor involvement and improved systems of internal control relative to quarterly data may take time to achieve, the Commission is not requiring the inclusion of such data in financial statements for fiscal periods beginning prior to December 26, 1975. In addition, quarterly data will not be required for quarterly periods beginning prior to that date. Earlier implementation of the requirements by registrants is encouraged.

Inclusion of Quarterly Data in Financial Statements Included in Annual Reports to Stockholders

The rules adopted hereby require that large companies whose shares are actively traded include the disclosure of certain quarterly data in financial statements filed with the Commission. The Commission believes that these companies also should include this disclosure in financial statements furnished to stockholders.

Adoption of Amendments to Form 10-Q

The Commission has determined to adopt substantially increased requirements for the content of quarterly reports on Form 10-Q which will be applicable to all registrants. These requirements include condensed financial statements, a narrative analysis of results of operations, the approval of any accounting change by the registrant's independent public accountant, and a signature by the registrant's chief financial officer or chief accounting officer. In addition, the revised form permits additional financial disclosures deemed appropriate by management and permits management to state that financial data in the form has been reviewed by independent public accountants and to include as an exhibit to the form a letter

from the independent public accountant in regard to this review.

The Commission originally proposed to require financial statements prepared in accordance with Regulation S-X except for the exclusion of certain footnote disclosure. A number of commentators suggested that such statements would be more detailed than required by investors and would be costly to prepare. Accordingly, the rule adopted provides that the financial statements furnished need only include the major captions set forth in Regulation S-X and permits the combination of such captions when certain materiality tests are met. The only subcaptions required by the rule are those which set forth the components of inventory (raw materials, work in process and finished goods), if applicable, since users of financial statements have indicated that these subcaptions are of considerable importance in evaluating the significance of changes in inventory. In addition, the rule permits a summarized statement of source and application of funds. The rule retains the original proposed provision that rules included in Regulation S-X which call for detailed footnote disclosures and schedules do not apply to financial statements filed in Form 10-Qs. A number of commentators indicated that the proposed language was not sufficiently specific since all footnote disclosures required in annual financial statements could be said to meet the test of being necessary to prevent the statements from being misleading. The Commission did not intend this interpretation, since it believes that detailed footnote disclosures required annually need not be updated quarterly in the absence of highly unusual circumstances. It has attempted to clarify the language to make its intent clear although it has retained in the rule the general obligation to make disclosures adequate to make the information presented not misleading. This is a requirement for all filings with the Commission and has been included in Form 10-Q since the time of its adoption.

The new rules require income statements for the most recent quarter, the equivalent calendar quarter in the preceding year and year-to-date data for both years. Condensed funds statements are required on a year-to-date basis for the current and prior year. In addition, registrants are permitted to show income statement data and funds statement data for the twelve month period ending at the interim reporting date for both years if they elect to do so. Balance sheets are required as of the end of the most recent quarter and at the same date in the preceding year.

In addition, the new rules require increased pro forma information in the case of business combinations accounted for as purchases, conformity with the principles of accounting measurement set forth in the Accounting Principles Board opinion on interim financial reports, and increased disclosure of accounting changes.

In connection with accounting changes, a letter from the registrant's independent public accountant is required to be filed in which the accountant states whether or not the change is to an alternative principle which in his judgment is preferable under the circumstances. A number of accountants objected to this requirement on the grounds that no standards exist for judging preferability among generally accepted accounting principles and that authoritative accounting principles only require that management justify that a change is to a preferable method. The Commission believes that professional accounting judgment can be applied to determine whether an alternative accounting principle is preferable in a particular set of circumstances. Since a substantial burden of proof falls upon management to justify a change, the Commission believes that the burden has not been met unless the justification is sufficiently persuasive to convince an independent professional accounting expert that in his judgment the new method represents an improved method of measuring business operations in the particular circumstances involved. The proposed rule has therefore been adopted as proposed.

In addition to financial statements, a new instruction to Form 10-Q requires management to provide a narrative analysis of the results of operations. The Commission's original proposal required such an analysis to follow the guidelines set forth in Guide 1 of

"Guides for Preparation and Filing of Reports and Registration Statements under the Securities Exchange Act of 1934." Commentators pointed out that this Guide was designed to apply to a summary of earnings covering a period of several years and that some of the tests set forth in that Guide were not precisely applicable to interim reporting on Form 10-Q. While the Commission believes that the general principles set out in Guide 1 would be relevant to a quarterly analysis, it recognizes that certain quantitative tests are inapplicable, and that the shorter period covered by interim reports may have an impact on the types of analysis which will be most meaningful to investors. Accordingly, this instruction has been redrafted to make it specifically applicable to Form 10-Q and to give more general guidance to registrants rather than setting down quantitative tests. The new instruction requires explanation of the reasons for material changes in the amount of revenue and expense items from one quarter to the next (even though the preceding quarter may not be reported as such in the Form 10-Q), between the most recent quarter and the equivalent quarter in the preceding year, and between the year-to-date data and comparable data for the prior year. While such explanations are to be presented in narrative form, it is expected that they will include quantitative data in explaining the reasons for changes. In addition to requiring an analysis of operations, the new form includes an instruction which permits the registrant to furnish any additional information which management believes will be of significance to registrants. This same instruction requires the registrant to indicate whether a Form 8-K was filed during the quarter reporting either unusual charges or credits to income or a change of auditors.

Under the new rules, Form 10-Q must be signed by either the chief financial officer or the chief accounting officer of the corporation. This requirement was included in recognition of the fact that the data in the form were primarily financial, and that it was appropriate to emphasize the responsibility of the chief financial or accounting officer for the representations explicit and implicit in the filing. This signature will not relieve other corporate officers of their responsibilities.

Rescission of Form 7-Q

Since the rules and instructions adopted herein for Form 10-Q require a condensed quarterly statement of source and application of funds for all companies, the separate form (Form 7-Q) which sets forth this requirement for certain real estate companies is no longer required. Accordingly, Form 7-Q and the rules specifying its application are rescinded.

Review of Form 10-Q Data by Independent Public Accountant

The financial information included in Form 10-Q need not be reviewed prior to filing by an independent public accountant. However, certain registrants will be required to include certain data contained in the Form 10-Q in an unaudited note to financial statements for the year. Such a note must be reviewed by an independent public accountant in accordance with prescribed professional standards in connection with the annual audit. Since review procedures must be applied to quarterly data in connection with the annual audit of such registrants in any event, the additional cost to these registrants of having a review made on a timely basis should be small, particularly if the annual audit is planned with such a review in mind.

The Commission believes that all registrants would find it useful and prudent to have independent public accountants review quarterly financial data on a timely basis during the year prior to the filing of Form 10-Q and it encourages registrants to have such a review made. While such a review does not represent an audit and cannot be relied upon to detect all errors and omissions that might be discovered in a full audit of quarterly data, it will bring the reporting, accounting and analytical expertise of independent professional accountants to bear on financial reports included in Form 10-Q and therefore should increase the quality and the

reliability of the data therein in a cost-effective way.

Instruction K of Form 10-Q permits registrants to state that an independent accountant has reviewed the financial information included therein if the accountant has reviewed the data in accordance with established professional standards and procedures for such a review. In Release No. 33-5612 of this date the Commission has proposed for comment such professional standards and procedures and it plans to adopt such standards prior to the effective date of the Form 10-Q revisions. The Commission notes, however, that AudSEC has issued for exposure a set of proposed standards and procedures for such a review, and if professional standards are adopted which the Commission believes are satisfactory to protect the interests of investors, it is the intention of the Commission to withdraw its proposed standards and rely on the standards established by AudSEC.

If the registrant has the independent public accountant perform such a review and elects to state this fact, the statement must also indicate whether all adjustments or additional disclosures proposed by the independent accountant have been reflected in the data presented, and if not, why not.

In addition, if the registrant states that such a review has been made, there may (but need not be) included as an exhibit to the form a letter from the registrant's independent accountant conforming or otherwise commenting upon the registrant's representations and making such other comments as the independent accountant deems appropriate.

A number of commentators have indicated that they do not believe that independent accountants should be permitted to associate their names with data on the basis of limited review procedures. This position is also taken in the AudSEC exposure draft on interim reviews referred to above. This view is based on the concern that users of the accountant's report will not be able to distinguish between a report covering an audit conducted in accordance with generally accepted auditing standards and a report on a limited review following specified procedures, and hence will be misled. The Commission has considered these comments, but is not prepared to conclude that investors will be unable to distinguish appropriately between different types of reports. It believes that an accountant's report on a limited review may provide significant and useful information to investors and that such reports should be encouraged. At the present time, however, the Commission does not propose to require such reports in connection with Form 10-Q filings.

In Securities Act Release No. 5579, the Commission proposed to amend the facing sheet of Form 10-Q to require registrants to indicate by check mark whether or not financial statements required by the form had been reviewed by independent public accountants. A number of commentators suggested that such a requirement would imply that a review was mandatory and that a "no" answer would indicate a deficiency in the form. Others commented that a simple yes or no answer on the front of the form would oversimplify a complex matter and would increase the likelihood of investors being misled.

The Commission has concluded that at the present time, the proposed check mark on the facing sheet of Form 10-Q is not necessary and it has determined not to adopt the amendment to the facing sheet.

Amendments to Forms S-7 and S-16

In Securities Act Release No. 5579 the Commission proposed amendments to Forms S-7 and S-16 which would have had the effect of permitting the use of Form S-7 by registrants not presently qualified to do so if the financial information included in their Form 10-Q filings was reviewed by indepenent public accountants and this fact was stated on Form 10-Q. Many commentators suggested that the involvement of public accountants on a review basis was not an equivalent test as compared to the current tests of financial strength and stability now required for the use of Form S-7. With few exceptions, they recommended that the amendments not be adopted.

The Commission is concerned about the

cost of registering securities for sale and it is desirous of keeping such costs at a minimum consistent with the protection of investors. Accordingly, the Commission has approved publication for comment amendments to Forms S-7 and S-16. While such proposed amendments do not include timely auditor involvement as one of the criteria for use of the forms, they are designed to broaden the availability of the use of the forms by a larger number of companies.

Effective Date of Form 10-Q Amendments

The Commission has determined to make changes in Form 10-Q adopted hereby effective for Form 10-Q reports filed covering periods beginning after December 25, 1975, but in no event shall disclosure of comparative balance sheet data and source and application of funds data be required for interim periods beginning prior to that date.

B. Amendments Adopted

The text of the amendments to Regulation S-X, Form 10-Q and Form 7-Q and related rules follows.

I. Regulation S-X

Rule 2-02. Accountants' Reports.

(a) through (d) (No change)

(e) *Association with unaudited note covering interim financial data.*

If the financial statements covered by the accountant's report designate as "unaudited" the note required by Rule 3-16(t), it shall be presumed that appropriate professional standards and procedures with respect to the data in the note have been followed by the independent accountant who is associated with the unaudited footnote by virtue of reporting on the financial statements in which it is included.

* * * * *

Rule 3-16. General Notes to Financial Statements. (See Release No. AS-4.)

* * * * *

(t) *Disclosure of selected quarterly financial data in notes to financial statements.*

Exemption. This rule shall not apply to any registrant that does not meet the following conditions:

(a) The registrant (1) has securities registered pursuant to Section 12(b) of the Securities Exchange Act of 1934 or (2) has securities registered pursuant to Section 12(g) of that Act which also (i) are quoted on the National Association of Securities Dealers Automated Quotation System and (ii) meet the requirements for continued inclusion on the list of OTC margin stocks set forth in Section 220.8(i) of Regulation T of the Board of Governors of the Federal Reserve System; and

(b) The registrant and its consolidated subsidiaries (1) have had a net income after taxes but before extraordinary items and the cumulative effect of a change in accounting, of at least $250,000 for each of the last three fiscal years; or (2) had total assets of at least $200,000,000 for the last fiscal year end.

(1) Disclosure shall be made in a note to financial statements of net sales, gross profit (net sales less costs and expenses associated directly with or allocated to products sold or services rendered), income before extraordinary item and cumulative effect of a change in accounting, per share data based upon such income, and net income for each full quarter within the two most recent fiscal years and any subsequent interim period for which income statements are presented.

(2) When the data supplied in (1) above vary from the amounts previously reported on the Form 10-Q filed for any quarter, such as would be the case when a pooling of interests occurs or where an error is corrected, reconcile the amounts given with those previously reported describing the reason for the difference.

(3) Describe the effect of any disposals of segments of a business, and extraordinary, unusual or infrequently occurring items recognized in each full quarter within the two most recent fiscal years and any subsequent interim period for which income statements are presented, as well as the aggregate effect and the nature of year-end or other adjustments which are material to the results of that quarter.

(4) Where this note is part of financial statements which are presented as audited, it may be designated "unaudited."

* * * * *

Article 11A. Statement of Source and Applications of Funds.

Rule 11A-01. Application of Article 11A.

This article shall be applicable to statements of source and application of funds filed pursuant to requirements in registration and reporting forms under the Securities Act of 1933 and the Securities Exchange Act of 1934.

II. Rule 13a-13. Quarterly Reports on Form 10-Q.

(a), (b)(1), (c) and (d) (No change)

(b)(2) (Deleted)

(b)(3), (4) and (5) become (b)(2), (3) and (4), respectively.

III. Rule 13a-15. Quarterly Reports of Certain Real Estate Companies on Form 7-Q.

(This rule is rescinded.)

IV. Rule 15d-13. Quarterly Reports on Form 10-Q.

(a), (b)(1), (c) and (d) (No change)

(b)(2) (Deleted)

(b)(3), (4) and (5) become (b)(2), (3) and (4), respectively.

V. Rule 15d-15. Quarterly Reports of Certain Real Estate Companies on Form 7-Q.

(This rule is rescinded.)

VI. Form 7-Q. For Quarterly Reports of Certain Real Estate Companies Under Section 13 or 15(d) of the Securities Exchange Act of 1934.

(This form is rescinded.)

VII. Form 10-Q. For Quarterly Reports Under Section 13 or 15(d) of the Securities Exchange Act of 1934.

Instructions A through G (No change)

H. Financial Statements

(a) The registrant shall furnish an income statement, balance sheet and statement of source and application of funds for the periods set forth in (b) below. These statements shall follow the general form of presentation set forth in Regulation S-X with the following exceptions:

(1) Balance sheets and income statements shall include only major captions (i.e., numbered captions) set forth in Regulation S-X, with the exception of Inventories where data as to raw materials, work in process and finished goods shall be included, if applicable. Where any major balance sheet caption is less than 10% of total assets, and the amount in the caption has not increased or decreased by more than 25% since the previous balance sheet presented, the caption may be combined with others. When any major income statement caption is less than 15% of average net income for the most recent three years and the amount in the caption has not increased or decreased by more than 20% as compared to the next preceding comparable income statement, the caption may be combined with others. In calculating average net income, loss years should be excluded. If losses were incurred in each of the most recent three years, the average loss shall be used for purposes of this test. Notwithstanding these tests, Rule 3-02 of Regulation S-X applies and *de minimus* amounts therefore need not be shown separately.

(2) The statement of source and application of funds may be abbreviated, starting with a single figure of funds provided by operations and showing other sources and applications individually only when they exceed 10% of the average of funds provided by operations for the most recent three years. Notwithstanding this test, Rule 3-02 of Regulation S-X applies and *de minimus* amounts therefore need not be shown separately.

(3) Rules 3-08 and 3-16 of Regulation S-X and other requirements which call for detailed footnote disclosure and schedules shall not apply. As with all information filed with the Commission, however, disclosures must be adequate to make the information presented not misleading.

A company in the promotional or development stage to which paragraph (b) of Rule 5A-01 of Article 5A of Regulation S-X is applicable shall furnish the information specified in Rules 5A-02, 5A-03, 5A-04 and 5A-06 of Regulation S-X in lieu of the above financial statement requirements.

(b) The condensed financial statements shall be provided for periods set forth below:

(1) The condensed income statement shall be presented for the most recent fiscal quarter, for the period between the end of the last fiscal year and the end of the most recent fiscal quarter, and for corresponding periods of the preceding fiscal year. It also may be presented for the cumulative twelve month period ended during the most recent fiscal quarter and for the corresponding period of the preceding fiscal year.

(2) The balance sheet shall be presented as of the end of the most recent fiscal quarter and for the end of the corresponding period of the preceding fiscal year. However, balance sheets for dates prior to December 26, 1975, are not required.

(3) The statement of source and application of funds shall be presented for the period between the end of the last fiscal year and the end of the most recent fiscal quarter, and for the corresponding period of the preceding fiscal year. It also may be presented for the cumulative twelve month period ended during the most recent fiscal quarter and for the corresponding period of the preceding fiscal year.

(c) For registrants engaged in the seasonal production and the seasonal sale of a single-crop agricultural commodity, the income statement may be presented for the twelve months ended with the current interim quarter, with comparative data for the corresponding period of the preceding fiscal year in place of the current quarter and year-to-date information specified by (b)(1) above.

(d) If, during the current period specified in (b) above, the registrant or any of its consolidated subsidiaries, entered into a business combination treated for accounting purposes as a pooling of interests, the interim financial statements for both the current year and the preceding year shall reflect the combined results of the pooled businesses. Supplemental disclosure of the separate results of the combined entities for periods prior to the combination shall be given, with appropriate explanations.

(e) In case the registrant has disposed of any significant portion of its business during any of the periods covered by the report, the effect thereof on revenues and net income—total and per share—for all periods shall be disclosed. In addition, where a material business combination accounted for as a purchase has occurred during the current fiscal year, pro forma disclosure shall be made of the results of operations for the current year up to the date of the end of the most recent fiscal quarter (and for the comparable period in the preceding year) as though the companies had combined at the beginning of the period being reported on. This pro forma information should as a minimum show revenue, income before extraordinary items and the cumulative effect of accounting changes, such income on a per share basis and net income.

(f) The financial statements to be included in this report shall be prepared in conformity with the standards of accounting measurement set forth in Accounting Principles Board Opinion No. 28 and any amendments thereto adopted by the Financial Accounting Standards Board. In addition to meeting the reporting requirements for accounting changes specified therein, the registrant shall state the date of any change and the reasons for making it. In addition, in the first Form 10-Q filed subsequent to the date of an accounting change, a letter from the registrant's independent accountants shall be filed as an exhibit indicating whether or not the change is to an alternative principle which in his judgment is preferable under the circumstances; except that no letter from the accountant need be filed when the change is made in response to a standard adopted by the Financial Accounting Standards Board which requires such change.

(g) (Formerly paragraph k) If appropriate, the income statement shall show earnings per share and dividends per share applicable to common stock and the basis of the earnings per share computation shall be stated together with the number of shares used in the computation. The registrant shall file as an exhibit a statement setting forth in reasonable detail the computation of per share earnings, unless the computation is otherwise clearly set forth in the report.

(h) and (i) (No change)

(j) (Deleted)

(k) (Now becomes (g))

I. Management's Analysis of Quarterly Income Statements.

The registrant shall provide a narrative analysis of the results of operations explaining the reasons for material changes in the amount of revenue and expense items between the most recent quarter and the quarter immediately preceding it, between the most recent quarter and the same calendar quarter in the preceding year, and, if applicable, between the current year to date and the same calendar period in the preceding year. Explanations of material changes should include, but not be limited to, changes in the various elements which determine revenue and expense levels such as unit sales volume, prices charged and paid, production levels, production cost variances, labor costs and discretionary spending programs. In addition, the analysis should include an explanation of the effect of any changes in accounting principles and practices or in the method of their application that have a material effect on net income as reported.

J. Other Financial Information.

The registrant may furnish any additional information related to the periods being reported on which, in the opinion of management, is of significance to investors, such as the seasonality of the company's business, major uncertainties currently facing the company, significant accounting changes under consideration and the dollar amount of backlog of firm orders. In addition, the registrant shall indicate whether any Form 8-K was required to be filed reporting any material unusual charges or credits to income during the most recently completed fiscal quarter or whether any Form 8-K was required to be filed during that period reporting a change in independent accountants.

K. Review by Independent Public Accountant.

The financial information included in this form need not be reviewed prior to filing by an independent public accountant. If, however, a review of the data is made in accordance with established professional standards and procedures for such a review, the registrant may state that the independent accountant has performed such a review. If such a statement is made, the registrant shall indicate whether all adjustments or additional disclosures proposed by the independent accountant have been reflected in the data presented, and, if not why not. In addition, a letter from the registrant's independent accountant confirming or otherwise commenting upon the registrant's representations and making such other comments as the independent accountant deems appropriate may be included as an exhibit to the form.

L. Filing of Other Statements in Certain Cases. (Formerly Instruction I) (No change)

M. Sales of Unregistered Securities (Debt or Equity) (Formerly Part C)

The information called for herein shall be given as to each "security" as defined in Section 2(1) of the Securities Act of 1933. If the information called for has been previously reported on another form, it may be incorporated by a specific reference to the previous filing.

Give the following information as to all securities of the registrant sold by the registrant during the fiscal quarter, which were not registered under the Securities Act of 1933, in reliance upon an exemption from registration provided by Section 4(2) of that Act. Include sales of the registrant's reacquired securities as well as new issues, securities issued in exchange for property, services or other securities, and new securities resulting from the modification of outstanding securities:

(1) Give the date of sale, and the title and amount of the registrant's securities sold;

(2) Give the market price on the date of sale, if applicable;

(3) Give the names of the brokers, underwriters or finders, if any. As to any securities sold but which were not the subject of a public offering, name the persons or identify the class of persons to whom the securities were sold;

(4) As to securities sold for cash, state the aggregate offering price and the aggregate underwriting discounts, brokerage commissions, or finder's fees. As to any securi-

ties sold otherwise than for cash, state the nature of the transaction and the nature and aggregate amount of consideration received by the registrant;

(5) Indicate the section of the Act or rule of the Commission under which exemption from registration was claimed, and state briefly the facts relied upon to make the exemption available; and (6) State whether the securities have been legended and stop-transfer instructions given in connection therewith, and if not, state the reasons why not.

N. Signature and Filing of Report. (Formerly Instruction J)

Eight copies of the report shall be filed with the Commission. At least one copy of the report shall be filed with each exchange on which any class of securities of the registrant is listed and registered. At least one copy of the report filed with the Commission and one copy filed with each such exchange shall be manually signed on the registrant's behalf by a duly authorized officer of the registrant and by the principal financial officer or chief accounting officer of the registrant. Copies not manually signed shall bear typed or printed signatures.

A. Summarized Financial Information

(Existing Part A deleted)

B. Capitalization and Stockholders' Equity

(Existing Part B deleted)

C. Sales of Unregistered Securities (Debt or Equity)

(Part C becomes General Instruction M)

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

____
(Registrant)

Date __________ ________________
(Signature)*

Date __________ ________________
(Signature)*

* Print name and title of the signing officer under his signature.

* * * * *

These amendments are adopted pursuant to authority in Sections 6, 7, 8, 10 and 19(a) of the Securities Act of 1933; Sections 12, 13, 15(d) and 23(a) of the Securities Exchange Act of 1934; and Sections 5(b), 14 and 20(a) of the Public Utility Holding Company Act of 1935.

The amendments of Rule 11A-01 of Regulation S-X, Exchange Act Rules 13a-13, 13a-15, 15d-13, 15d-15 and Forms 7-Q and 10-Q will be effective for reports filed for periods beginning after December 25, 1975, but in no event shall comparative balance sheet data or source and application of funds data be required for interim periods beginning prior to December 25, 1975. Rules 2-02(e) and 3-16(t) of Regulation S-X shall be applicable to financial statements for all fiscal periods beginning subsequent to December 25, 1975, but in no event shall disclosure of quarterly data be required for quarters beginning prior to that date.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 178

October 9, 1975

SECURITIES ACT OF 1933
Release No. 5625

SECURITIES EXCHANGE ACT OF 1934
Release No. 11721

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 19203

Notice of Adoption of Amendments to Regulation S-X with Respect to Accounting for Research and Development Costs

The purpose of these amendments is to conform the requirements pertaining to the accounting and reporting for research and development costs in Regulation S-X, Form and Content of Financial Statements, and the standards established by the Financial Accounting Standards Board in Statement of Financial Accounting Standards No. 2, Accounting for Research and Deelopment Costs, in October 1974. Differences exist between the requirements in Regulation S-X and FASB Statement No. 2 in that Statement No. 2 specifies in summary that research and development costs shall be charged to expenses as incurred, whereas various rules and items in Regulation S-X relate to the recordation and amortization of deferred research and development expenses.

The Commission stated, in Accounting Series Release No. 150, that the pronouncements of the FASB will be considered to constitute substantial authoritative support for accounting and reporting procedures and practices used in preparing financial statements filed with the Commission. In accordance with this policy, the Commission issued on November 21, 1974, Securities Act Release No. 5541 (Securities Exchange Act Release No. 11109, Public Utility Holding Company Act Release No. 18667) which contained proposals to amend the affected rules and items in Regulation S-X, including Caption 20 in Rule 5-02, Schedule VII in Rule 5-04, Rule 12-08, and Items 3 and 8 in Rule 12-16, to eliminate the differences, and to add a new caption in Rule 5-03 to provide for disclosure in the financial statements of the research and development costs charged to expense as specified in Statement No. 2.

Comments received from the public indicated general agreement with the proposed amendments. Minor technical changes which were suggested in the comments on the proposals are reflected in these amendments. An instruction is added to the proposed new caption in the income statement (Caption 3A of Rule 5-03) for research and development expenses to permit the alternative of disclosing the amount of such expenses in a note to the financial statements. The interpretation and guideline in Accounting Series Release No. 141 which pertains to Item 8, Research and development costs, under Rule 12-16 of Regulation S-X, is rescinded inasmuch as Item 8 is rescinded and because a definition of research and development is provided in FASB Statement No. 2 that is considered applicable to that term where it appears elsewhere in Regulation S-X. A reference to research and development expense in Rule 3-16(o)(1) of Regulation S-X is deleted.

The Commission hereby adopts (1) amendments of Regulation S-X revising paragraph (1) of Rule 3-16(o), Caption 20 of Rule 5-02, the title of Schedule VII of Rule 5-04, the title and instruction Nos. 1, 3 and 7 of Rule 12-08, and Item 3 of Rule 12-16, adding Caption 3A to Rule 5-03, and deleting Item 8 of Rule 12-16; and (2) an amendment of Accounting Series Release No. 141 rescinding an interpretation in Part A pertaining to Item 8, Research and development costs, in Rule 12-16 of Regulation S-X.

(The text of the amendments is omitted.)

The amendments are adopted pursuant to authority in Sections 6, 7, 8, 10 and 19(a) of the Securities Act of 1933; Section 12, 13, 15(d) and 23(a) of the Securities Exchange Act of 1934; and Sections 5(b), 14 and 20(a) of the Public Utility Holding Company Act of 1935. The amendments are effective on November 15, 1975, for financial statements for fiscal years beginning on or after January 1, 1975.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 179A
November 24, 1975

SECURITIES ACT OF 1933
Release No. 5628A

SECURITIES EXCHANGE ACT OF 1934
Release No. 11736A

Amended Order Suspending Accountant from Appearance or Practice Before the Commission in the Matter of Thomas R. Mathews.[1]

On October 31, 1974, an order was entered by the Commission pursuant to Rule 2(e)(3)(i)(a) of the Rules of Practice temporarily suspending respondent Thomas R. Mathews, a certified public accountant, from appearing or practicing before the Commission. These proceedings were instituted pursuant to respondent's petition to lift the temporary suspension. See Rule 2(e)(3)(ii) of the Rules of Practice.

The Commission's order of October 31, 1974, was based on the fact that in *Securities and Exchange Commission* v. *Harold L. Fisher, et al.*, S.D. Ohio, Civil Action File No. 8876, respondent had previously consented, without admitting or denying any of the allegations of the Commission's complaint, to the entry of an order permanently enjoining him from violations of Section 17(a) of the Securities Act of 1933, and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The complaint in that action alleged that Harmony Loan Company ("Harmony"), a small loan and consumer finance company incorporated in Kentucky, was the subject of a fraudulent scheme whereby control of the company was transferred in October 1971, and that in this transaction the sellers received valuable corporate assets which the purchasers replaced on the books of the company with certain grossly overvalued assets. The complaint further alleged that after the transfer of control, the company, in February 1972, began selling a new issue of debentures to the public by means of a prospectus filed with the State of Kentucky which contained false and misleading statements and omissions of material facts, and that over $110,000 was obtained from investors before the Kentucky Securities Division suspended sales on March 13, 1972.

The Commission's complaint alleged that respondent performed accounting services for Harmony and further alleged that in November 1971 he was responsible for making certain entries on Harmony's books in order to conceal the method by which control of Harmony had been transferred. According to the Commission's complaint, these entries were allegedly made with the knowledge and expectation that they would be reflected in financial statements prepared for the company which would be distributed to the investing public. The complaint also alleged that the

[1] On October 15, 1975, the Commission inadvertently issued the text of an order, designated Securities Act of 1933 Release No. 5628, Securities Exchange Act of 1934 Release No. 11736 and Accounting Series Release No. 179. That order is hereby rescinded in its entirety and should be considered to have no force or effect. The instant amended order is issued in its stead.

entries concealed the fact that as of October 31, 1971, Harmony was insolvent.

According to the Commission's complaint, respondent was alleged to be responsible for making the following entries, which were reflected in financial statements prepared for the company as of October 31, 1971:

(1) The complaint alleged that certain revenue bonds transferred to Harmony were recorded as "Marketable Securities" at their face value of $341,000, when in act there was no market for the bonds and their original cost was only $132,000. The complaint also alleged that at the same time "appraisal surplus" was falsely recorded on the books to reflect the difference between the cost of the revenue bonds and the valuation placed upon them as a current asset of Harmony.

(2) The complaint also alleged that the interest on the bonds was recorded as an asset entitled "Accrued Interest Receivable—Marketable Securities" despite the fact that interest on the bonds had been in default for almost two years.

(3) The complaint further alleged that, in order to inflate the value of Harmony's assets, treasury stock was improperly recorded on Harmony's books as an asset in the amount of $226,520, and that the recordation of treasury stock as an asset under such circumstances was not in accord with generally accepted accounting principles. See, e.g., Rule 3-14 of Regulation S-X.

The Commission believes the effect of the foregoing entries was to conceal the looting of valuable corporate assets from Harmony. The financial statements of October 31, 1971 were included in a prospectus filed with the State of Kentucky. In that prospectus, these unaudited financial statements were referred to as having been prepared by respondent's firm. As noted above, in February and March 1972, Harmony began selling a new issue of its debentures to the public by means of this prospectus.

It appears to the Commission that due to his prior association with Harmony, respondent knew that Harmony had on several occasions obtained money from the public by sale of its securities and would continue to do so and that in the offer and sale of such securities, prospectuses would be used which contained financial statements reflecting his entries on the books of the company. The Commission is of the opinion that, in these circumstances, respondent would be responsible for such violations of the antifraud provisions of the federal securities laws as may be proven to result from such entries.[2]

Since these proceedings were instituted, respondent, solely for the purpose of settling this matter, and without admitting or denying any of the allegations of the Commission's complaint, or the statements herein, submitted an offer of settlement consenting to the order set forth below, which the Commission has determined to accept. Such consent is given on the understanding that the order is not and shall not be evidence of any violation of or compliance with any statute or law, or an admission or denial of the wrongdoing or liability by respondent in any

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[2] The financial statements prepared for Harmony were unaudited. According to the American Institute of Certified Public Accountants' Committee on Auditing Procedure *Statement on Auditing Standards*, §516.01 (see prior *Statement of Auditing Procedure* No. 38):

"This type of an engagement is an accounting service as distinguished from an examination of financial statements in accordance with generally accepted auditing standards. *** [T]he [unaudited financial] statements are representations of management, and the fairness of their representation is management's responsibility."

However, the Commission believes an accountant is not excused from compliance with generally accepted accounting principles merely because he does not express an opinion with respect to representations contained in financial statements. The Commission further believes §516.03 of *Statement of Auditing Standards*, *supra*, makes it clear that the Certified Public Accountant is "associated with" unaudited financial statements in a situation such as this, and that in such cases, §516.04 requires the practitioner to disclaim an opinion on such financial statements with which he is associated.

See also, Opinion No. 8 of the Committee on Professional Ethics of the American Institute of Certified Public Accountants (entitled: "Denial of the Opinion Does not Discharge Responsibility in All Cases"). In that Opinion, the Committee stated:

"In a circumstance where a member believes the financial statements are false or misleading as a whole or in any significant respect, it is the opinion of the committee that he should require adjustments of the accounts or adequate disclosure of the facts, as the case may be, and failing this the independent accountant should refuse to permit his name to be associated with the statements in any way."

action now or hereafter pending against respondent or any other person. On the basis of respondent's offer of settlement, it is

ORDERED that Thomas R. Mathews be, and he hereby is, suspended from appearing or practicing before the Commission; and it is further

ORDERED that on and after October 30, 1977, Mathews shall have the right to apply for reinstatement of his privilege to appear and practice, and any such application shall be granted if supported by a showing that:

(A) Mathews has enrolled in and attended a total of 100 or more hours of professional seminars or college courses dealing with the registration and disclosure requirements of the federal securities laws and generally accepted accounting principles and auditing standards during the period of his suspension; and

(B) Nothing has occurred during the suspension period that would be a basis for adverse action against Mathews under Rule 2(e).

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 180
November 4, 1975

SECURITIES ACT OF 1933
Release No. 5640

SECURITIES EXCHANGE ACT OF 1934
Release No. 11790

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 19235

Notice of the Institution of a Series of Staff Accounting Bulletins

The Securities and Exchange Commission today announced the institution of a series of Staff Accounting Bulletins intended to achieve a wider dissemination of the administrative interpretations and practices utilized by the Commission's staff in reviewing financial statements. The Division of Corporation Finance and the Office of the Chief Accountant began the series today with the publication of Bulletin No. 1 (S.A.B. Rel. No. 1, November 4, 1975). The statements in the Bulletin are not rules or interpretations of the Commission nor are they published as bearing the Commission's official approval; they represent interpretations and practices followed by the Division and the Chief Accountant in administering the disclosure requirements of the federal securities laws.

Description of Series

The process of financial reporting is dynamic and evolutionary. Consequently, new or revised administrative interpretations and practices must be implemented in response to changes in the reporting process. While large accounting firms who practice before the Commission have many opportunities to exchange information and views with the staff, the Commission has been concerned about comments that small accounting firms have fewer such opportunities and may be at an unfair competitive disadvantage because there has been no formal dissemination of staff positions.

The announced series of bulletins attempts to curtail these problems by making avail-

able to the public a compilation of certain existing staff interpretations and practices and by providing a means by which new or revised interpretations and practices can be quickly and easily communicated to registrants and their advisors. Thus, this series should not only reduce the staff's workload by eliminating repetitive comments and inquiries, but also save registrants both time and money in the registration and reporting process.

It is anticipated that the bulletins will be prepared for publication from time to time and will be collated periodically, but not more frequently than on a quarterly basis. The new bulletins would keep the series current by stating staff positions on specific new problems that may be of general interest and on matters which are arising frequently in letters of comment. Each bulletin would contain material organized according to the broad topics specified in Staff Accounting Bulletin No. 1. New topics may be added to accommodate material not readily associated with existing topics.

Two indices have been provided to assist registrants in ascertaining information relevant to their particular needs. The first index presents a comprehensive listing of all subject matters discussed in the bulletins. The second index lists the published rules, regulations, forms, releases and opinions specifically cited in the bulletins. These indices should facilitate (a) the use of the bulletins by registrants and their professional advisors and (b) the periodic revision and updating of the bulletins necessitated by the evolutionary process discussed above.

All interested persons are invited to submit their views and comments on the administration of these interpretations and practices to Howard P. Hodges, Chief Accountant, Division of Corporation Finance, and on the policies reflected therein to John C. Burton, Chief Accountant of the Commission.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 181
November 10, 1975

SECURITIES ACT OF 1933
Release No. 5642

SECURITIES EXCHANGE ACT OF 1934
Release No. 11817

Notice of Amendments of Regulation S-X and of Certain Filing Forms with Respect to Financial Reporting Requirements for Companies in the Development Stage

The Commission hereby amends Article 5A and certain rules of Regulation S-X which specifies the requirements for the form and content of the financial statements and schedules to be included in registration statements and periodic reports filed with the Commission by certain commercial, industrial and mining companies in the promotional, exploratory or other stages of development; amends instructions in various registration and reporting forms regarding the applicability of Article 5A requirements to the financial statements to be included in those forms filed by the development stage companies; and amends other references to Article 5A in forms and rules.

Article 5A, prior to these amendments, contained specialized requirements for the financial statements of development stage companies meeting specified standards, and they differed in several significant respects from the requirements for financial statements in Regulation S-X which are applicable to companies which are not in a development stage, particularly for balance sheets and income statements (Article 5), state-

ments of other stockholders' equity (Article 11), and statements of source and application of funds (Article 11A). When these specialized requirements for the form and content of the financial statements of certain companies in the development stage were adopted by the Commission, there were no authoritative statements of the accounting profession regarding the appropriate accounting and financial reporting directly applicable to such companies.

In June 1975 the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 7, "Accounting and Reporting by Development Stage Enterprises," which specifies in summary that financial statements issued by a development stage enterprise shall conform to generally accepted accounting principles applicable to established operating enterprises, and that certain additional information shall be disclosed in the financial statements. This FASB Statement relates to all of the types of companies to which Article 5A and the related rules in Regulation S-X were applicable, as well as to other development stage companies which did not meet the standards for utilization of the Article 5A requirements.

The Commission stated, in Accounting Series Release No. 150, that the pronouncements of the FASB will be considered to constitute substantial authoritative support for accounting and reporting procedures and practices used in preparing financial statements filed with the Commission. Therefore, the Commission considered that it should revise its requirements for the presentation of financial statements by development stage companies in filings with the Commission to conform them to the requirements in the FASB Statement. Proposed amendments were issued for public comment on July 31, 1975 in Securities Act Release No. 5601. Comments received indicated general agreement with the proposals. Minor technical changes were suggested which have been effected in the amendments.

In the amendments, Article 5A in Regulation S-X is revised to eliminate the specialized financial statement requirements for all companies to which Article 5A was applicable and to prescribe additional information, as specified in FASB Statement No. 7, to be included in financial statements in registration statements and periodic reports filed by all companies in the development stage. All other rules and instructions in Regulation S-X relating to the prior Article 5A requirements are also eliminated. The instructions as to financial statements applicable to the development stage companies in Forms S-2, S-3, 1-A, 10 and 10-K are amended to conform the requirements for the form and content of financial statements applicable to those prescribed for established operating companies in Article 5, 11, and 11A of Regulation S-X to require the additional financial information specified in revised Article 5A. General Instruction H(a) in Form 10-Q and Rules 13a-13 and 15d-13 under the Exchange Act which contained references to Article 5A are revised.

The exemption in Form 10-K from the requirements for audited financial statements for development stage companies under certain conditions, which was proposed to be rescinded, has been retained. However, that exemption and the exemption from requirements to file quarterly reports on Form 10-Q provided for certain mining companies in the development stage in Rule 13a-13 and 15d-13 will be restudied to determine whether such exemptions continue to be appropriate.

Form S-1 is the general form used for registration of securities under the Securities Act; Form S-2 is used by commercial and industrial companies in the development stage and Form S-3 is used by mining companies in the development stage for registration of equity securities for sale for cash under the Securities Act; Form 1-A is used for filing the notification and offering circular for securities pursuant to Regulation A under the Securities Act; Form 10 is the general form used for registration of securities under the Exchange Act; Form 10-K is used for annual reports and Form 10-Q is used for quarterly reports pursuant to the Exchange Act.

(The text of the amendments of Article 5A and Rules 12-01, 12-06, 12-06A and 12-07 of

Regulation S-X, of Forms S-2, S-3, 1-A, 10 and 10-K, and of Exchange Act Rules 13a-13 and 15d-13 is omitted.)

The amendments are adopted pursuant to authority in Sections 6, 7, 8, 10 and 19(a) of the Securities Act of 1933; and Sections 12, 13, 15(d) and 23(a) of the Securities Exchange Act of 1934.

The amendments are effective for fiscal periods beginning on or after December 26, 1975. When financial statements, or financial summaries or other data derived therefrom, for periods prior to the effective date are included with such financial statements or data for periods after the effective date in filings with the Commission, they shall be restated, where necessary, to conform to the amended requirements for financial statements of development stage companies.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 182
November 12, 1975

SECURITIES EXCHANGE ACT OF 1934
Release No. 11821

Notice of Permanent Disqualification from Appearance or Practice Before the Commission in the Matter of Charles H. Southerland

On June 24, 1975, the Commission entered an order, pursuant to Rule 2(e)(3)(i) of its Rules of Practice, temporarily suspending Charles H. Southerland, a certified public accountant, from appearing or practicing before the Commission. The order was based on the fact that on April 23, 1975, Southerland was permanently enjoined by the United States District Court for the Northern District of Texas, Dallas Division, in a suit brought by the Commission,[1] from violating Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act, and Rule 10b-5 thereunder. Southerland consented to the injunction without admitting or denying the allegations in the Commission's complaint.

The complaint in the injunctive action alleged that Southerland violated the above provisions of the federal securities laws, in that he prepared a certified financial statement for Sports International, Inc. which contained false and misleading information.

Rule 2(e)(3)(ii) of the Commission's Rules of Practice provides that any person temporarily suspended in accordance with paragraph (i) may, within 30 days after service upon him of the order of temporary suspension, petition the Commission to lift such suspension, but that if no petition has been received by the Commission within 30 days after such service, the suspension shall become permanent. Southerland was duly notified of this provision. The 30 day period has expired and no petition to lift the suspension has been received by the Commission.

Accordingly, notice is hereby given that the temporary suspension of Charles H. Southerland has become permanent and that Southerland is therefore disqualified from appearing or practicing before the Commission.

GEORGE A. FITZSIMMONS
Secretary

[1] *S.E.C.* v. *Sports International, Inc., et al.* (N.D. Tex., Dal. Div., Civ. Action No. 3-75-0371-C).

RELEASE NO. 183

November 14, 1975

SECURITIES ACT OF 1933
Release No. 5644

SECURITIES EXCHANGE ACT OF 1934
Release No. 11827

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 19243

INVESTMENT COMPANY ACT OF 1940
Release No. 9031

Notice of Adoption of Revision of Regulation S-X to Revise Requirements as to Form and Content of Financial Statements of Insurance Companies Other Than Life and Title Insurance Companies

The Securities and Exchange Commission today adopted a general revision of Article 7 of Regulation S-X which contains requirements as to form and content of financial statements for insurance companies other than life and title companies. The revision reflects changes in financial reporting by these companies since 1961 when Article 7 was last revised. In addition to revising Article 7, the schedule prescribed by Rule 12-29 is revised and the schedules prescribed by Rules 12-17, 12-23, 12-24, 12-25, 12-26, 12-28 and 12-30 are revoked. The revision was proposed on July 11, 1974,[1] and letters of comment have been received and have been given consideration in determining the form of the revision herein adopted.

The most significant change adopted is a requirement that the statements be prepared in accordance with generally accepted accounting principles (GAAP) (7-02-1). This replaces the existing requirement of Article 7 that the financials follow statutory accounting requirements and that they be accompanied by supplemental statements reconciling net income and stockholder's equity on the GAAP and statutory bases. In recent years we have observed that a majority of the financial statements of fire and casualty insurance companies included in filings and annual reports to stockholders were prepared on the GAAP basis as against the required statutory statements with supplemental reconciliations. The adoption of the requirements for GAAP statements reflects this development in reporting practices.

Statutory accounting requirements may be followed by those companies domiciled in states whose statutes prohibit publication of an insuror's primary financial statements on another basis; however, in such situations the statutory statements shall be accompanied by supplemental GAAP statements (7-02-2). Whether the basic statements are prepared on the GAAP or statutory basis, they must be accompanied by supplemental reconciliations of material differences between GAAP and statutory accounting (7-02-3).

Inasmuch as Regulation S-X has for many years classified title insurance companies with commercial and industrial companies with an implicit requirement that their financial statements be prepared in accordance with GAAP, it appears to be inappropriate at this time to make them subject to the requirements of Article 7. The provision that these companies shall comply with Article 5 will be retained (7-01).

The revised article permits mutual insurance companies and wholly owned stock subsidiaries of mutual insurance companies to prepare financial statements in accordance with statutory accounting requirements (7-02-4). However, these companies are encouraged to prepare their filings in accordance with GAAP if they desire and to include them in filings.

Consistent with the requirements for life insurance companies in Article 7A, investments of fire and casualty companies may be stated on the balance sheet at cost or value

[1] Notice of the proposed amendments was made in Securities Act Release No. 5513, Securities Exchange Act Release No. 10912, Public Utility Holding Company Act Release No. 18490 and Investment Company Act Release No. 8422 (S7-528) dated July 11, 1974.

provided that the alternates to the amounts at which bonds and stocks are stated are disclosed parenthetically (7-03-1). Realized profits or losses on investments are to be included as a component of net income (7-04-13),[2] while appreciation or depreciation of investments carried on the balance sheet at value is reflected in a stockholders' equity account (7-03-20(3)). This presentation is not viewed as a final resolution of the accounting and reporting problems associated with investments but rather as a temporary solution which provides for similar treatment by life and fire and casualty insurance companies. Many of the insurance company groups and holding company groups filing with the Commission include both life and fire and casualty subsidiaries. In connection with the reporting of realized investment profits or losses on the income statement, the change in value of marketable equity securities during the period is to be disclosed parenthetically or on a line immediately following the income statement. (See Accounting Series Release No. 166.) An additional requirement in a note calls for an analysis of realized and unrealized gains and losses on bonds and stocks (7-05-3). This analysis is required regardless of whether bonds and stock are stated at cost or value on the balance sheet.

Prior to its dissolution the Accounting Principles Board considered the problems related to accounting for marketable securities but was unable to reach conclusions as to appropriate treatment. While the matter is not presently on the agenda of the Financial Accounting Standard Board,[3] it is one which will have to be addressed in due course. At such time as new accounting principles are prescribed, the Commission will consider what changes are necessary in its requirements for insurance company and other financial statements.

The revised requirements are substantially similar to those proposed in July 1974. Wherever appropriate, captions and instructions conform with corresponding ones in Article 5 which applies to commercial and industrial companies or in Article 7A. The order of the items of the financial statements is generally similar to the order of items in our life insurance company requirements. The following are a number of additional requirements which are specific in nature:

1. To the extent that they are pertinent, the general rules in Articles 1, 2, 3 and 4 of Regulation S-X are applicable (7-02-1).
2. In preparing consolidated financial statements for an insurance holding company whose consolidated subsidiaries are primarily insurance companies other than life insurance companies consideration shall be given to utilization of the format of the financial statements, notes and schedules in Article 7 (7-01).
3. A statement of accounting principles and practices reflected in the statements (7-05-1).
4. The name of any person in which the investment exceeds two percent of total investments (7-03-1(6)).
5. Information as to policy, nature and changes in deferred policy acquisition costs (7-03-8, 7-04-5, 7-05-1 and 12-29).
6. Elimination of details of sources of investment income from the income statement. Such information would be stated separately in a note (7-04-2).
7. Details of restrictions on stockholders' equity (7-05-2).
8. Information concerning the significance of reinsurance ceded (7-05-4).
9. Rule 12-29, a schedule which is concerned with premiums, losses and policy acquisition costs, has been extensively revised.
10. The summary of investments contained in Rule 12-27 is made applicable to insurance companies covered by Article 7.
11. The detailed schedules of investments which have been the subject of Rules 12-23, 12-24, 12-25 and 12-26 are eliminated.

[2] Under statutory accounting requirements for fire and casualty insurance companies such profits or losses are included in net income. GAAP as applied generally would include such profits or losses in net income.

[3] The Board's exposure draft on marketable equity securities deals only with a limited part of this problem.

12. The schedule requirement for a summary of realized gains or losses on sale or maturity of investments is eliminated (12-30).
13. In view of the application of the schedule required by Rule 12-04 concerning investments in and earnings of affiliates, the similar schedule required by Rule 12-17 is no longer necessary and is eliminated.

These amendments are adopted pursuant to authority conferred on the Securities and Exchange Commission by the Securities Act of 1933, particularly 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 text of the amendments is omitted.)

These amendments shall be effective with respect to financial statements filed after December 25, 1975, although they may be applied in statements filed prior to that time.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 184
November 26, 1975

SECURITIES ACT OF 1933
Release No. 5648

SECURITIES EXCHANGE ACT OF 1934
Release No. 11878

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 19267

INVESTMENT COMPANY ACT OF 1940
Release No. 9057

Minor Amendments to Sections of Regulation S-X Which Were Originally Revised by Accounting Series Release Nos. 147, 148 and 149

I. Introduction

Since the issuance of Accounting Series Release (ASR) No. 147 (October 5, 1973) requiring additional disclosure about leases, ASR No. 148 (November 13, 1973) regarding disclosure of compensating balances and short-term borrowing arrangements, and ASR No. 149 (November 28, 1973) setting forth improved disclosure requirements for income tax expense items, registrants have pointed out certain editorial inconsistencies or ambiguities in the associated Regulation S-X rule changes and guidelines. Registrants also noted that a materiality test in ASR No. 149 results in disclosure of *de minimus* amounts and that ASR No. 148 disclosures are not required for several types of companies covered by separate rule sections in Regulation S-X.

On May 27, 1975, rule changes were proposed to correct such items as well as making an editorial change in one of the ASR No. 148 guidelines (Securities Act Rel. No. 5587, Securities Exchange Act Rel. No. 11442, Public Utility Holding Company Act Rel. No. 19005, Investment Company Act Rel. No. 8801). Based on letters of comment some modifications of the proposals have been made as noted below. None of the modifications constitute substantive changes from those originally proposed.

II. Discussion of the Amendments

Most of the amendments constitute minor editorial changes of existing requirements. However, the following amendments constitute changes in the substance of such requirements.

A. Rule 3-16(o)(1) has been amended to avoid disclosure of immaterial components of deferred tax expense. Changes made to the proposal based on the letters of comment will now meet this objective. Also, Rule 3-16(o)(3) has been amended to call specifically for reconciliations in loss situations. Most registrants have been providing such reconciliations but the amendment now resolves any ambiguity about this issue.

B. Proposed changes in Rule 3-16(q)(2) have been modified to eliminate the requirement to disclose minimum rental commitments for more than the date of latest balance sheet required.

C. The last sentence of Rule 5-02-1 has been amended to eliminate the unintended requirement for separate disclosure of a compensating balance related to an unused portion of a regular line of credit when a total compensating balance amount, covering both used and unused lines of credit, is presented.

D. Rule 5-02-25 has been amended to require separate disclosure of borrowings from factors and other financial institutions in addition to banks and commercial paper holders as presently required. Combined information about short-term borrowing rates from banks, factors or other financial institutions, and commercial paper holdings will now be required.

E. Article 6 (Management Investment Companies), Article 6B (Face Amount Certificate Investment Companies), and Article 7A (Life Insurance Companies) of Regulation S-X have been amended to include many of the disclosures now required by ASR No. 148 for other types of companies. Rules 6-03-1 and 6-22-1 have been modified to include specific reference to time deposits as part of cash on hand and demand deposits. Although the Commission is concerned about the classification of such items for purposes of meeting the requirements of a "diversified company" under Section 5(b)(1) of the Investment Company Act of 1940, it has determined not to conclude on this matter at this time.

F. The guidelines and interpretations section of ASR No. 148 contains a paragraph dealing with criteria for classifying short-term debt which is intended to be rolled over at maturity. Since the issuance of ASR No. 148, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 6 ("Classification of Short-term Obligations Expected to Be Refinanced," May 1975) which established standards in this area. Accordingly, this paragraph was rescinded. (ASR No. 172, June 13, 1975.)

G. As noted above, Article 6, Article 6B and Article 7A have been amended to include for other types of companies many of the disclosures now required by ASR No. 148 for Article 5 companies. The Guidelines and Interpretations set forth in Section C of ASR No. 148 are now applicable to companies covered by Articles 6, 6B and 7A of Regulation S-X to the extent that equivalent rules have been amended in such Articles.

III. Amendments to Regulation S-X and Modifications of ASR No. 148 Guidelines

Rules 3-16(o), 3-16(q), 5-02-1, 5-02-18, 5-02-25, 6-03-11, 6-03-12, 6-03-16, 6-22-1, 6-22-15, 6-22-17, 6-22-19, 6-22-21, 7A-03-2, 7A-03-8 and 7A-03-17 are amended as follows:

* * * * *

Rule 3-16(o). *Income tax expense.*

(1) Disclosure shall be made, in the income statement or a note thereto, of the components of income tax expense, including (i) taxes currently payable; (ii) the net tax effects, as applicable, of (a) timing differences (Indicate separately the amount of the estimated tax effect of each of the various types of timing differences, such as depreciation, warranty costs, etc., where the amount of each such tax effect exceeds five percent of the amount computed by multiplying the income before tax by the applicable statu-

tory Federal income tax rate; other differences may be combined.) and (b) operating losses; and (iii) the net deferred investment tax credits. Amounts applicable to United States Federal income taxes, to foreign income taxes and to other income taxes shall be stated separately for each major component. Amounts applicable to foreign or other income taxes each of which is less than five percent of the total of the major component need not be separately disclosed.

(2) If it is expected that the cash outlay for income taxes with respect to any of the succeeding three years will substantially exceed income tax expense for such year, that fact should be disclosed together with the approximate amount of the excess, the year (or years) of occurrence and the reasons therefor.

(3) Provide a reconciliation between the amount of reported total income tax expense (benefit) and the amount computed by multiplying the income (loss) before tax by the applicable statutory Federal income tax rate, showing the estimated dollar amount of each of the underlying causes for the difference. If no individual reconciling item amounts to more than five percent of the amount computed by multiplying the income before tax by the applicable statutory Federal income tax rate, and the total difference to be reconciled is less than five percent of such computed amount, no reconciliation need be provided unless it would be significant in appraising the trend of earnings. Reconciling items that are individually less than five percent of the computed amount may be aggregated in the reconciliation. The reconciliation may be presented in percentages rather than in dollar amounts. Where the reporting person is a foreign entity, the income tax rate in that person's country of domicile should normally be used in making the above computation, but different rates should not be used for subsidiaries or other segments of a reporting entity. When the rate used by a reporting person is other than the United States Federal corporate income tax rate, the rate used and the basis for using such rate shall be disclosed.

* * * * *

Rule 3-16(q). *Leased assets and lease commitments.*

Any contractual arrangement which has the economic characteristics of a lease, such as a "heat supply contract" for nuclear fuel, shall be considered a lease for purposes of this rule. Leases covering oil and gas production rights and mineral and timber rights are not to be considered leases for purposes of this rule. For purposes of this rule, a financing lease is defined as a lease which, during the noncancelable lease period, either (i) covers 75 percent or more of the economic life of the property or (ii) has terms which assure the lessor a full recovery of the fair market value (which would normall be represented by his investment) of the property at the inception of the lease plus a reasonable return on the use of the assets invested subject only to limited risk in the realization of the residual interest in the property and the credit risk generally associated with secured loans. The disclosures set forth under sections (1) and (2) below are only required if gross rental expense in the most recent fiscal year exceeds one percent of consolidated revenues.

(1) Total rental expense (reduced by rentals from subleases, with disclosure of such amounts) entering into the determination of results of operations for each period for which an income statement is required shall be disclosed. Rental payments under short-term leases for a month or less which are not expected to be renewed need not be included. Contingent rentals, such as those based upon usage or sales shall be reported separately from the basic or minimum rentals. Rentals on noncapitalized financing leases shall be shown separately for both categories of rentals reported.

(2) The minimum rental commitments under all noncancelable leases shall be disclosed, as of the date of the latest balance sheet required, in the aggregate (with disclosure of the amounts applicable to noncapitalized financing leases) for (i) each of the five succeeding fiscal years; (ii) each of the next three five-year periods; and (iii) the remainder as a single

amount. The amounts so determined should be reduced by rentals to be received from existing noncancelable subleases (with disclosure of the amounts of such rentals). For purposes of this rule, a noncancelable lease is defined as one that has an initial or remaining term of more than one year and is noncancelable, or is cancelable only upon the occurrence of some remote contingency or upon the payment of a substantial penalty.

(3) (No change.)

(4) For all noncapitalized financing leases there shall be disclosed:

(i) The present values of the minimum lease commitments in the aggregate and by major categories of properties, such as real estate, aircraft, truck fleets and other equipment. Present values shall be computed by discounting net lease payments (after subtracting, if practicable, estimated, or actual amounts, if any, applicable to taxes, insurance, maintenance and other operating expenses) at the interest rate implicit in the terms of each lease at the time of entering into the lease. Such disclosure shall be made as of the date of any balance sheet required. If the present value of the minimum lease commitments is less than five percent of the sum of long-term debt, stockholders' equity and the present value of the minimum lease commitments, and if the impact on net income required to be disclosed under (iv) below is less than three percent of the average net income for the most recent three years, this disclosure is not required;

(ii) (No change.)

(iii) (No change.)

(iv) The impact upon net income for each period for which an income statement is required if all noncapitalized financing leases were capitalized, related assets were amortized on a straight-line basis and interest cost was accrued on the basis of the outstanding lease liability. The amount of amortization and interest cost included in the computation shall be separately identified. If the impact on net income is less than three percent of the average net income for the most recent three years, that fact may be stated in lieu of this disclosure. In calculating average net income, loss years should be excluded. If losses were incurred in each of the most recent three years, the average loss shall be used for purposes of this test.

* * * * *

Rule 5-02-1. *Cash and cash items.*

State separately (a) cash on hand and unrestricted demand deposits; (b) legally restricted deposits held as compensating balances against short-term borrowing arrangements; (c) time deposits and certificates of deposit (excluding amounts included in (b) above or Rule 5-02-18(c) below); (d) funds subject to repayment on call or immediately after the date of the balance sheet required to be filed; and (e) other funds, the amounts of which are known to be subject to withdrawal or usage restrictions, e.g., special purpose funds. The general terms and nature of such repayment provisions in (d) and withdrawal or usage restrictions in (b) or (e) shall be described in a note referred to herein. In cases where compensating balance arrangements exist but are not agreements which legally restrict the use of cash amounts shown on the balance sheet, describe in the notes to the financial statements these arrangements and the amounts involved, if determinable, for the most recent audited balance sheet required and for any subsequent unaudited balance sheet required in the notes to the financial statements. Compensating balances that are maintained under an agreement to assure future credit availability shall be disclosed in the notes to the financial statements along with the amount and terms of such agreement.

* * * * *

Rule 5-02-18. *Other assets.*

State separately (a) noncurrent receivables from persons specified in captions 3(a)(1) and (4) above; (b) each pension or other special fund; (c) legally restricted deposits held as compensating balances against long-term borrowing arrangements; and (d) any other item not properly classed in one of the pre-

ceding asset captions which is in excess of five percent of total assets.

Rule 5-02-25. *Accounts and notes payable.*

(a) State separately amounts payable to (1) banks for borrowings; (2) factors or other financial institutions for borrowings; (3) holders of commercial paper; (4) trade creditors; (5) parents and subsidiaries; (6) other affiliates and other persons the investments in which are accounted for by the equity method; (7) underwriters, promoters, directors, officers, employees and principal holders (other than affiliates) of equity securities of the person and its affiliates; and (8) others. Exclude from (7) amounts for purchases from such person subject to usual trade terms, for ordinary travel expenses and for other such items arising in the ordinary course of business. With respect to (5) and (6), state separately in the registrant's balance sheet the amounts which in the related consolidated balance sheet are (i) eliminated and (ii) not eliminated.

(b) The weighted average interest rate and general terms (as well as formal provisions for the extension of the maturity) of each category of aggregate short-term borrowings (the sum of items (a)(1), (a)(2) and (a)(3) above) reflected on each balance sheet required shall be disclosed along with the maximum amount of aggregate short-term borrowings outstanding at any month end (or similar time period) during each period for which an end-of-period balance sheet is required. In addition, the approximate average aggregate short-term borrowings outstanding during the period and the approximate weighted average interest rate (and a brief description of the means used to compute such averages) for such aggregate short-term borrowings shall be disclosed in the notes to the financial statements.

(c) (No change.)

* * * * *

Rule 6-03-1. *Cash and cash items.*

State separately (a) cash on hand, unrestricted demand deposits, and time deposits; (b) call loans; (c) legally restricted deposits held as compensating balances against short-term borrowing arrangements; (d) funds subject to repayment on call or immediately after the date of the balance sheet required to be filed; and (e) other funds, the amounts of which are known to be subject to withdrawal or usage restrictions, e.g., special purpose funds. The general terms and nature of such repayment provisions in (d) and withdrawal or usage restrictions in (c) or (e) shall be described in a note referred to herein (see Rule 5-02-1).

* * * * *

Rule 6-03-11. *Other assets.*

State separately (a) total of amounts due from directors and officers, not included under caption 6 above; (b) each pension or other special fund; (c) real estate and improvements not included under caption 8 above; (d) furniture and fixtures; (e) legally restricted deposits held as compensating balances against long-term borrowing arrangements; and (f) any other item not properly classed in one of the preceding asset captions which is in excess of five percent of total assets.

Rule 6-03-12. *Notes payable.*

(a) State separately amounts payable within one year (1) to banks and (2) to others, and (b) provide here or in a note to the financial statements the information required under Rule 5-02-25(b) and (c). See also caption 16(a).

* * * * *

Rule 6-03-16. *Long-term debt.*

(a) (No change.)
(b) (No change.)
(c) (No change.)
(d) The amount and terms (including commitment fees and the conditions under which commitments may be withdrawn) of significant unused commitments for long-term debt that would be disclosed under this rule if used shall be disclosed in the notes to the financial statements.

* * * * *

Rule 6-22-1. *Cash and cash items.*

State separately (a) cash on hand, unrestricted demand deposits, and time deposits; (b) call loans; (c) legally restricted deposits held as compensating balances against short-term borrowing arrangements; (d) funds subject to repayment on call or immediately after the date of the balance sheet required to be filed; and (e) other funds, the amounts of which are known to be subject to withdrawal or usage restrictions, e.g., special purpose funds. The general terms and nature of such repayment provisions in (d) and withdrawal or usage restriction in (c) or (e) shall be described in a note referred to herein (see Rule 5-02-1).

* * * * *

Rule 6-22-15. *Other assets.*

State separately (a) amounts due from directors and officers, (b) legally restricted deposits held as compensating balances against long-term borrowing arrangements, and (c) any other items in excess of five percent of the amount of all assets other than qualified assets.

* * * * *

Rule 6-22-17(a). *Notes payable.*

(i) State separately amounts payable within one year (1) to banks and (2) to others, and (ii) provide in a note to the financial statements the information required under Rule 5-02-25(b) and (c).

* * * * *

Rule 6-22-19. *Funded debt.*

(a) (First sentence unchanged.)

(b) The amount and terms (including commitment fees and the conditions under which commitments may be withdrawn) of significant unused commitments for long-term debt that would be disclosed under this rule if used shall be disclosed in the notes to the financial statements.

* * * * *

Rule 6-22-21. *Other long-term debt.*

(First three sentences unchanged.)

The amount and terms (including commitment fees and the conditions under which commitments may be withdrawn) of significant unused commitments for long-term debt that would be disclosed under this rule if used shall be disclosed in the notes to the financial statements.

* * * * *

Rule 7A-03-2. *Cash and cash items.*

State separately (a) cash on hand and unrestricted demand deposits; (b) legally restricted deposits held as compensating balances against short-term borrowing arrangements; (c) funds subject to repayment on call or immediately after the date of the balance sheet required to be filed; and (d) other funds, the amounts of which are known to be subject to withdrawal or usage restrictions, e.g., special purpose funds. The general terms and nature of such repayments provisions in (c) and withdrawal or usage restrictions in (b) or (d) shall be described in a noted referred to herein (see Rule 5-02-1).

* * * * *

Rule 7A-03-8. *Other assets.*

Amend last sentence as follows:

Include legally restricted deposits held as compensating balances against long-term borrowing arrangements.

* * * * *

Rule 7A-03-17. *Other liabilities.*

(First sentence unchanged.)

The amount and terms (including commitment fees and the conditions under which commitments may be withdrawn) of unused commitments for long-term financing arrangements not provided for under Rule 7A-03-14 shall be disclosed in the notes to the financial statements if significant.

* * * * *

In the third full paragraph of the guidelines set forth in ASR No. 148 concerning "Unused Lines of Credit or Commitments" the definition of "usable lines" in the second sentence is modified as follows:

For this purpose usable lines are con-

strued to be total lines used to support commercial paper and other debt arrangements less lines needed to meet "clean-up" provisions of a borrowing arrangement.

IV. Effective Date

These amendments are adopted pursuant to authority in Sections 6, 7, 8, 10 and 19(a) of the Securities Act of 1933; Sections 12, 13, 15(d) and 23(a) of the Securities Exchange Act of 1934; Sections 5(b), 14 and 20(a) of the Public Utility Holding Company Act of 1935; and Sections 8, 30, 31(c) and 38(a) of the Investment Company Act of 1940.

These amendments shall be applicable to all financial statements filed with the Commission for all fiscal periods ending subsequent to December 25, 1975. Earlier application is encouraged.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 185
December 11, 1975

SECURITIES ACT OF 1933
Release No. 5654

SECURITIES EXCHANGE ACT OF 1934
Release No. 11917

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 19296

INVESTMENT COMPANY ACT OF 1940
Release No. 9080

Notice of Adoption of Amendments to Article 9 of Regulation S-X Relating to Financial Statements of Bank Holding Companies and Banks

In Securities Act Release No. 5620* the Commission proposed amendment of Article 9 of Regulation S-X to conform certain reporting practices of bank holding companies and banks to generally accepted accounting principles as practiced in other industries. Comments on the proposal have been received and considered and with one modification the proposed amendment is now adopted. Regulation S-X which specifies the form and content of financial statements is amended by adding to the provisions applicable to banks (Rule 9-05) three subparagraphs relating to reporting of reserves for loan losses, classification of unearned income, and classification of certain debt instruments, sometimes referred to as capital debt.

As noted in Release 33-5620 these changes had been discussed from time to time with representatives of the banking community, Federal bank regulatory authorities, the American Institute of Certified Public Accountants, and the Internal Revenue Service. In addition, because of concerns that the change in reporting loan loss reserves would adversely affect the reserve accumulated for tax purposes, the Chief Accountant requested and received from the Internal Revenue Service a letter which said, in part:

> The Service has no requirement that the financial statements conform to the books in the case of additions to the bad debt reserves for banks already on the reserve method. We would deem it appropriate, however, that, if material, the disparity between the amount shown on the books and the amount shown on the financial statements be disclosed to the shareholder by way of a footnote or other method and the two amounts reconciled on the books.

* Notice of the proposed amendments was made in Securities Act Release No. 5620, Securities Exchange Act Release No. 11672, Public Utility Holding Company Act Release No. 19186 and Investment Company Act Release No. 8951, dated September 24, 1975.

The letters commenting on the proposal were favorable. It was suggested that the rule should provide for disclosure of the difference between the loan loss reserve stated on the financial statements and the reserve accumulated for tax purposes if material and such a change has been made. In addition the proposal to reclassify capital debt has been changed to make it clear that it includes subordinated indebtedness.

In connection with the provision that bonds, notes and debentures be reported as liabilities rather than capital, the recent proposal of the Federal bank regulatory authorities to amend their periodic Report of Condition (Call Report) reclassifies such debt in a similar manner. The description of that proposed revision states that the change "does not necessarily imply any supervisory change in the treatment of these notes by the banking agencies.

The following is the text of the three subparagraphs hereby added to Rule 9-05 of Regulation S-X:

(e) The valuation portion of the reserve for loan losses shall be reported as a deduction from loans receivable, the deferred tax portion as a deferred tax item, and the contingency portion as a part of undivided profits. If materially different from the valuation portion, the reserve accumulated under the Internal Revenue Code provisions shall be disclosed in a note and the two amounts reconciled.

(f) Bonds, notes, debentures and similar debt (including subordinated indebtedness) shall be reported as liabilities. Debt instruments may not be grouped with stockholders' equity under the caption "Capital."

(g) Unearned income shall be reported as a deduction from loans receivable.

These amendments are adopted pursuant to authority conferred on the Securities and Exchange Commission by the Securities Act of 1933, particularly 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.

These amendments shall be effective with respect to financial statements filed after January 15, 1976, although they may be applied in statements filed prior to that time.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 186
December 5, 1975

SECURITIES EXCHANGE ACT OF 1934
Release No. 11906

Order Instituting Proceeding and Imposing Sanctions Pursuant to Rule 2(e) of the Commission's Rules of Practice in the Matter of Robert L. Ingis.

The Securities and Exchange Commission ("Commission") deems it appropriate to institute proceedings against Robert L. Ingis ("Ingis"), a C.P.A., pursuant to Rule 2(e) of the Commission's Rules of Practice, 17 CFR 201.2(e).[1] Accordingly, IT IS HEREBY OR-

[1] Rule 2(e)(3), 17 CFR 201.2(e)(3), provides in part:

"(i) The Commission, with due regard to the public interest ... may by order temporarily suspend from appearing or practicing before it any ... accountant ... who ... has been by name: (a) permanently enjoined by any court of competent jurisdiction by reason of his misconduct in an action brought by the Commission from violation or aiding and abetting the violation of any provision of the Federal securities laws or the rules and regulations thereunder; ... (b) found by any court of competent jurisdiction in an action brought by the Commission to which he is a party ... to have violated or aided and abetted the

DERED that such proceedings be, and they hereby are, instituted.

Ingis has submitted an offer of settlement in this proceeding. Under the terms of his offer of settlement, Ingis, without admitting or denying the factual assertions set forth herein, consents, solely for purposes of this proceeding and any other proceeding that the Commission may institute against him, to the entry of the findings and the orders made herein.

I. Background

Kalvex, Inc. ("Kalvex") is a Delaware corporation the common stock of which is registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78*l*(b). It is engaged, through its wholly-owned and majority-owned subsidiaries, in the distribution of drugs, consumer products, and motor homes as well as the manufacture and distribution of graphic arts and commercial printing. Among its other holdings, Kalvex is the owner of approximately 23,971 shares, or about 52 percent, of the preferred stock of Allied Artists Pictures Corporation ("Allied")[2]. The common stock of Allied is also registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78*l*(b).

II. The Relationship of Ingis

Ingis is a certified public accountant who served as the executive vice-president and chief operational officer of Kalvex until September 10, 1974, when he was removed as an officer and employee by the board of directors. Ingis was also a director of Allied and served as its chief financial officer until September, 1974, when he was removed from these positions.

III. The Violations by Ingis

In March 1973, Ingis was approached by a friend with the idea of starting a computer firm that would provide computer services to Kalvex, Allied and other companies. Subsequently, on April 2, 1973, the computer company, which was known as Shared Computer and Personnel, Inc. ("SCP"), was incorporated in Delaware, and Ingis was elected as one of its directors. Thereafter, Ingis suggested to Emanuel L. Wolf ("Wolf"), the president and chairman of the board of directors at both Kalvex and Allied, that Kalvex invest $150,000 as "seed money" in SCP. Ingis represents that he was told by Wolf that Wolf would approve the investment by Kalvex in SCP only if certain concessions were given to Wolf.[3] Ingis accordingly asked that SCP, as a condition to receiving investment capital from Kalvex, agree to a kickback arrangement to Wolf that envisioned the delivery to Wolf of 10 percent of the monthly billings received by SCP from Kalvex and Allied, $23,000 of the monies to be received by SCP from Kalvex and Allied for original systems design to be furnished by SCP and a 10 percent equity interest in SCP.

Thereafter, Ingis demanded a partial payment from SCP, and, accordingly, he received a check from SCP in the amount of $3,000. Pursuant to Ingis' instructions, the payee of this check was left blank. The $3,000 SCP check was later co-signed by Ingis because all checks in excess of $2,500 had to be jointly signed by the president of SCP and Ingis or another officer of Kalvex. In order to deposit this check, Ingis inserted the name Royalty Management Corp. ("RMC") as payee and endorsed the check. RMC was an inactive corporation that was originally intended to be used to perform audits and facilitate venture capital investments by Ingis and others. Ingis was later advised by SCP that a second $3,000 check was ready. Pursuant to Ingis' instructions, the check was made payable to

violation of any provision of the Federal securities laws . . . or of the rules and regulations thereunder (unless the violation was found not to have been willful)."

[2] Pursuant to a provision of the Articles of Incorporation of Allied Artists, if the dividends on preferred shares are in arrears for six consecutive calendar quarters, the preferred shareholders are accorded a voting preference over the common shareholders of Allied Artists. During the relevant period, forty-six (46) quarterly dividends had not been paid to the preferred shareholders of Allied Artists and were in arrears. As a result, Kalvex was, and still is, able to elect and control a majority of the board of directors of Allied Artists.

[3] Wolf denies that he made any such demands.

RMC as payee and Ingis co-signed the second check and deposited it in the RMC account. Finally, on May 7, 1974, a third check in the amount of $2,500 was given to Ingis by the president of SCP. The check was likewise deposited by Ingis in the same manner as the previous checks. Subsequent to the delivery of the third check, SCP did not have the funds to make further payments and Ingis advised its President on May 10, 1974 to cease making any more payments and not to issue the stock.[4] Thus, the shares demanded as part of the scheme were in fact never issued or delivered.

Ingis then discovered that Wolf had engaged in double-billing of expenses and reported it to the board of directors of Kalvex. Shortly after Ingis' participation in the kickback scheme was exposed by Wolf, Ingis demanded that the board of directors of Kalvex institute an outside audit for the purposes of verifying the double-billing of expenses by Wolf. The board decided to conduct an internal audit, rather than the outside audit demanded[5] by Ingis, and ultimately discharged Ingis as an officer and employee of the company by virtue of his participation in the kickback scheme.[6] The Allied board also declined to institute an outside audit demanded by Ingis. Thereafter, Ingis advised the Commission's staff of the activities discussed above.

The Commission instituted proceedings against Ingis and others arising out of the kickback scheme described above and other related events.[7] The Commission alleged that Ingis violated and aided and abetted violations of Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(a) and rules 14a-3 and 14a-9 promulgated thereunder, 17 CFR 240.14a-3 and 240.14a-9. In particular, the Commission contended that both Kalvex and Ingis, as a person standing for election as a director, were subject to the proxy disclosure requirements of Section 14(a) and the rules promulgated thereunder. In its opinion rendered on July 1, 1975, the United States District Court for the Southern District of New York found that

> Ingis knew that he was standing for election as a director; he knew that the proxy statements which had been filed and distributed were false and misleading.

Securities and Exchange Commission v. *Kalvex, Inc.*, Civil Action No. 74 CIV 5643, CCH Fed. Sec. L. Rep. (Current) §95,226 at page 98,187 (S.D.N.Y. 1975). Accordingly, the district court held that "Ingis violated and aided and abetted violations of Section 14(a) of the Exchange Act and Rules 14a-3 and 14a-9 thereunder . . . ." *Id.*

The Commission also alleged that Ingis aided and abetted violations of Section 13(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78m(a) and Rules 13a-1 and 13a-13 promulgated thereunder, 17 CFR 240.13a-1 and 240.13a-13. In particular, the Commission alleged that the quarterly and annual reports filed by Kalvex were false and misleading by failing to accurately reflect the

[4] SCP had agreed in writing, however, to the kickback arrangements, including the issuance and delivery before April 1, 1974 to RMC of 15,000 shares of SPC's common stock, or about 15 percent of the equity interest in SCP.

[5] In *Securities and Exchange Commission* v. *Kalvex, Inc.*, Civil Action No. 74 CIV 5643, CCH Fed. Sec. L. Rep. (Current) ¶ 95,226 (S.D.N.Y., 1975), in which Ingis was a defendant, the district court found, however, that an outside audit, even if conducted would not have exposed Ingis' kickback scheme. *Id.* at p. 98,189.

[6] Ingis has instituted a civil action against Kalvex alleging that he was wrongfully and maliciously discharged.

[7] *Securities and Exchange Commission* v. *Kalvex, Inc.*, Civil Action No. 74 CIV 5643, CCH Fed. Sec. L. Rep. (Current) ¶ 95,226 (S.D.N.Y., 1975). In addition to the kickback scheme discussed *infra*, the Commission alleged that Wolf submitted duplicate expense vouchers to both Allied and Kalvex, which resulted in filing of false and misleading reports with the Commission in violation of Section 13(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78m(a) and Rules 13a-1 and 240.13a-13. Wolf, without admitting or denying the factual assertions made by the Commission, consented to the entry of a permanent injunction against future violations of Sections 13(a) and 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78m(a) and 78n(a), and Rules 13a-1, 13a-13, 14a-13 and 14a-9 promulgated thereunder, 17 CFR 240.13a-1, 240.13a-13, 240.14a-3 and 240.14a-9. In addition, Kalvex consented to a final judgment by which the firm agreed to appoint an audit committee and to adopt procedures to avoid the repetition of similar activities in the future.

accounts of the company, falsely stating the income and expenses of the company, and failing to disclose that Ingis had caused the making of false entries which permitted him to receive improper reimbursements by submitting false expense vouchers. In addition, it was argued that the quarterly reports for the quarters ending March 29, 1974, and June 28, 1974, were false and misleading in that the reports failed to disclose that RMC, a corporation under Ingis' control, had received $8,500 in kickbacks from SCP. The district court held:

> As a person who provided assistance and encouragement to conduct patently in violation of the securities laws, defendant [Ingis] must be held responsible for such conduct as an aider and abetter.

Id. at page 98,188.

The district court permanently enjoined Ingis from future violations of the Federal securities laws.

Id. at page 98,189.

IV. Finding

The Commission finds that Robert L. Ingis is subject to sanction under Rule 2(e)(3) of the Commission's Rules of Practice, 17 CFR 201.2(e)(3) by virtue of his having been found to have violated and aided and abetted violations of the federal securities laws and the rules promulgated thereunder and having been permanently enjoined from future violations of Sections 13(a) and 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78m(a) and 78n(a), and Rules 13a-1, 13a-13, 14a-3 and 14a-9 thereunder, 17 CFR 240.13a-1, 240.13a-13, 240.14a-3 and 240.14a-9.

V. Offer of Settlement

In his offer of settlement, Ingis makes the following statements which he asks the Commission to consider, *viz:*

1. Ingis has never previously been the subject of any other Commission proceeding;
2. Ingis initially apprised Kalvex and the Commission of the facts relating to the double-billing of expenses by Wolf and voluntarily admitted to the Commission his own participation in the acts subsequently complained of by the Commission;[8]
3. Ingis voluntarily assisted the Commission in its investigation;
4. Ingis has placed into an interest bearing trust account $7,409.78 of the $8,500 that he deposited into the RMC account and has instructed the trustees to deliver the $7,409.78 to SCP, Kalvex or such other person who is determined to be the rightful owner of these funds.[9]
5. Ingis did not personally benefit from the $8,500. deposited in the RMC account; and
6. The activities charged by the Commission did not involve a report filed by Ingis as a CPA.[10]
7. Ingis represents that all of the acts relating to the kickback scheme were based on Wolf's instructions.

VI. Sanction

After due consideration of all the circumstances, and upon the recommendation of the staff, the Commission has determined to accept Ingis' offer of settlement. In arriving at this determination, the Commission has taken into consideration the statements made by INGIS in his offer of settlement.

Accordingly, IT IS FURTHER ORDERED THAT:

1. ROBERT L. INGIS, a CPA, be and he hereby is prohibited from appearing or practicing before the Commission as an accountant other than as an employee of an accountant or consultant under supervision of an accountant.
2. After twenty-two months, Ingis may apply for permission to resume appearance and

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[8] Ingis came to the Commission, however, only after Kalvex decided to conduct an internal audit but refused to institute the outside audit which he had requested and after he had been removed from his positions at Kalvex and Allied.

[9] Ingis represents that RMC incurred expenses in the amount of $200 for secretarial work and $890.22 in legal fees and expenses which were paid out of the $8,500 deposited in the RMC account. The remaining $7,409.78 was retained in the RMC account since June, 1974, which was under the control of Ingis as a signatory.

[10] Ingis was, however, the chief financial officer at Allied and the chief executive officer at Kalvex.

practice before the Commission as an accountant, provided that if during the pending of the prohibition:

A. Ingis has been employed by an accountant or as a consultant under the supervision of an accountant, then he will submit an affidavit from a partner of each accounting firm in which he was employed or which supervised him attesting to his professional competence as an accountant;

B. Ingis commences an independent accounting practice, then Ingis will request the AICPA to review his auditing procedures as to clients whose audits were supervised or conducted by Ingis and to render a report on his professional competence to the Chief Accountant of the Commission; and

C. Ingis becomes a partner of an accounting firm, he will not handle a certified audit unless it is reviewed by another partner of such accounting firm who will attest in writing to Ingis' professional competence as an accountant.

3. Before applying for permission to resume practice and to appear before the Commission, Ingis shall submit satisfactory proof that he has attended courses or seminars in subjects relating to public accounting or auditing to the extent of at least 40 hours for the twelve months immediately preceding his application for readmission.

By the Commission

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 187
December 15, 1975

SECURITIES ACT OF 1933
Release No. 5655

SECURITIES EXCHANGE ACT OF 1934
Release No. 11923

Order Accepting Resignation from Commission Practice as an Accountant in the Matter of Bill D. Steele (Rules of Practice—Rule 2(e))

On March 5, 1974, the Commission institute an injunctive action in the United States District Court for the Central District of California alleging, among other things, that Bill D. Steele, an accountant and formerly the chief financial officer of the Seaboard Corporation, violated the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.[1] Without admitting or denying the allegations in the Commission's complaint, Steele consented to entry of a permanent injunction in that action enjoining him from fraudulent conduct in connection with the offer, purchase and sale of securities.[2]

Having been advised that the Commission was contemplating the institution of administrative proceedings pursuant to Rule 2(e) of its Rules of Practice, based on the allegations in the injunctive action, to determine whether he should be temporarily or permanently denied the privilege of appearing or practicing before it as an accountant, Steele agreed to resign from Commission practice as an accountant on condition that no administrative action be brought against him. He further agreed that if he subsequently applies for readmission to such practice, certain allegations in the injunctive action, which are specified in his letter of resignation, shall, for purposes of any such application only, be deemed true and correct. In addition, he agreed that any such application shall be supported by a showing that: (a) he

[1] *S.E.V.* v. *The Seaboard Corporation, et al.*, Civil Action No. CV 74-567-MML.

[2] The injunction was entered on July 31, 1975.

has familiarized himself with the registration and the disclosure provisions of the federal securities statutes and with the Commission's requirements with respect to accounting procedures, and (b) nothing has occurred during the intervening period that would be a basis for adverse action against him pursuant to Rule 2(e).

After due consideration, and upon the recommendation of its staff, the Commission determined to accept Steele's resignation from Commission practice as an accountant.

Accordingly, IT IS ORDERED that resignation of Bill D. Steele from appearing or practicing before the Commission be, and it hereby is, accepted, and he shall no longer have the privilege of so appearing or practicing.

For the Commission, by its Secretary, pursuant to delegated authority.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 188
January 7, 1976

SECURITIES ACT OF 1933
Release No. 5667

SECURITIES EXCHANGE ACT OF 1934
Release No. 11985

INVESTMENT COMPANY ACT OF 1940
Release No. 9115

Interpretive Statement by the Commission on Disclosure by Registrants of Holdings of Securities of New York City and Accounting for Securities Subject to Exchange Offer and Moratorium

The Commission has noted developments with respect to the financial problems of the City of New York, including the moratorium imposed by the state legislature on the enforcement by holders of the terms of certain outstanding short-term obligations of the City of New York,[1] recent amendments adopted by the legislature to the Local Finance Law (Title 6-A), the creation of the Municipal Assistance Corporation for the City of New York ("Municipal Assistance Corporation"), the enactment by the legislature of statutes providing for a three-year financial plan for the City and the enactment by Congress of The New York City Seasonal Financing Act of 1975 (Public Law 94-143). These developments have created significant questions with respect to disclosure and accounting by registrants who are holders of New York City securities. In light of these developments, the Commission has determined that it would be helpful to investors and to registrants and independent public accountants to publish its views on some aspects of these problems.

The Commission's present rules require certain specific disclosures of the cost and market values of investments in securities. Commercial and industrial companies are required to state the cost and market value of marketable securities and other securities investments, either by setting forth each issue separately or by the use of reasonable groupings.[2] Management investment compa-

[1] The legality of the moratorium has been challenged in litigation and upheld in the Supreme Court of New York (*Flushing National Bank* v. *Municipal Assistance Corp. for the City of New York*, *et al.*, decided December 22, 1975 by Judge Harold Baer, Index No. 20245-1975, Supreme Court, New York). The plaintiff has indicated an intention to appeal.

[2] Regulation S-X, Rules 5-02-2, 5-02-12, 12-02.

nies are required to state the cost and value of each issue held.[3] Insurance companies and banks are required to state the cost and value of the aggregate holdings of bonds and notes issued by states, municipalities and political subdivisions, and in the case of insurance companies, corporate securities.[4]

In addition to these specific rules, the Commission has long required registrants to include in filings "such further material information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading."[5] In interpreting this requirement, the Commission has from time-to-time issued statements which call attention to particular problems where disclosure beyond the specific requirements of rules may be necessary.

In view of the circumstances referred to above, the Commission believes that certain information in regard to holdings of New York City securities set forth below is material and should assist investors in making their own judgments about the effects, if any, on the income and business of registrants of the developments referred to above with respect to the financial situation of New York City.

Accordingly, registrants who hold New York City notes that are in moratorium; other securities issued by the City of New York that will mature within three years; securities of the Municipal Assistance Corporation that were issued in exchange for New York City notes in moratorium; or securities of the Municipal Assistance Corporation that were made subject to an agreement modifying terms, should make the following disclosures in notes to financial statements (and, if appropriate, in management's analysis of the summary of earnings) if the book value of such securities in the aggregate amounts to more than 10% of stockholders' equity:

(1) The total cost and carrying value (if other than cost) of the above described securities which were held at the end of 1975, and the income on such securities recorded in 1975.

(2) Of the total amount included in (1), identify separately the cost and carrying value of those securities

- (a) issued by New York City in moratorium,
- (b) other securities issued or guaranteed by or otherwise obligating the City of New York which will mature within three years,
- (c) issued by the Municipal Assistance Corporation in exchange for the New York City notes in moratorium, and
- (d) issued by the Municipal Assistance Corporation and subject to an agreement modifying terms.

(3) A discussion of the effect of the moratorium, exchanges or agreements on future income in comparison with the income recorded in 1975.

This disclosure reflects the fact that New York City has encountered an acute financial problem which has required certain emergency measures. On the other hand, in the light of the measures referred to there does not appear to be any adequate basis at this time for concluding that the long term risks involved are unique, and, therefore, the Commission believes the existing provisions of Regulation S-X which require, in addition to disclosure of the aggregate cost, disclosure of the aggregate market value of all municipal securities, including those of New York City, should adequately reflect the long term risks. The Commission has therefore determined, after consultation with the bank regulatory authorities, not to mandate specifically at this time disclosures beyond those presently required and those stated above.

The disclosures referred to above reflect the Commission's conclusion that developments with respect to the financial problems of the City of New York call for disclosure at this time of significant holdings of New York City securities which are particularly affected by recent developments in the affairs

[3] Regulation S-X, Rules 6-02-7, 12-19.

[4] Regulation S-X, Rules 7-03-1, 7a-03-1, 12-19, 9-05(b)(2) and Regulation F, Form F-9A-2(a)(3) of the Federal Reserve Board.

[5] Regulation S-X, Rule 3-06; also Rule 408 under the Securities Act of 1933 and Rule 12b-20 under the Securities Act of 1934.

of the City. The Commission recognizes, however, that other issuers of securities may suffer financial difficulties that could adversely impact holders of material investments in such securities. As a part of a longer term and more generalized effort to deal with the fact that significant concentration of holdings in any security may warrant disclosure, the Commission is proposing an amendment to Rule 3-16( ) of Regulation S-X which would require footnote disclosure by all registrants of certain concentrations in securities holdings. (See Securities Act Release No. 5668, dated January 7, 1976).

In addition to the questions of disclosure discussed above, questions have arisen as to how holders of securities subject to the moratorium or securities into which they have been exchanged should account for those securities in their financial statements at December 31, 1975. Various views have been expressed, and it is apparent from the diversity of reaction to the factual circumstances set forth herein that there is no single answer to the questions within the currently existing body of authoritative accounting pronouncements.

Because there are differing opinions among accountants as to the proper accounting treatment under existing authoritative pronouncements, and in view of the fact that the Financial Accounting Standards Board has agreed to undertake a study of the accounting problems raised by the moratorium and exchange with the intention of developing standards which can be applied to year-end statements in 1976, the Commission is not prepared at this time to require the use of any particular accounting method to account for holdings of such securities at December 31, 1975. It believes that the disclosures set forth above, together with a description of the accounting methods followed, should assist investors in evaluating the impact of the moratorium and exchange on registrants and to estimate the amounts which might have been recorded under alternative accounting methods.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 189
February 9, 1976

SECURITIES ACT OF 1933
Release No. 5684

SECURITIES EXCHANGE ACT OF 1934
Release No. 12081

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 19379

Notice of Withdrawal of Release No. 33-5612 Which Proposes Amendments to Form 10-Q and Regulation S-X Regarding Interim Financial Reporting

On September 10, 1975 the Commission issued Accounting Series Release No. 177 adopting amendments to Form 10-Q and Regulation S-X regarding interim financial reporting. In that release, the Commission adopted substantially increased requirements for the content of quarterly reports on Form 10-Q by all registrants now reporting on Forms 7-Q and 10-Q and a new rule [Rule 3-16(t)] which requires disclosure of selected quarterly financial data in notes to financial statements of certain registrants whose

shares are actively traded and whose size is above certain limits. Reference is made to Accounting Series Release No. 177 for a discussion of the new reporting requirement on Form 10-Q and applicability of Rule 3-16(t) to registrants.

The Commission noted in ASR No. 177 that the inclusion of interim data in an unaudited footnote to the financial statements will associate the independent accountant with these data. Therefore, the Commission simultaneously issued for comment Release No. 5612 in which it proposed review and reporting procedures which set forth its expectations as to the responsibilities of independent accountants who are associated with interim financial data. The purpose of the proposal was to provide the profession with appropriate "professional standards and procedures" to protect the interests of investors.

The Commission noted in ASR No. 177 that the subject of auditor involvement with interim financial data has been under active consideration by the Auditing Standards Executive Committee (AudSEC) of the American Institute of Certified Public Accountants. The Commission urged AudSEC to continue its study of auditor involvement in the interim reporting process. It indicated that if AudSEC adopted a statement which satisfactorily defines the standards and procedures to be followed by auditors for such involvement, it would withdraw Release No. 5612.

In December 1975 AudSEC issued Statement on Auditing Standards No. 10 entitled "Limited Review of Interim Information." The standards and procedures set forth in that statement appropriately define the role of the auditor in the interim reporting process. Accordingly, the Commission is withdrawing the proposed rules set forth in Release No. 5612 and intends to rely on the standards adopted by AudSEC.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 190
March 23, 1976

SECURITIES ACT OF 1933
Release No. 5695

SECURITIES EXCHANGE ACT OF 1934
Release No. 12240

PUBLIC UTILITIES HOLDING COMPANY ACT OF 1935
Release No. 19437

Notice of Adoption of Amendments to Regulation S-X Requiring Disclosure of Certain Replacement Cost Data

A. General Statement

In Securities Act Release No. 5608 issued August 21, 1975, the Commission proposed for comment amendments to Regulation S-X which would require footnote disclosure of certain financial data regarding current replacement cost. These proposals were designed to enable investors to obtain more relevant information about the current economics of a business enterprise in an inflationary economy than that provided solely by financial statements prepared on the basis of historical cost. More than 350 letters of comment have been received on the propos-

als and after giving these comments careful consideration, the Commission has determined to adopt the proposals in somewhat revised form. In addition, the Commission has decided to create an advisory committee to assist its staff in providing guidance to registrants in the problems of implementing this new rule.

The new rule as adopted requires registrants who have inventories and gross property, plant and equipment which aggregate more than $100 million and which comprise more than 10% of total assets to disclose the estimated current replacement cost of inventories and productive capacity at the end of each fiscal year for which a balance sheet is required and the approximate amount of cost of sales and depreciation based on replacement cost for the two most recent full fiscal years. In addition, registrants are required to disclose the methods used in determining these amounts and to furnish any additional information of which management is aware and believes is necessary to prevent the information from being misleading. This information may be presented either in a footnote to the financial statements or in a separate section of the financial statements following the notes. In either place, the information may be designated as "unaudited."

In requiring these data, the Commission is aware that it is requiring companies to make disclosures of costs which cannot be calculated with precision. They must be estimated on the basis of numerous assumptions which may vary over time and from company to company and through the use of techniques which are not so fully developed that they can be standardized at the present time, if ever. This is because estimates of current replacement cost must be made within the framework of each registrant's economic situation and because there are difficult conceptual and empirical judgments which must be made in the light of different specific factual circumstances in developing the data. Nevertheless, the Commission believes that such data are important and useful to investors and are not otherwise obtainable. It feels that imprecision, if properly explained, will not make the data misleading. The Commission encourages registrants to supplement the required disclosures with information which management believes will be helpful to investors in understanding the impact of price changes and other current economic conditions on reported results.

In recognition of the imprecise nature of the data, the Commission is proposing for comment a "safe harbor" rule designed to recognize in a rule the Commission's view that if such data have a reasonable basis, are prepared with reasonable care and in good faith and are presented with adequate disclosure the data do not constitute an "untrue statement of a material fact" or a "manipulative, deceptive or fraudulent device."

Decision not to Delay

The Commission was urged by many commentators to delay the adoption of rules (or at least the effective date) until the means of compliance with the rules could be spelled out with precision. The Commission has concluded that such delay is not appropriate in general, although it has permitted a one year delay in effectiveness of the rule for mineral resources in the extractive industries. This was done in recognition of the particularly severe implementation problems for such assets and in the light of the expressed willingness of a leading trade association in the largest of these industries to undertake a major research effort within this year to resolve such problems. In addition, a one year delay has been permitted in effectiveness for foreign assets located outside the North American continent and the European Economic Community if certain specific disclosures relating to such assets are made.

The Commission's judgment that delay is not appropriate is based on a number of factors. First, it believes that under current economic conditions, data about the impact of changes in the prices of specific goods and services on business firms is of great significance to investors in developing an understanding of the current operations of any firm. While the current general rate of inflation has been reduced from 1974 levels, it is still at a level such that unsupplemented historical cost based data do not adequately

reflect current business economics. Further, in any inflationary economy specific costs and prices which may affect a business change more rapidly than the general price level. These factors make the impact of delay more severe than would be the case in a time of price stability.

In addition, as a practical matter, it would never be possible for the Commission to anticipate every possible circumstance that may be faced in the application of this new disclosure rule. This is particularly true since the rule covers new ground and requires subjective judgments in its application. Accordingly, the Commission believes that various approaches taken in implementing the rule should be viewed as experimental, and that alternative approaches will be acceptable as long as the methods used are fully described and are applied in good faith and with reasonable care. There does not seem to be any persuasive reason, therefore, to deny these data to investors while experimentation in alternative techniques takes place.

By requiring full disclosure of the approaches used and permitting considerable flexibility in the way in which the data are displayed, the Commission is confident that it has provided sufficient latitude so that registrants will be able to communicate effectively the meaning of the data to investors. Registrants may, for example, present the data in supplemental financial statements, show estimates in terms of ranges rather than single figures, and discuss the imprecisions inherent in the data. They may describe historical relationships between costs and selling prices, point out the cost savings and any incremental costs and changed economic lives associated with new equipment, indicate their plans for the replacement or non-replacement of assets, and present any other information which they believe will assist investors in understanding the impact of changing prices and inflation in general on the registrant. This may include a discussion of possible favorable effects of inflation on the firm, such as the benefits from repaying debt in less valuable dollars and the possible benefits of operating leverage in an inflationary environment.

While certain standards and guidelines for application of this rule may be developed after experimentation has taken place, it is highly unlikely that a totally uniform set of procedures can ever be developed which will make the implementation of the rule a mechanical process.

Creation of Advisory Committee to Assist in Implementation

Nevertheless, the Commission recognizes that it is important that registrants receive guidance on implementation problems and that experience in this regard is shared. Accordingly, it has determined to appoint an advisory committee composed of persons working with the problems of implementation to meet on a regular basis with the staff of the Commission to consider problems raised by registrants in complying with the rule. The composition and procedures of this committee will be announced shortly. From these meetings and from its other experiences in dealing with registrants, the staff will publish staff accounting bulletins which set forth its judgments. The first staff accounting bulletin on this subject which responds to questions raised in letters of comment on the proposal and to problems arising from the staff's experience in participating in pilot programs by business firms is being published simultaneously with the issuance of this release.

In addition to its own efforts, the Commission believes that it would be useful for industry groups and associations to consider specialized problems in the application of replacement cost concepts to their areas of interest. In this connection, such groups may undertake to develop specific price indices applicable to particular classes of assets and suggest uniform industry-wide reporting approaches. The Commission staff would be willing to lend such assistance as it can to such efforts.

Analysis of Costs and Benefits

The release which accompanied the proposed rules specifically requested data as to the cost of compliance. Many respondents

expressed concern about costs, but only a small number made specific estimates. Those estimates varied widely, and in general the cost estimates supplied by companies which had implemented replacement cost systems or undertaken pilot studies were substantially below those which had not. This suggests that as companies take steps to implement the rules adopted herein, they will find that the cost of compliance will be less than that estimated. Nevertheless, the Commission recognizes that the cost of implementing this rule will be significant, particularly in the first year of preparing the necessary data. It also seems clear that the cost will be proportionately higher for small companies with less sophisticated accounting systems.

The Commission has carefully considered the cost of implementation and weighed it against the need of investors for replacement cost information. It has concluded that in the case of companies of large size which generally have the largest public investor interest, the data are of such importance that the benefits of disclosure clearly outweigh the costs of data preparation. In the case of smaller companies where the cost burden is proportionately greater and the extent of public investor interest is proportionately less, the balance between economic costs and benefits is less clear. Accordingly, the Commission has determined initially to exempt from the rule companies whose inventories and gross property, plant and equipment aggregate less than $100 million. While it urges such companies to make appropriate disclosure of the effect of specific price changes and inflation in general on their operations, it is not at this time requiring them to make the specific disclosure required by this rule. As experience is gained with the costs of implementing the rule and the benefit of the information to investors, the Commission will consider the desirability of eliminating or amending the exemption.

In addition, the Commission has concluded that companies whose inventories and gross properties comprise less than 10% of total assets need not make the disclosure since in the case of such companies the effects of such disclosure on financial statements would generally be immaterial.

Inclusion of Data in Financial Statements and Auditor Responsibility

The Commission also asked for specific comment on whether the required data should be audited. Most commentators suggested that due to both cost considerations and the lack of articulated standards, it would be undesirable to require the replacement cost information to be audited. Many advocated that the data be removed from the financial statements and included elsewhere in annual reports and filings.

In response to these comments, the Commission has concluded that the required data need not be audited and it accordingly will permit the required information to be labeled "unaudited." It does not believe, however, that the information should be removed from the financial statements. As it has previously stated,[1] it believes that significant financial disclosures about business operations during a period should generally be included in the financial statements for that period, and it does not see any compelling reasons for excluding this information. In a business world characterized by uncertainty, it is necessary to recognize that many estimates based on subjective judgments must be included in financial statements and that appropriate means of describing the uncertainties and the lack of precision in the data must be found.[2]

While the original proposal required that the data be displayed in a footnote, the Commission recognizes that in some circumstances the required data when supplemented by additional disclosures explaining the basis for its preparation and other information deemed appropriate by management may be of considerable length and include substantial data. Both because of its length and its nature registrants may feel that it should not be included in the notes to the financial statements. Accordingly, the adopted rule permits the disclosures either in the footnote or in a separate section of the financial statements which follows the notes and is appropriately labeled. If such a separate section is

[1] Accounting Series Release No. 177
[2] Accounting Series Release No. 166

used, a brief cross reference in the notes (such as in the note on accounting policies) would be appropriate.

The unaudited footnote or separate section of the financial statements containing the data will be a part of financial statements reported on by independent accountants. Accordingly, the independent accountant will be associated with the replacement cost information even though it is unaudited. The Commission urges the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants to develop appropriate standards applicable to the auditor in the case of such association.

Non-Preemption of Financial Accounting Standards Board

A number of those commenting upon the proposal expressed concern that the rules if adopted would preempt the Financial Accounting Standards Board (FASB) and possibly the conclusions of the Commission's general study of financial disclosure now under way. The Commission does not believe that these concerns are merited.

In December 1974, the FASB issued an exposure draft of a statement which would require financial statements to include supplemental data in which historical costs were adjusted for changes in the general price level. In the Commission's proposal, it noted that general price level adjustments might be used either with historical cost or current replacement cost financial data. Accordingly, it did not and does not view its proposal as competitive with that of the FASB. In fact, in implementing the Commission's rule, some registrants may wish to use data regarding changes in the general price level as part of the analysis of reasons for changes in replacement costs. At the present time, however, the Commission does not propose to require the presentation of data restated for changes in the general purchasing power of the monetary unit.

Similarly, the Commission does not believe its new requirements prejudge any conclusions which may arise from the FASB's study of the conceptual framework of financial statements. As it noted in its original proposal, the Commission believes that fundamental changes in the basic accounting model should come about only after careful study by the FASB. It believes that experimentation with replacement cost information of the sort that will result from the implementation of this rule will materially assist the FASB in its study as well as providing meaningful supplemental disclosure to investors in the interim.

Finally, the Commission does not feel that adoption of this rule will have any adverse effect on its own broad study of financial disclosure. One of the reasons for the study was the concern expressed by some that the Commission's requirements emphasized objective disclosure to the exclusion of relevant information. Certainly this rule will give the study group the opportunity to observe the response of registrants and investors to a requirement for non-precise subjective disclosure. The rule will of course be part of the total framework studied and its adoption at this time does not exclude it from consideration in the study.

Non-Inclusion of Other Current Cost and Value Data

Some commentators on the proposed rule objected to its partial approach. They suggested that data be required concerning the current value of other assets and liabilities and the effect of inflation on monetary items held by the company. The Commission recognizes that its rule is a limited one and does not deal either with all effects of inflation on financial position and operations, or with the current value of all assets and liabilities. Its primary objective, as articulated in the adopted rule, is to provide investors with meaningful additional information not otherwise available about the current economics of a business as a supplement to historical cost data. A secondary objective is to provide data about the current cost of inventories and productive capacity at the balance sheet date. These are the principal operating assets of many businesses. It is recognized that replacement cost does not always measure the current economic values of such assets,

but in most cases it is a reasonable approximation.

The Commission views its rule as a first step in a process of providing more meaningful disclosure about current economic costs and values to investors. It believes that the rule will encourage meaningful experimentation with the various approaches to providing such information, and as noted above it will assist the FASB in addressing the broad conceptual and practical issues involved.

The Commission also believes that the rule will provide investors with significant data now unavailable about the effect of current economic conditions on the business. The effect of inflation on monetary assets and liabilities can be approximated from data now publicly available, and the current market value of marketable securities portfolios is required to be disclosed. With the additional data provided as a result of this rule, analysts and investors should be able to develop a number of different methods of analyzing economic results, such as estimating the return on new investment, calculating rates of return on capital based on varying assumptions and developing alternative measures of economic results.

The Commission cautions investors and analysts against simplistic use of the data presented. It intentionally determined not to require the disclosure of the effect on net income of calculating cost of sales and depreciation on a current replacement cost basis, both because there are substantial theoretical problems in determining an income effect and because it did not believe that users should be encouraged to convert the data into a single revised net income figure. The data are not designed to be a simple road map to the determination of "true income." In addition, investors must understand that due to the subjective judgments and the many different specific factual circumstances involved, the data will not be fully comparable among companies and will be subject to errors of estimation.

Legal Exposure of Registrants

Finally, commentators expressed concern about the possible legal liabilities to which they would be exposed as a result of including data based on subjective judgments and estimates. While the Commission believes that registrants are protected under the law as it now exists if such data have a reasonable basis, are prepared with reasonable care and in good faith and are accompanied by disclosure of the basis of their calculation and the imprecisions inherent therein, it has determined to propose an amendment to Rule 3-17 to make this clear. This proposal is being issued for comment (in Securities Act Release No. 5696) simultaneously with the adoption of these amendments to Regulation S-X.

Effect on Competition

The Commission has considered the impact which the foregoing amendments to Regulation S-X would have upon competition and has concluded that the preparation and disclosure of replacement cost information of the type in question to the public, including registrants' competitors, will not significantly burden competition. In addition, the Commission has concluded that requiring these disclosures only by those companies whose inventories and gross property, plant and equipment aggregate $100 million or more, and whose total inventories and gross property, plant and equipment are 10% or more of its total assets, will not significantly burden the ability of such companies to compete with those which do not meet these criteria. In any event, the Commission has determined that any possible resulting burden will be far outweighed by, and is necessary and appropriate to achieve, the important benefits to investors discussed herein.

Effective Date of Regulation S-X Amendments

The Commission has determined to make Rule 3-17 of Regulation S-X effective for financial statements covering fiscal years ending on or after December 25, 1976, with the exception that it shall not apply to the mineral resource assets of companies engaged in the extractive industries prior to fiscal years ending on or after December 25, 1977, nor shall it apply to the assets located

outside the North American continent and the countries of the European Economic Community prior to fiscal years ending on or after December 25, 1977, provided that the historical cost and a description of any such assets excluded from the supplemental replacement cost data are disclosed.

B. Amendments Adopted

Regulation S-X.

* * * * *

Rule 3-17. Current Replacement Cost Information.

Statement of Objectives

The purpose of this rule is to provide information to investors which will assist them in obtaining an understanding of the current costs of operating the business which cannot be obtained from historical cost financial statements taken alone. Such information will necessarily include subjective estimates and it may be supplemented by additional disclosures to assist investors in understanding the meaning of the data in particular company situations. A secondary purpose is to provide information which will enable investors to determine the current cost of inventories and productive capacity as a measure of the current economic investment in these assets existing at the balance sheet date.

Exemption. This rule shall not apply to any person where the total of inventories and gross property, plant and equipment (i.e., before deducting accumulated depreciation, depletion and amortization) as shown in the consolidated balance sheet at the beginning of the most recently completed fiscal year is less than $100 million or where the total of inventories and gross property, plant and equipment is less than 10 percent of the total assets of the person as shown in the consolidated balance sheet at the beginning of the most recently completed fiscal year.

The information set forth below shall be shown in a note to the financial statements or as part of a separate section of the financial statements following the notes. The note or the separate section may be designated "unaudited."

(a) The current replacement cost of inventories at each fiscal year end for which a balance sheet is required shall be stated. If current replacement cost exceeds net realizable value at that date, that fact shall be stated and the amount of the excess disclosed.

(b) For the two most recent fiscal years, state the approximate amount which cost of sales would have been if it had been calculated by estimating the current replacement cost of goods and services sold at the times when the sales were made.

(c) State the estimated current cost of replacing (new) the productive capacity together with the current depreciated replacement cost of the productive capacity on hand at the end of each fiscal year for which a balance sheet is required. For purposes of this rule, assets held under financing leases as defined in Rule 3-16(q) shall be included in productive capacity. In the case of any major business segments which the company does not intend to maintain beyond the economic lives of existing assets, the disclosures set forth in Rules 3-17(c) and (d) are not required provided full disclosure of the facts, amounts and circumstances is made.

(d) For the two most recent fiscal years, state the approximate amount of depreciation, depletion and amortization which would have been recorded if it were estimated on the basis of average current replacement cost of productive capacity. For purposes of this calculation, economic lives and salvage values currently used in calculating historical cost depreciation, depletion or amortization shall generally be used. For assets being depreciated, depleted or amortized on a time expired basis, the straight-line method shall be used in making this calculation. For assets depreciated, depleted or amortized on any other basis (such as use), that basis shall be used for this calculation.

(e) Describe the methods used in determining the amounts disclosed in items (a) through (d) above. Describe what consideration, if any, was given in responding to items

(a) and (b) to the related effects on direct labor costs, repairs and maintenance, utility and other indirect costs as a result of the assumed replacement of productive capacity. Where the economic lives or salvage values currently used in historical cost financial statements are not used in (d) above, an explanation of other bases used and the reasons therefor shall be disclosed. If depreciation, depletion or amortization expense is a component of inventory costs or cost of sales, indicate that fact and cross-reference the answer for this item in item (b) in order to avoid potential duplication in the use of these data.

(f) Furnish any additional information—such as the historical customary relationships between cost changes and changes in selling prices, the difficulty and related costs (such as those related to environmental regulations) which might be experienced in replacing productive capacity—of which management is aware and which it believes is necessary to prevent the above information from being misleading.

* * * * *

This amendment to Regulation S-X is adopted pursuant to Sections 6, 7, 8, 10 and 19(a) of the Securities Act of 1933; Sections 12, 13, 15(d) and 23(a) of the Securities Exchange Act of 1934; and Sections 5(b), 14 and 20(a) of the Public Utility Holding Company Act of 1935.

Rule 3-17 of Regulation S-X is effective for financial statements for fiscal years ending on or after December 25, 1976, except that the rule shall be initially applicable to the mineral resource assets of registrants engaged in the extractive industries and to registrants' assets located outside the North American continent and the countries of the European Economic Community in financial statements for fiscal years ending on or after December 25, 1977; provided that the historical cost and a description of any such assets excluded from the supplemental replacement cost data are disclosed.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 191
March 30, 1976

Findings, Opinion and Order Imposing Remedial Sanctions in the Matter of Rudolph, Palitz & Co. and Harvey B. Spiegel

These are proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice to determine whether Rudolph, Palitz & Co. ("the firm"), a public accounting firm, and Harvey B. Spiegel, a former partner of the firm, should be temporarily or permanently denied the privilege of appearing or practicing before the Commission.

Respondents have submitted an offer of settlement which the Commission has determined to accept. Solely for the purpose of these proceedings and without admitting or denying the allegations of the order for proceedings, respondents consent to institution of proceedings under Rule 2(e) of the Commission's Rules of Practice and to the entry of an order containing certain findings and remedial sanctions as set forth below.

On the basis of the order for proceedings and the offer of settlement, it is found that:

1. Capital Corporation of America (CCA), a Pennsylvania corporation, has been registered with the Commission as a management, closed-end, non-diversified investment company pursuant to Section 8 of the Investment Company Act of 1940 (1940 Act) since March 30, 1967. CCA is also a small business

investment company, licensed as such on August 9, 1962 under the Small Business Investment Act of 1958.

2. CCA filed with the Commission a registration statement on June 28, 1967 under the Securities Act of 1933 (1933 Act) which registration statement became effective September 17, 1970. CCA also filed reports and proxy solicitation materials as required by Sections 20 and 30(a) and (b) of the 1940 Act.

3. Respondent Spiegel was CCA's auditor from prior to March 31, 1967 through October 31, 1968. Respondent Rudolph, Palitz was CCA's auditor from November 1, 1968 to March 31, 1974. From November 1, 1968 through February 28, 1972, respondent Spiegel was a partner of respondent Rudolph, Palitz and was the partner in charge of the audit of CCA.[1]

4. Subchapter M of the Internal Revenue Code of 1954 enables an investment company to enjoy certain favorable tax treatment provided that, among other things, at the end of each fiscal quarter of the investment company, the values and distribution of certain securities owned by the investment company do not exceed specified percentages of the total assets of the investment company.

5. From sometime prior to March 31, 1967 continuing beyond March, 1972, CCA had established lines of credit with various banks. On or about March 31, 1970, CCA borrowed $500,000 against such lines of credit, issuing notes therefor, payable April 1, 1970. On or about March 31, 1971, CCA borrowed $740,000 against such lines of credit, issuing its notes therefor bearing a due date of April 1, 1971. On or about March 30, 1972, CCA borrowed $200,000 issuing its note payable April 3, 1972. April 3, 1972 was the first banking day following March 31, 1972. Each note was repaid on the due date.

6. Respondents knew that the purpose of the aforesaid borrowing was to increase the amount of cash of CCA at the end of the fiscal quarters ended March 31, 1970, March 31, 1971 and March 31, 1972,[2] so as to enable CCA to show the requisite ratios and thereby to qualify for the favorable tax treatment afforded investment companies under Subchapter M of the Internal Revenue Code. Respondents knew or should have known that CCA did not intend otherwise to use the proceeds of the loans made on or about March 31, 1970, March 31, 1971 and March 31, 1972 in the operations of CCA.

7. Respondents, in auditing and reporting on the financial statements for the fiscal years ended March 31, 1970, March 31, 1971 and March 31, 1972, acquiesced in the following treatment of the transactions for balance sheet purposes: The proceeds of the borrowings which occurred on or about March 31 of each year were included as cash on the asset side of the balance sheet. The amounts of the borrowings were included under liabilities and capital under the caption "Notes payable due within 90 days—unsecured."

8. The balance sheet of CCA dated March 31, 1970 showed cash in the amount of $533,-105. Of this amount, $500,000 represented the proceeds of the note dated March 31, 1970 payable April 1, 1970. The balance sheet of CCA dated March 31, 1971 showed cash in the amount of $859,619. Of this amount, $740,000 represented the proceeds of the note dated March 31, 1971 payable April 1, 1971. The balance sheet for March 31, 1972 showed cash in the amount of $448,393. Of this amount, $200,000 represented the proceeds of the note issued March 30, 1972 payable April 3, 1972.

9. The borrowings referred to above represented approximately 53 percent of the notes payable shown in the balance sheet dated March 31, 1970, approximately 50 percent of the notes payable shown in the balance sheet dated March 31, 1971 and 50 percent of the notes payable shown in the balance sheet dated March 31, 1972.

10. Because of the "one-day" nature of the notes, the uniqueness of the business purpose for which the transactions were entered into and the size of the transactions in relationship to the aggregate amounts of the cash and notes payable on the balance sheet dates, respondents should have clarified, by financial statement notes or other acceptable methods, the items "cash" and "notes payable" on the year-end balance sheets to

[1] Respondent Spiegel has not practiced as a public accountant since March 1, 1972.

[2] The fiscal year of CCA ends on March 31.

reflect the effect on those items of these borrowings and their repayment. Respondents, by failing to so clarify those items, failed to properly give effect to generally accepted accounting principles in reporting on the financial statements of CCA for the fiscal years referred to above.

11. The statement of consolidated income for the year ended March 31, 1971 contained in the annual report dated March 31, 1971 of CCA reflected $90,000 as a gain on investment resulting from the purported sale of property owned by CCA. This property had been acquired by CCA through foreclosure on 27 acres of land which had a cost basis to CCA of $60,000. On September 28, 1970, CCA sold its 27 acres to Affiliated Associates for $150,000. Affiliated Associates made no down payment on this purchase. CCA received a two-year, 6 percent purchase money mortgage in the principal amount of $150,000 with both principal and interest due and payable two years from the date. CCA further received warrants to purchase a 50 percent interest in Affiliated Associates stock at $.10 per share. Respondents knew that Affiliated Associates was not an operating company. At the time of the audit, the property was appraised at $250,000.

12. The $90,000 gain shown in the statement of consolidated income for the year ended March 31, 1971 referred to above, should not have been so reflected in such period and should have been deferred. In their weighing of the factors to determine whether the gain should or should not have been recognized, respondents failed to employ generally accepted accounting principles and auditing standards.[3]

After due consideration, the Commission has determined to accept the offer of settlement. In arriving at its determination, the Commission considered the fact that Respondent Rudolph, Palitz & Co., in order to insure that it performs its audits in accordance with generally accepted auditing standards, has agreed to the review described in the order, and likewise that Respondent Harvey B. Spiegel has agreed to participate in a program of continuing education.

Accordingly, IT IS ORDERED that proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice be, and they hereby are, instituted against Respondents.

IT IS FURTHER ORDERED that, upon the terms and conditions provided in the offer of settlement, Respondents consent to the entry by the Commission of an order which provides that:

1. Respondent Rudolph, Palitz & Co. is censured.
2. Respondent Harvey B. Spiegel is suspended from practice before the Commission as an accountant for a period of sixty (60) days.

Respondent Rudolph, Palitz & Co. has agreed that it will participate, after May 1, 1976 in a local firm quality peer review program conducted by the American Institute of Certified Public Accountants.

Respondent Harvey B. Spiegel has agreed that he will undertake a program of continuing professional education consistent with the guidelines recommended by the American Institute of Certified Public Accountants on continuing education for professional members of said association.

IT IS FURTHER ORDERED that Administrative Proceeding Number 3-4402 is hereby dismissed.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

[3] See Accounting Series Release No. 95, dated December 28, 1962, Securities Act Release No. 4566, Securities Exchange Act Release No. 6982.

RELEASE NO. 192

July 14, 1976

SECURITIES EXCHANGE ACT OF 1934
Release No. 12629

Notice of permanent disqualification from appearance or practice before the Commission in the Matter of Archie S. Barnhill

On April 6, 1976, the Commission entered an order, pursuant to rule 2(e)(3)(i) of its Rules of Practice, temporarily suspending Archie S. Barnhill, a certified public accountant from appearing or practicing before the Commission. The order was based on the fact that on January 16, 1976, Barnhill was permanently enjoined by the United States District Court for the Northern District of Texas, Dallas Division, in a suit brought by the Commission[1] from violating Section 5(a), 5(c) and 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Barnhill consented to the injunction without admitting or denying the substantive allegations in the Commission's complaint.

The complaint in the injunctive action alleged that Barnhill violated the above provisions of the federal securities laws in that, among other things, he certified a financial statement of Tex-A-Chief, Inc. following a purported audit, when in fact Barnhill's audit consisted mainly of discussions with that company's president and did not include independent verification of Tex-A-Chief's assets and liabilities.

Rule 2(e)(3)(ii) of the Commission's Rules of Practice provides that any person temporarily suspended in accordance with paragraph (i) of that rule may, within 30 days after service upon him of the order of temporary suspension, petition the Commission to lift such suspension, but that if no petition has been received by the Commission within 30 days after such service, the suspension shall become permanent. Barnhill was duly notified of this provision. The 30-day period has expired and no petition to lift the suspension has been received by the Commission.

Accordingly, notice is hereby given that the temporary suspension of Archie S. Barnhill has become permanent and that Barnhill is, therefore, disqualified from appearing or practicing before the Commission.

GEORGE A. FITZSIMMONS
Secretary

[1] *S.E.C.* v. *Tex-A-Chief, Inc.*, Civil Action No. 3-75-1478D.

RELEASE NO. 193

July 27, 1976

SECURITIES ACT OF 1933
Release No. 5729

SECURITIES EXCHANGE ACT OF 1934
Release No. 12662

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 19629

INVESTMENT COMPANY ACT OF 1940
Release No. 9369

Request by Arthur Andersen & Co.—Partial Response and Solicitation of Comments on Certain Questions

On June 15, 1976, the public accounting firm of Arthur Andersen & Co. ("Andersen") filed a "petition" with the Commission requesting, essentially, that we consider whether to:

(1) revoke Instruction H(f) of Form 10-Q [17 CFR 249.308a] which requires that independent accountants express their judgment regarding the preferability of an accounting principle adopted when accounting principles are changed at the discretion of a registrant.

(2) withdraw the statement of policy embodied in Accounting Series Release No. 150 [39 FR 1260] in which the Commission stated that it would consider accounting principles, standards and practices promulgated by the Financial Accounting Standards Board (FASB) as having substantial authoritative support and those contrary to such FASB promulgations as having no such support.[1]

(3) define the current meaning of the term "substantial authoritative support."

Preferability

Instruction H(f) to Form 10-Q was adopted by the Commission in Accounting Series Release No. 177 on September 10, 1975 [40 FR 55837]. It was originally proposed for comment in essentially the same form on December 19, 1974[2] and comments were received on it and carefully considered by the Commission. In addition, the issues regarding this instruction were presented at public hearings held in 1975 on the Commission's interim reporting proposals.

Subsequent to adoption of Instruction H(f), the Auditing Standards Executive Committee of the AICPA (AudSEC) requested that the Commission reconsider the instruction and, in response, the Commission held a public meeting with the Committee on April 23, 1976 at which the issues were discussed and at which time several submissions were received. On April 30, 1976, the Commission advised AudSEC that, after further consideration, it saw no reason to change its conclusion.

The substantive issues involving Instruction H(f) therefore have been thoroughly aired and the reasons for the Commission's conclusions have been fully set forth. In the absence of any showing by Andersen that it has presented any new substantive reasons for reconsideration of our action, the Commission has no basis before it warranting further reconsideration of the matter.

Establishment of Accounting Principles

The second and third actions requested by Andersen raise fundamental issues of importance upon which the Commission has concluded it wishes to have the benefit of public comment before determining what action, if any, it may be appropriate to take. In addi-

[1] The Commission noted in this connection that Rule 203 of the Rules of Conduct of the Code of Ethics of the American Institute of Certified Public Accountants provides that it is necessary to depart from accounting principles promulgated by the body designated by the Council of the AICPA if, due to unusual circumstances, failure to do so would result in misleading financial statements and that, in such a case, the use of other principles may be accepted or required by the Commission.

[2] Release Nos. 33-5549, 34-11142, 35-18718 [40 FR 1079].

tion, the Commission expects to hold a public meeting on the issues with invited representatives of persons with significant interests in financial reporting.

A cornerstone of the disclosure process envisioned by the securities laws is the financial information included in audited financial statements. Since 1933, when Congress determined to rely on independent accountants to provide assurance of reliability in financial statements, the Commission has relied upon the judgments of the accounting profession both in individual factual circumstances and in the establishment of principles of general acceptance. In 1938, the Commission stated its administrative policy with respect to financial statements in Accounting Series Release No. 4 [11 FR 10913]:

> "In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations or other official releases of the Commission, including the published opinions of its Chief Accountant."

In 1973, various private sector groups concerned with financial reporting established the Financial Accounting Standards Board and this body was designated by the accounting profession as the entity having the responsibility for considering and promulgating accounting standards and interpretations. Following this action, the Commission issued a Statement of Policy (ASR 150) reflecting its recognition of the FASB's role in the setting of accounting principles, standards and practices. ASR 150 reflected an explicit statement of the Commission's administrative practice in carrying out its responsibilities under the securities laws. Historically, the Commission has accepted as having substantial authoritative support those practices which have been identified by the accounting profession as standards to be followed by members of the profession. With the creation of the FASB, the Commission believed that it should publicly indicate that it viewed the standards, practices and interpretations issued by the FASB as constituting those practices having substantial authoritative support.

Andersen requests that the Commission withdraw these policies which have governed the manner by which it has determined whether financial statements meet the requirements of the Securities Acts. Before responding to Andersen's request, the Commission hereby solicits public comment on the following basic issues raised:

1. Should the Commission continue its policy of recognizing the pronouncements of the Financial Accounting Standards Board as providing a frame of reference for publicly held companies to satisfy their statutory disclosure obligations?
2. Should the Commission further define the phrase "substantial authoritative support"?
3. Should the Commission further define the phrase "accounting principles and practices" used in Rule 2-02(c) of Regulation S-X [17 CFR 210.2-02(c)]?

Comments in triplicate should be addressed to the Secretary, Securities and Exchange Commission, Washington, D.C. 20549 and should be referenced to File S7-647. Comments should be received by September 15, 1976. All comments will be available for public inspection.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 194

April 29, 1976

SECURITIES ACT OF 1933
Release No. 5730
PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 19630

SECURITIES EXCHANGE ACT OF 1934
Release No. 12663

Reporting Disagreements with Former Accountants—Adoption of Amendments of Requirements

In Securities Act Release No. 5701 issued on April 29, 1976, [41 FR 19132] the Commission proposed an amendment of Regulation S-X [17 CFR Part 210] which modifies previously existing requirements for disclosure in a note to the financial statements of certain disagreements with former accountants regarding accounting and financial disclosure matters. Nine letters of comment, all favorable, were received in response to the proposal. The Commission has determined to adopt the amendments substantially as proposed.

Background

In Accounting Series Release (ASR) No. 165, December 20, 1974, [40 FR 1010] the Commission announced adoption of certain amendments of Form 8-K, [17 CFR 249.308] Regulation S-X [17 CFR Part 210] and Schedule 14A [17 CFR 240.14A-101] of the proxy rules. The amendments then adopted were originally proposed on October 11, 1974, in Securities Act Release No. 5534 [39 FR 37999].

Among other matters, Rule 3-16(s) of Regulation S-X [17 CFR 210.3-16(s)] was adopted by that release. That rule called for disclosure in a note to financial statements of two distinct matters, as follows:

1. The *fact* of a reported disagreement. The first sentence of the rule stated:
   "If, within the twenty-four months prior to the date of the most recent financial statements, a Form 8-K has been filed reporting a change of accountants and included in such filing there is a reported disagreement on any matter of accounting principles or practices or financial statement disclosure, and if such disagreement, if differently resolved, would have caused the financial statements to differ materially from those filed, state the existence and nature of the disagreement."

In connection with this portion of the rule, the text of ASR 165 states:

> "This disclosure is believed necessary to put readers of the financial statements on notice that such a disagreement existed which could have significantly affected the statements."

2. The *effect on financial statements* of changing accountants as regards a reported disagreement. The second sentence of the rule stated:
   "In addition, if during the fiscal year in which the change in accountants took place or during the subsequent fiscal year there have been any transactions or events similar to those which involved a reported disagreement and if such transactions are material and were accounted for or disclosed in a manner different from that which the former accountants apparently concluded was required, state the effect on the financial statements if the method which the former accountant apparently concluded was required had been followed."

In connection with this portion of the rule, the text of ASR 165 states, in part:

> "This disclosure will make investors aware of situations where alternative accounting approaches may be followed and are favored by at least one professional accountant, and the effect of such alternative approaches. In addition, it is

> believed that such disclosure requirements may have the effect of discouraging shifts in accountants simply to obtain approval of an alternative accounting approach."

It should be noted that the *fact* of a disagreement with a former accountant is required to be reported in connection with rules of the Commission other than Rule 3-16(s) of Regulation S-X [17 CFR 210.3-16(s)]—specifically in Form 8-K following the resignation or dismissal of the former accountant or the engagement of a new accountant, and under Item 8 of Schedule 14A of the proxy rules. On the other hand, disclosure of the *effect on financial statements* of changing accountants as regards a disagreement reported in Form 8-K is required only by Rule 3-16(s) of Regulation S-X [17 CFR 210.3-16(s)].

Objections to Existing Rule

Several objections had been raised to continuing the requirement for disclosure in financial statements of the fact of disagreement in circumstances where disclosure regarding the effect on financial statements is not required.

1. In the vast majority of cases, disagreements regarding matters of accounting principles or practices or financial statement disclosure are resolved to the satisfaction of the former accountant and the same kind of transactions or events continue to be accounted for or disclosed consistent with what the former accountant apparently concluded was required. In such circumstances, the financial statements have not been affected by a treatment different from that which the former accountant apparently concluded was required. Thus, while a different resolution of the matter of disagreement could have affected the financial statements, the statements have not been so affected.

2. Many believe the requirements of Form 8-K and the proxy rules provide adequate notification to those users of financial statements who may deem the disclosure material to their considerations.

3. Disclosure of only the fact of a disagreement in a note to financial statements was intended only to inform readers that the financial statements might have been prepared differently if the matters of disagreement had been resolved differently and not to raise questions about the adequacy or fairness of the statements presented. This may be misunderstood.

4. Auditor changes that precipitate the reporting of disagreements on Form 8-K are not numerous and only a small portion of those cases is expected to involve circumstances where the successor accountant deems accounting principles or practices or financial statement disclosures acceptable which the former accountant found unacceptable. Thus, if the vast majority of notes to financial statements regarding "disagreements on accounting and financial disclosure matters" do not require any disclosure of the effect on the financial statements, there may be a tendency for readers to give less attention than warranted to those which do contain disclosures about the effects.

Amendment of Rule 3-16(s) [17 CFR 210.3-16(s)]

The Commission has concluded that these objections have substantial validity. Accordingly, it is adopting the amendment to Rule 3-16(s) of Regulation S-X [17 CFR-210.3-16(s)] to require disclosure in a note to the financial statements of the existence and nature of a previously reported disagreement only when disclosure is also required of the effect on financial statements if the method which the former accountant apparently concluded was required had been followed, i.e., only in those cases when the successor accountant found acceptable what the former accountant found unacceptable.

Pursuant to Section 23(a)(2) of the Exchange Act the Commission has carefully considered the impact which the foregoing rule amendment would have upon competition and has concluded that, to the extent the amendment imposes burdens on competition, such burdens are necessary and appropriate in furtherance of the purposes of the securities laws.

PART 210—FORM AND CONTENT OF FI-

NANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, AND INVESTMENT COMPANY ACT OF 1940

* * * * *

§210.3-16. General notes to financial statements.
(See Release No. AS-4.)

* * * * *

(s) *Disagreements on accounting and financial disclosure matters.*—If, (1) within the twenty-four months prior to the date of the most recent financial statements, a Form 8-K has been filed reporting a change of accountants, (2) included in the Form 8-K there was a reported disagreement on any matter of accounting principles or practices or financial statement disclosure, (3) during the fiscal year in which the change of accountants took place or during the subsequent fiscal year there have been any transactions or events similar to those which involved the reported disagreement, and (4) such transactions or events were material and were accounted for or disclosed in a manner different from that which the former accountants apparently would have concluded was required, state the existence and nature of the disagreement and also state the effect on the financial statements if the method had been followed which the former accountants apparently would have concluded was required. These disclosures need not be made if the method asserted by the former accountants ceases to be generally accepted because of authoritative standards or interpretations subsequently issued.

* * * * *

These amendments are adopted pursuant to authority in Sections 5, 7, 8, 10 and 19(a) [15 U.S.C. 77f, 77g, 77h, 77j, 77s] of the Securities Act of 1933; Sections 12, 13, 15(d) and 23(a) [15 U.S.C. 78*l*, 78m, 78o(d), 78w] of the Securities Exchange Act of 1934; and Sections 5(b), 14 and 20(a) [15 U.S.C. 79e, 79n, 79t] of the Public Utility Holding Company Act of 1935.

This amendment shall be effective with respect to financial statements filed after August 31, 1976.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

RELEASE NO. 195
August 6, 1976

SECURITIES ACT OF 1933
Release No. 5732

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 19642

SECURITIES EXCHANGE ACT OF 1934
Release No. 12694

Minor Amendments to Regulation S-X

The Commission announces herein the adoption of minor amendments to sections 2-02(c), 5-02-32 and 12-08 of Part 210 of 17 CFR (Regulation S-X).

Section 210.2-02(c) is amended to remove a requirement for accountants to comment in their audit reports accompanying financial statements filed with the Commission on certain changes in accounting practices, which affect comparability of financial statements but do not arise from changes in accounting principles. The type of changes affected by this amendment are accounting changes which result from altered conditions, e.g.,

changes in amounts of depreciation charges resulting from changes in estimates of remaining useful lives of fixed assets, rather than from a change in accounting principles.

Since these changes have long been required to be disclosed in a note to the financial statements under §210.3-07(a) and more recently have been required to be disclosed in the section of financial reports devoted to management's discussion and analysis of operations, it no longer is considered necessary to require a specific comment on these changes by accountants in their audit reports. This requirement is eliminated by deletion from §210.2-02(c) of the words "as required to be set forth in §210.3-07(a)" which heretofore have linked the reporting requirement in §210.2-02(c) to the changes in accounting practices specified in §210.3-07(a).

Section 210.5-02-32 is amended to correct references therein to captions in §210.5-02-25 to reflect revisions in those captions which were recently adopted in Accounting Series Release No. 184 [40 FR 59340].

Section 210.12-08 is amended to reinstate the last three sentences that were in Instruction 3 of that section prior to the adoption of Accounting Series Release No. 178 [40 FR 48359] wherein the sentences were inadvertently deleted.

Commission action: The Commission hereby amends sections 2-02(c), 5-02-32 and Instruction 3 of section 12-08, all of Part 210 of Chapter II of Title 17 of the Code of Federal Regulations, to read as set forth below:

PART 210—FORM AND CONTENT OF FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, AND INVESTMENT COMPANY ACT OF 1940.

* * * * *

§210.2-02. Accountants' Reports

* * * * *

(c) *Opinion to be expressed.*—The accountant's report shall state clearly: (1) The opinion of the accountant in respect of the financial statements covered by the report and the accounting principles and practices reflected therein; and (2) the opinion of the accountant as to the consistency of the application of the accounting principles, or as to any changes in such principles which have a material effect on the financial statements.

* * * * *

§210.5-02. Balance sheets.

* * * * *

32. *Other long-term debt.*—(a) Include under this caption all amounts of long-term debt not provided for under captions 29(a) and 31 above. State separately amounts payable to (1) persons specified in captions 25(a)(1), (2), (3) and (6); and (2) others, specifying any material item. Indicate the extent that the debt is collateralized. Show here, or in a note referred to herein, the information required under caption 29.

(b) * * *

* * * * *

§210.12-08 Intangible assets, preoperating expenses and similar deferrals.[1,2,7]

* * * * *

(Instruction) 3. Show by major classifications in each part, such as franchises, goodwill, etc. If such classification is not present or practicable, each part may be stated in one amount. The additions included in column C shall, however, be segregated in accordance with an appropriate classification. Items of minor importance may be included under a miscellaneous caption in each part.

* * * * *

The amendments are adopted pursuant to authority in Sections 6, 7, 8, 10 and 19(a) [15 U.S.C. 77f, 77g, 77h, 77j, 77s] of the Securities Act of 1933; Sections 12, 13, 15(d) and 23(a) [15 U.S.C. 78l, 78m, 78o(d), 78w] of the Securities Exchange Act of 1934; Sections 5(b), 14 and 20(a) [15 U.S.C. 79e, 79n, 79t] of the Public Utility Holding Company Act of 1935; and Sections 8, 30, 31(c) and 38(a) [15 U.S.C. 80a-8, 80a-29, 80a-30(c), 80a-37(a)] of the Investment Company Act of 1940.

Inasmuch as the amendments reduce the requirements of section 210.2-02(c) and correct minor errors in other sections the Commission finds that, for good cause, the notice and procedures specified in the Administration Procedures Act of 1946 are unnecessary, and accordingly the foregoing amendments are adopted effective immediately upon publication in the Federal Register.

By the Commission.

GEORGE A. FITZSIMMONS
Secretary

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