Gary John Peete

Accounting Series Releases

Compilation of

RELEASES 1 to 112 Inclusive

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

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PREFACE

On April 1, 1937, the Securities and Exchange Commission announced a program for the publication, from time to time, of opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions. These opinions are contained in the Accounting Series Releases and are specifically referred to in Regulation S-X which states the requirements applicable to the form and content of most financial statements required to be filed with the Commission.

In earlier printings of these releases each release, except No. 69, was printed in its entirety. In this printing each release number is retained together with a brief statement of circumstances or problems which made the release necessary at the time it was issued. Only releases which appear to be of value currently are being reprinted in their entirety.

Copies of releases from which the text material has been omitted in this printing may be obtained from the Commission by complying with the Commission's rules relating to the reproduction of material in the files of the Commission. All requests for copies of such materials should be directed to the Public Reference Section, Securities and Exchange Commission, Washington, D.C. 20549.

IMPORTANT NOTICE

Individuals or firms who wish to receive all opinions, proposals and adopted changes contained in the Accounting Series Releases are requested to fill in this coupon and forward promptly to the Securities and Exchange Commission, Washington, D.C. 20549.

Name____

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City______________________State____________Zip Code________

This request relates to changes after August 12, 1968

CONTENTS

Subject matter

SECURITIES ACT OF 1933

Release No.		Page
1210	Treatment of Federal income and excess profits taxes and surtax on undistributed profits	1

ACCOUNTING SERIES

1	Treatment of losses resulting from revaluation of assets	1
2	Independence of accountants—Relationship to registrant	1
3	Treatment of investments in subsidiaries in consolidated statements	2
4	Administrative policy on financial statements	3
5	Treatment of dividends on corporation's own capital stock held in sinking-fund	4
6	Treatment of excess of proceeds from sale of treasury stock over cost thereof	4
7	Commonly cited deficiencies in financial statements filed under the Securities Act of 1933 and the Securities Exchange Act of 1934	5
8	Creation by promotional companies of surplus by appraisal	9
9	Presentation of stock having preferences on involuntary liquidation in excess of par or stated value	9
10	Treatment of unamortized bond discount and expense applicable to bonds retired prior to maturity with proceeds from sale of capital stock	10
11	Consolidation of foreign subsidiaries of domestic corporations	11
12	Adoption of Regulation S-X—Amendments to Forms 15 and 17	12
13	Form of accountants' certificates	12
14	Amendment of rule adopting Regulation S-X	14
15	Description of surplus accruing subsequent to effective date of quasi-reorganization	14
16	Disclosure of charge of deficit to capital surplus without approval of stockholders	15
17	Use of natural business year as basis for corporate reporting	16
18	Amendment of Rule 4-09 of Regulation S-X	17
19	In the matter of McKesson & Robbins, Inc.—Summary of findings and conclusions	17
20	Amendment of Rule 12-16 of Regulation S-X	25
21	Amendment of Rules 2-02 and 3-07 of Regulation S-X	25
22	Independence of accountants—Indemnification by registrant	28
23	Treatment of Federal income and excess profits taxes	31
24	Amendment to Articles 1, 6, and 12 of Regulation S-X	31
25	Procedure in quasi-reorganizations	31
26	Interpretation of Rule 5-02 of Regulation S-X regarding the omission of an analysis of registrant's surplus accounts	33
27	The nature of the examination and certificate required by paragraph (4) of Rule N-17F-1 and paragraph (7) of Rule N-17F-2 under the Investment Company Act of 1940	34
28	Findings and Opinion of the Commission in the matter of proceeding under Rule II(e) of the Rules of Practice, to determine whether the privilege of Kenneth N. Logan to practice as an accountant before the Securities and Exchange Commission should be denied, temporarily or permanently	35
29	Amendment of Rule 1-01 of Regulation S-X and adoption of Article 6A and the related rules of Article 12 of Regulation S-X pertaining to unit investment trusts	46
30	Auditing of inventories under wartime conditions	46
31	Amendment to Articles 5, 6, and 12 of Regulation S-X	46
32	Accountants' certificates—Application of Rules 2-02, 3-07, 4-02, and 4-04 of Regulation S-X regarding requirements as to disclosure by independent public accountants of the principle followed in including or excluding subsidiaries in consolidated statements	47

CONTENTS

Release No.		Page
33	Amendment to Articles 1, 6, 6A, and 12 of Regulation S-X	48
34	Amendment to Rule X-13A-2 of the General Rules and Regulations under the Securities Exchange Act of 1934 and amendment to Article 1 of Regulation S-X	49
35	Disclosure to be given to certain types of provisions and conditions that limit the availability of surplus for dividend purposes	49
36	Treatment by an investment company of interest collected on defaulted bonds applicable to a period prior to the date on which such bonds and defaulted interest were purchased	50
37	Amendment of Rule 2-01 of Regulation S-X—Qualifications of accountants certifying to financial statements required to be filed with the Commission. Superseded by release No. 44	51
38	Treatment in financial statements of postwar refunds of Federal excess profits taxes	52
39	Amendments to Uniform System of Accounts for Public Utility Holding Companies	52
40	Amendment to Articles 3, 5, and 12 of Regulation S-X—Simplification of reporting requirements	54
41	Conditions under which companies reporting on Forms 10-K and N-30A-1 may file copies of their regular annual reports to stockholders in place of certain of the financial statements required to be filed by such forms	54
42	Disclosure to be made in financial statements with respect to reserves established to provide for possible losses and other contingencies arising out of existing war conditions	56
43	Amendment to Rules 4-13 and 5-02 of Regulation S-X, prescribing manner in which original cost data and other components of utility plant are to be shown in balance sheets of utility companies	57
44	Amendments to Rule 2-01 of Regulation S-X, regarding qualifications of accountants certifying to financial statements required to be filed with the Commission	57
45	Treatment of premiums paid upon the redemption of preferred stock	58
46	Amendments to Rule 5-04 and Rule 12-06 of Regulation S-X	60
47	Independence of certifying accountants—Summary of past releases of the Commission and a compilation of hitherto unpublished cases or inquiries arising under several of the Acts administered by the Commission	60
48	Findings and Opinion of the Commission in the matter of C. Cecil Bryant, proceeding pursuant to Rule II(e), Rules of Practice, permanent disqualification of accountant from practice before the Commission	64
49	Amendment to Rule 1-01 of Regulation S-X	67
50	The propriety of writing down goodwill by means of charges to capital surplus	67
51	Disposition of Rule II(e) proceedings against certifying accountant failing to observe appropriate audit requirements as to financial statements of broker-dealer under Rule X-17A-5	68
52	Presentation in financial statements of Federal income and excess profits taxes in cases where a company for which individual statements are filed pays its tax as a member of a consolidated group of companies	69
53	In the matter of "Charges in lieu of Taxes"—Statement of the Commission's opinion regarding "Charges in lieu of income taxes" and "provisions for income taxes" in the profit and loss statement	70
54	Amendment to Caption 16 of Rule 5-03 of Regulation S-X to provide for special disclosure of war costs, losses and expenses	96
55	Announcement of public conference date to consider proposed revision of Article 6 of Regulation S-X	96
56	Procedures which management investment companies may follow in allocating past dividends so as to arrive at (1) the balance of undistributed net income; and (2) accumulated net realized gain or loss on investments	96
57	Complete restatement of Article 6 of Regulation S-X and amendments to Rules 4-10, 11-01, 11-02, 12-19, 12-20, 12-21, and 12-22 of such regulation—Statement of the Commission relating to the problems involved	98
58	Amendment of Regulation S-X redesignating Rule 6-10 of Article 6A as Rule 6-10A	103
59	Findings and Opinion of the Commission in the matter of proceeding under Rule II(e) of the Rules of Practice, to determine whether the privilege of Williams and Kingsolver, to practice as accountants before the Securities and Exchange Commission should be denied, temporarily or permanently	103
60	Amendment to Rule 6-10 of Regulation S-X	106
61	Notice of proposal to issue a release in the accounting series regarding the use of public accountants' names in connection with summary earnings tables included in registration statements filed under the Securities Act of 1933	106
62	Circumstances under which independent public accountants may properly express an opinion, and the form of such opinion with respect to summary earnings tables to be included in registration statements filed under the Securities Act of 1933	107
63	Notice of proposals to amend Rule N-8B-2 and to adopt Form N-8B-4 and Rule N-8C-4 under the Investment Company Act of 1940—Notice of proposal to adopt a new Article 6B in Regulation S-X	110
64	In the matter of Drayer-Hanson, Incorporated—Report of investigation pursuant to Section 8(e) of the Securities Act of 1933, File No. 2-6670	110
65	Notice of proposal to amend Regulation S-X	124
66	Amendment of Regulation S-X by adoption of Article 5A; amendment to Article 1, Rule 1-01; Article 4, Rule 4-14; Article 5, Rule 5-01; Article 12, Rule 12-06, Rule 12-06A and Rule 12-07; amendments to Form 10 and Form 10-K	125

CONTENTS

Release No.		Page
67	Findings and Opinion of the Commission in the matter of proceedings under Rule II(e) of the Rules of Practice, to determine whether the privilege of Barrow, Wade, Guthrie Co., Henry H. Dalton and Everett L. Mangam to practice as accountants before the Securities and Exchange Commission should be denied, temporarily or permanently	126
68	Findings and Opinion of the Commission in the matter of proceedings under Rule II(e) of the Rules of practice to determine whether the privilege of F. G. Masquelette Co. and J. E. Cassell to practice as accountants before the Securities and Exchange Commission should be defined, temporarily or permanently	139
69	Notice of proposal to amend Regulation S-X; a general revision of Articles 1, 2, 3, 4, 5 and 11 of that regulation. As revised this release became Accounting Series Release No. 70	142
70	Amendment of Regulation S-X; adoption of comprehensive amendments to Articles 1, 2, 3, 4, 5 and 11	143
71	Amendment of Rule N-8B-2; adoption of Form N-8B-4 and Rule N-8C-4; Adoption of Article 6B of Regulation S-X	144
72	Adoption of revised Form U5S	144
73	Findings and Opinion of the Commission in the matter of Haskins Sells and Andrew Stewart, File No. 4-66 (Rules of Practice—Rule II(e))	144
74	Adoption of amendments to certain rules of Article 6 of Regulation S-X	161
75	Adoption of amendments to certain rules of Artic'e 6 of Regulation S-X	162
76	Adoption of Rule 3-20(d) of Article 3 of Regulation S-X	162
77	Disposition of Rule II(e) proceedings against certifying accountant alleged to have failed to observe appropriate audit requirements as to financial statements of broker-dealer under Rule X-17A-5 under the Securities Exchange Act of 1934	163
78	Findings and Opinion of the Commission in the Matter of Touche, Niven, Bailey & Smart, et al., proceeding pursuant to Rule II(e), Rules of Practice	164
79	Amendment of Rule 2-01 of Regulation S-X	194
80	Amendment to Rule 1-01 of Article 1 and Rule 5A-01 of Article 5A of Regulation S-X	195
81	Independence of cert fying accountants—Compilation of representative administrative rulings in cases involving the independence of accountants	196
82	Findings and Opinion of the Commission in the matter of Bollt and Shapiro, Theodore Bollt, and Bernard L. Shapiro, proceeding pursuant to Rule II(e), Rules of Practice	208
83	Amendment to minimum audit requirements prescribed in Form X-17A-5 under the Securities Exchange Act of 1934	209
84	Revision to uniform system of accounts for Public Utility Holding Companies	211
85	Statement of administrative policy regarding balance sheet treatment of credit equivalent to reduction in income taxes	226
86	Response to comment on statement of administrative policy regarding balance sheet treatment of credit equivalent to reduction in income taxes	229
87	In the Matter of Bollt and Shapiro, Theodore Bollt, and Bernard L. Shapiro. Orderr eadmitting accountant to practice before the Commission	230
88	Findings and Opinion of the Commission in the matter of Myron Swartz, pursuant to Rule II(e), Rules of Practice	231
89	Revision of Articles 7 and 12 of Regulation S-X	234
90	Certification of income statements	235
91	Findings and Opinion of the Commission in the matter of Arthur Levison and Levison and Company, proceeding pursuant to Rule 2(e), Rules of Practice	237
92	Findings and Opinion of the Commission in the matter of Morton I. Myers, pursuant to Rule 2(e), Rules of Practice	241
93	Adoption of Form 11-K and Rule 15d-21 and amendments to Form 10-K and Regulation S-X	244
94	Order in the matter of Nathan Wechsler, pursuant to Rule 2(e), Rules of Practice	244
95	Accounting for Real Estate Transactions where circumstances indicate that profits were not earned at the time the transactions were recorded	245
96	Accounting for the "Investment Credit"	247
97	Findings and Opinion of the Commission in the matter of Harmon R. Stone, pursuant to Rule 2(e), Rules of Practice	249
98	Maintenance of records of transactions by Broker-Dealers as underwriters of investment company shares	253
99	Order dismissing proceedings in the matter of Roberts & Morrow, pursuant to Rule 2(e), Rules of Practice	253
100	Adoption of Article 7A and Rule 12-31 of Regulation S-X	254

CONTENTS

Release No.		Page
101	Order readmitting accountant to practice before Commission in the matter of Morton I. Myers, pursuant to Rule 2(e), Rules of Practice	255
102	Balance sheet classification of deferred income taxes arising from installment sales	255
103	The nature of the examination and certificate required by paragraph (a)(5) of Rule 206(4)-2 under the Investment Advisers Act of 1940	256
104	Order in the matter of John C. Hurdman, doing business as Hurdman and Company	258
105	Order accepting withdrawal from practice and dismissing proceedings—In the matter of Homer E. Kerlin, pursuant to Rule 2(e), Rules of Practice	258
106	Adoption of revisions of the Uniform System of Accounts for Mutual Service Companies, and subsidiary service companies, under the Public Utility Holding Company Act of 1935, to permit orderly destruction of certain records of service companies	272
107	Net capital requirements for Brokers and Dealers—Interpretation and guide	273
108	Order in the matter of Nicolas J. Raftery, a certified public accountant	294
109	Order in the matter of Edwin Aronowitz, a public accountant	295
110	Order in the matter of Meyer Weiner, a certified public accountant	295
111	Amendment to Rule 1-01 of Article 1 of Regulation S-X	296
112	Independence of accountants examining a nonmaterial segment of an international business	297

RELEASE NO. 1210*

January 6, 1937

SECURITIES ACT OF 1933
Release No. 1210

SECURITIES EXCHANGE ACT OF 1934
Release No. 1004

HOLDING COMPANY ACT
Release No. 508

Treatment of Federal income and excess profits taxes and surtax on undistributed profits.

RELEASE NO. 1*

April 1, 1937

SECURITIES ACT OF 1933
Release No. 1353

SECURITIES EXCHANGE ACT OF 1934
Release No. 1121

HOLDING COMPANY ACT
Release No. 590

Treatment of losses resulting from revaluation of assets.

RELEASE NO. 2

May 6, 1937

SECURITIES ACT OF 1933
Release No. 1426

SECURITIES EXCHANGE ACT OF 1934
Release No. 1181

HOLDING COMPANY ACT
Release No. 645

Independence of accountants—Relationship to registrant.

The Securities and Exchange Commission today published an opinion relative to the question of the independence of an accountant when certifying financial statements before the Commission.

The opinion is the second of a series of interpretations on accounting principles. It follows:

The Securities and Exchange Commission from time to time has been called upon to determine whether, in a particular case, the relationship existing between a registrant and an accountant was of such a nature as to prevent him from being considered independent for the purpose of certifying financial statements to be filed in connection with the registration of securities under the Securities

* Text of release omitted.

Act of 1933 and the Securities Exchange Act of 1934.

In response to such requests, the Commission has taken the position that an accountant cannot be deemed to be independent if he is, or has been during the period under review, an officer or director of the registrant or if he holds an interest in the registrant that is significant with respect to its total capital or his own personal fortune.

In a recent case involving a firm of public accountants, one member of which owned stock in a corporation contemplating registration, the Commission refused to hold that the firm could be considered independent for the purpose of certifying the financial statements of such corporation and based its refusal upon the fact that the value of such holdings was substantial and constituted more than 1 percent of the partner's personal fortune.

RELEASE NO. 3

September 13, 1937

Treatment of investments in subsidiaries in consolidated statements.

The Securities and Exchange Commission today published an opinion in its Accounting Series outlining a procedure which would prevent write-ups arising in the consolidation of accounts by a parent company with those of its subsidiaries through the elimination of only a portion of the investment account.

The opinion, prepared by Carman G. Blough, Chief Accountant, was written with reference to one unnamed company, but the principles enunciated have wider application, in the Commission's belief.

The opinion contends that the purpose of the consolidated balance sheet is to reflect the financial condition of a parent company and its subsidiaries as if they were a single organization. Thus the parent's actual equities in the subsidiaries' net assets should be substituted for its investments in the consolidation of the accounts. In some instances, the Commission has found that only the par or stated value of stocks of subsidiaries are eliminated in the substitution with the result that the surpluses of the subsidiaries are improperly included as surplus in the consolidation. This, the opinion indicates, constitutes, in effect, a write-up in the consolidated accounts, since no new assets have actually been added.

Mr. Blough's letter follows:

"You have requested my opinion concerning the propriety of the practice whereby the subject company, in consolidating its accounts with those of its subsidiaries, eliminated from its investment account only the par or stated value of the stocks of subsidiaries.

"It is my understanding that—

"1. The aggregate cost of these investments to the parent company was in excess of its proportionate interest in the equities in the net assets of the subsidiaries as shown on the books of the latter.

"2. The parent's equities in the surpluses of the subsidiaries at the dates their stocks were acquired by the parent were included as part of consolidated surplus.

"3. The amount of the parent's investment account not eliminated was shown as an asset on the consolidated balance sheet, designated 'excess of cost over par or stated value of the securities of subsidiaries eliminated in consolidation.'

"The acquisition by one company of the controlling stock interest in another constitutes, in effect, the acquisition of the assets of the acquired company subject to its liabilities and the interests of minority stockholders. The value of such assets, after deducting the liabilities and minority interests, constitute the equity of the parent in the subsidiary and the book value of such equity is equal to the par or stated value of the stock(s) owned by the acquiring company plus the portion of the surplus(es) of the subsidiary applicable thereto.

"The purpose of a consolidated balance sheet is to reflect the financial condition of a parent company and its subsidiaries as if they were a single organization. Thus, in such a balance sheet, the parent company's equities in net assets of subsidiaries are substituted for its investments therein. This substitution is effected by eliminating from the parent company's investment account an amount equal to the par or stated value of the subsidiaries' stocks owned by the parent and its proportionate share of their surpluses at acquisition. Any part of the parent's investment account remaining (representing the excess cost thereof over the equities in the net assets represented thereby) may properly be retained among the consolidated assets.

"The foregoing consolidation procedure, which, in my opinion, conforms to sound and generally accepted accounting practice, has not been followed by the subject company. Instead, by eliminating only an amount equal to the par or stated value of the subsidiaries' stocks from the parent company's investment account, consolidated assets and surplus are overstated in an amount equal to the parent's proportionate share of the surpluses of the subsidiaries as at the respective dates of the acquisition of their stocks."

The opinion is the third of a series of interpretations on accounting principles which the Commission is publishing from time to time for the purpose of contributing to the development of uniform standards and practice in major accounting questions.

RELEASE NO. 4

April 25, 1938

Administrative policy on financial statements.

The Securities and Exchange Commission today issued the following statement of its administrative policy with respect to financial statements:

"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."

RELEASE NO. 5

May 10, 1938

Treatment of dividends on corporation's own capital stock held in sinking-fund.

The Securities and Exchange Commission today issued an additional release in its Accounting Series, dealing with "treatment of dividends on a corporation's own capital stock held in sinking-fund." The opinion, prepared by Carman G. Blough, the Chief Accountant, in response to an inquiry, follows:

"You have asked whether it is proper for a corporation to treat as income dividends applicable to shares of its own stock held in a sinking-fund.

"In my opinion dividends on a corporation's own stock held in its treasury or in sinking or other special funds should not be included in income. The treatment of such dividends as income results in an inflated showing of earnings inasmuch as the earnings from which dividends are paid have already been included in income or surplus either during the current or prior accounting periods.

"When a corporation's own stock is held in a sinking or other special fund, the requirements in respect of which are such that earnings accuring to the securities held therein must be added to the fund, dividends applicable to the corporation's own stock so held should, nevertheless, not be treated as income."

RELEASE NO. 6

May 10, 1938

Treatment of excess of proceeds from sale of treasury stock over cost thereof.

The Securities and Exchange Commission today announced the issuance of an additional opinion in its Accounting Series, dealing with "treatment of excess of proceeds from sale of treasury stock over the cost thereof." The opinion was prepared by Carman G. Blough, the Chief Accountant, with respect to a particular example, but the principle in question has wider application. The opinion follows:

"Question has been raised with respect to the proper treatment of an item of $488,211.83 representing 'excess of proceeds from sale of 12,200 reacquired shares of the company's capital stock over the cost thereof.' These shares represent part of 41,400 shares of the capital stock of the registrant, a manufacturing company, reacquired by it prior to the year 1934 'for the purpose of resale when market conditions improved.'

"Under the laws of most States there are certain legal restraints upon the issuance of new shares that do not apply to the sale of treasury shares. However, from an accounting standpoint, there appears to be no significant difference in the final effect upon the company between (1) the reacquisition and resale of a company's own common stock and (2) the reacquisition and retirement of such stock together with the subsequent issuance of stock of the same class.

"It is recognized that when capital stock is reacquired and retired any surplus arising therefrom is capital and should be accounted for as such and that the full proceeds of any subsequent issue should also be treated as capital. Transactions of this nature do not result in corporate profits or in earned surplus. There would seem to be no logical reason why surplus arising from the reacquisition of the company's capital stock and its subsequent resale should not also be treated as capital.

"In my opinion the $488,211.83 excess of proceeds from the sale of 12,200 reacquired shares of this registrant's capital stock over the cost thereof should be treated as capital stock or capital surplus as the circumstances require."

RELEASE NO. 7

May 16, 1938

Commonly cited deficiencies in financial statements filed under the Securities Act of 1933 and the Securities Exchange Act of 1934.

The Securities and Exchange Commission today announced the issuance of an analysis of the deficiencies commonly cited by the Commission in connection with financial statements filed under the Securities Act of 1933 and the Securities Exchange Act of 1934.

The analysis, prepared by Carman G. Blough, Chief Accountant, covers accountants' certificates, consolidated financial statements, balance sheet, liabilities, capital stock, surplus, profit and loss statement, and various schedules.

The analysis is addressed to accountants practicing before the Commission and is designed to facilitate their work in the preparation of financial data. The analysis, including a note by Mr. Blough, follows:

MAY 6, 1938.

To Accountants Practicing Before the
Securities and Exchange Commission:

GENTLEMEN: As an aid to registrants and their accountants in the preparation of financial statements to be filed with this Commission pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934 there is submitted herewith a list of the more common deficiencies which it has been found necessary to cite in connection with financial data included in registration statements filed with this Commission.

It will be noted that many of the deficiencies cited do not involve any important problem in accounting and that some involve simply the failure to follow the express regulations and instructions of the Commission.

It is thought that if particular attention is given to the items comprising this list and to the instructions pertaining thereto, contained in the Commission's forms and regulations, considerable inconvenience and expense to registrants will be avoided and the work of the Commission's staff in reviewing the statements filed will be greatly facilitated.

Very truly yours,

(S) CARMAN G. BLOUGH
Chief Accountant.

Deficiencies commonly cited by the Securities and Exchange Commission in Connection with Financial Statements Filed Pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934

ACCOUNTANTS' CERTIFICATES

1. Accountant's opinion in respect of (1) the financial statements of, and (2) the accounting principles and procedures followed by the registrant, not clearly stated.

2. Use of equivocal phrases such as "subject to the foregoing," "subject to the above comments," "subject to comments and explanations in exhibits," "subject to the accompanying comments," etc..

3. A reasonably comprehensive statement as to scope of the audit made not included in the certificate..

4. Adequate audit not made by certifying accountant. In this connection attention is directed to the regulation that accountants shall not omit "any procedure which independent public accountants would ordinarily employ in the course of a regular annual audit."

5. Failure to certify all financial statements required to be submitted, *e.g.*, failure to certify profit and loss statement as well as balance sheet, and failure to certify statements of registrants as well as statements of registrant and subsidiaries consolidated.

6. Financial statements and supporting

schedules covered by the certificate not clearly identified.

7. Certifying that the accounting principles followed by the registrant are in accordance with the system of accounts prescribed by a State regulatory body, or in a particular industry, but without indicating whether the practice of the registrant is in accordance with generally accepted accounting principles and procedures.

8. Effect upon the financial statements of substantial changes in accounting policies of the registrant not commented upon and explained by the certifying accountants.

9. Effect upon the financial statements of the registrant's failure to follow generally accepted accounting principles and procedures not commented upon and explained by the certifying accountants.

10. Disclaimer of responsibility on the part of the certifying accountants with respect to matters clearly within their province.

11. Reservations on the part of the certifying accountants with respect to matters not within their province which might indicate that apparently the accountants were not satisfied that such matters as legal titles, outstanding liabilities, etc., were properly reflected in the financial statements.

12. Certificate undated, or not manually signed.

CONSOLIDATED FINANCIAL STATEMENTS

BALANCE SHEETS

1. Failure to include footnote indicating the method followed in dealing with the difference between the investment in subsidiaries, as shown in the parent's books, and the parent's equity in net assets of the subsidiaries, as shown in the books of the latter and to state the amount of such difference.

2. Amount of the minority interest in the capital and in the surplus of the subsidiaries consolidated not stated separately in the consolidated balance sheet.

3. Failure to state, as required, the principle adopted in determining the inclusion and exclusion of subsidiaries in each consolidated balance sheet.

4. Improper treatment, in consolidation, of surpluses of subsidiary companies existing at date of acquisition by parent company. (See Accounting Series Release No. 3.)

PROFIT AND LOSS STATEMENTS

1. Preparation of consolidated profit and loss statement on a different basis than the consolidated balance sheet, *e.g.*, inclusion in the consolidated profit and loss statement income and expenses of subsidiaries whose assets and liabilities are not reflected in the consolidated balance sheet but for which separate balance sheets are submitted.

2. Failure to eliminate intercompany items, or to explain satisfactorily the reasons for not eliminating such items.

BALANCE SHEET

ASSETS

1. Failure to state total of current assets and to designate the total.

2. Inclusion among current assets of assets not realizable within 1 year, excepting where recognized trade practices, which are stated, permit otherwise.

3. Classification, in the parent company's balance sheet, of receivables from subsidiaries as current assets, in cases where the subsidiaries classify their obligations to the parent company as noncurrent.

4. Failure to indicate, where required, assets hypothecated or pledged.

5. Failure to disclose, with adequate explanation, assets held conditionally.

6. Classification as marketable securities, securities not having a ready market.

7. Failure to state, where required, the basis of determining the balance sheet amounts of investment or marketable securities. In this connection the term "book value" is unacceptable.

8. Failure to state parenthetically the aggregate quoted value of investment and marketable securities when not shown on basis of current market.

9. Failure to reduce the carrying value of investments in subsidiaries to the extent of any dividends received thereon out of surplus

of such subsidiaries existing at date of acquisition.

10. Inclusion in trade accounts receivable of accounts not properly within such category.

11. Failure to state separately in the balance sheet, or in a schedule therein referred to, major classes of inventory such as (a) raw materials; (b) work in process; (c) finished goods; and (d) supplies, or to use any other classification reasonably informative.

12. Basis of determining the amounts of the inventories as shown in the balance sheet not stated.

13. Reserve for depreciation on appreciated value of fixed assets not provided.

14. Inclusion in carrying values of fixed assets, expenditures not properly includible therein, such as discount or commissions on capital stock and promotion expenses.

15. Method used in amortizing debt discount and expense not stated.

16. Failure to explain what provisions have been made for writing off discounts and commissions on capital stock.

17. Where treasury stock is carried as an asset, failure to state reasons for such practice.

18. Failure to state separately the amount of reacquired long-term debt of the registrant.

19. Absence of a reserve for doubtful accounts not explained.

LIABILITIES

1. Failure to state total of current liabilities and to designate the total.

2. Inclusion, with general reserves, of accurals for taxes which are actual liabilities.

3. Failure to state separately by years, where required, the total amounts of the respective maturities of long-term debt.

4. Accounts and notes payable, and accurals, not segregated as required.

5. Deferred income not set out separately.

6. Failure to disclose, with full particulars, all contingent liabilities.

CAPITAL STOCK

1. Aggregate capital stock liability of each class of stock not stated separately.

2. Failure to show the number of shares authorized, in treasury, and outstanding.

3. Assigned or stated value of no par value stock not indicated.

SURPLUS

1. Failure to show in balance sheet the division of surplus into various classes, in cases where registrant has differentiated in its accounting for surplus.

2. Use of capital surplus to absorb write-down in plant and equipment which should have been charged to earned surplus. (See Accounting Series Release No. 1.)

3. Failure to date earned surplus account after deficit has been eliminated (with stockholders' approval) by a charge to capital surplus.

4. Failure to state amount of surplus restricted (a) because of acquisition of company's own stock and (b) to the extent of the difference between par, assigned or stated value of preferred stock and the liquidating value of such stock.

5. Deficit not clearly designated in the balance sheet.

6. Treatment of surplus of subsidiary at date of acquisition as earned surplus.

PROFIT AND LOSS STATEMENT

1. Charges made to surplus rather than profit and loss for expenses or losses properly attributable to current operations.

2. Crediting profit and loss rather than surplus for sale of assets previously written off by a charge to surplus.

3. When opening and closing inventories are used in determining cost of goods sold, failure to state basis of determining the amount of such inventories.

4. Where no depletion or depreciation has been provided, failure to indicate that fact and the effect upon current operations in the profit and loss statement.

5. Failure to state basis of conversion of all items in foreign currencies, and the amount and disposition of resulting unrealized profit and loss when significant.

6. Gross sales net of discounts, returns, and allowances not shown in profit and loss statement.

7. Failure to state separately, as required by instructions, gross sales and operating revenues when the lesser amount is more than 10 percent of the sum of the two items.

8. Selling, general, and administrative expense not segregated in profit and loss statement.

9. Failure to explain in footnote to profit and loss statement, effect of change in significant accounting principle or practice.

10. Failure to show separately from other taxes surtax on undistributed profits or failure to state expressly that no liability existed for such tax. (See Securities Act of 1933 Release No. 1210.)

11. Principle followed in determining the cost of securities sold not stated, *e.g.*, "average cost," "first-in, first-out," "specific certificate or bond."

12. Failure to state basis of taking profits into income when sales are made on an installment or other deferred basis.

13. Failure to refer in profit and loss statement to supporting schedule when analysis of certain expense is presented in such schedule.

SCHEDULE OF PROPERTY, PLANT, AND EQUIPMENT

1. Failure to show property by major classifications such as land, buildings, equipment, leaseholds, etc., where required.

2. Nature of changes in property, plant, and equipment during the year not explained clearly, and accounts affected not indicated.

3. Failure to explain fully policy of amortization and/or depreciation of property, plant, and equipment credited directly to asset accounts.

SCHEDULE OF RESERVES FOR DEPRECIATION, DEPLETION, AND AMORTIZATION OF FIXED ASSETS

1. Failure to follow instructions: "State the company's policy with respect to the provisions for depreciation, depletion, and amortization or reserves created in lieu thereof during the fiscal year."

2. Failure to comply with the instructions: "Where practicable, reserves shall be shown to correspond with the classifications of property in [property scheduled] separating especially depreciation, depletion, and amortization."

3. Charges to reserve other than retirements, renewals, and replacements, not adequately described as required by instructions.

SCHEDULE OF INTANGIBLE ASSETS

1. Intangible assets not listed by major classes as required by instructions.

2. Failure to state policy with respect to provisions for depreciation and amortization of intangible assets in cases where a separate schedule for such reserves is not provided.

SCHEDULE OF RESERVE FOR DEPRECIATION AND /OR AMORTIZATION OF INTANGIBLE ASSETS

1. Failure to comply with instructions: "State the company's policy with respect to the provisions for depreciation and amortization of intangible assets, or reserves created in lieu thereof."

SCHEDULE OF FUNDED DEBT

1. Each issue of funded debt not designated fully as required by instructions.

SCHEDULE OF RESERVES

1. Failure to reflect all changes in reserves during the year and to properly describe major changes thereto.

SCHEDULE OF CAPITAL STOCK

1. Failure to list each issue of capital stock of all corporations in a consolidated group, whether eliminated in consolidation or not.

2. Treatment of unissued stock as treasury stock.

SCHEDULE OF SURPLUS

1. Failure to show division of surplus into classes when required by instructions.

2. Analysis of surplus account not included either in balance sheet or as a continuation of the profit and loss statement, or in a schedule referred to in the balance sheet.

3. Failure to describe in detail miscellaneous additions to and deductions from surplus.

SCHEDULE OF ANALYSIS OF CERTAIN EXPENSES IN PROFIT AND LOSS STATEMENT

1. Amounts charged to costs and those charged to other profit and loss items not segregated.

2. Failure to report in this schedule all expenses pertaining to maintenance and repairs.

3. Items in this schedule at variance with other statements or schedules.

SCHEDULE OF INCOME FROM DIVIDENDS

1. Failure to show as required in column C of this schedule the "amount of equity in net profit and loss for the fiscal year" of affiliates, notwithstanding the fact that no dividends were received during the year from affiliates.

2. Failure to show separately for each affiliate the "amount of dividends" and the "amount of equity in net profit and loss for the fiscal year" when registrant does not meet requirements that these items may be reported in total only when substantially all the stock and funded debt of the subsidiaries are held within the affiliated group.

RELEASE NO. 8

May 20, 1938

Creation by promotional companies of surplus by appraisal.

The Securities and Exchange Commission today issued an additional statement in its Accounting Series. The statement, relating to the creation of surplus by appraisal in balance sheets representing the accounts of promotional companies, follows:

"In connection with a registration statement, an industrial company in its promotional stages with no record of business or earning capacity, filed a balance sheet in which property, plant, and equipment, acquired in an arm's length transaction at a cost of $200,000, was carried at $720,042.81 which represented its 'sound value' derived from an independent appraisal of the estimated 'replacement value new less (observed) depreciation.' Thus the balance sheet figures exceeded cost by $520,042.81, which excess was carried as 'surplus arising from revaluation of property.'

"In the appraisal report filed, the term 'sound value' was qualified by the appraiser as being 'The value for use by a going concern having prospects for the profitable use, at normal plant capacity, of the properties appraised.'

"The registrant was required to amend its balance sheet to eliminate the surplus and to show the fixed assets at cost."

RELEASE NO. 9

December 23, 1938

Presentation of stock having preferences on involuntary liquidation in excess of par or stated value.

The Securities and Exchange Commission today announced the issuance of an additional opinion in its Accounting Series, dealing with the "balance sheet presentation of preferred or other senior classes of capital stock having preferences on involuntary liquidation in excess of the par or stated value." The opinion, prepared by William W. Werntz, the Chief Accountant, in response to an inquiry, follows:

"Inquiry has been made with respect to the proper presentation in statements filed with the Commission of preferred or other senior classes of capital stock having preferences on involuntary liquidation in excess of the par or stated value. In such cases the method of presentation is of importance in order to reflect fully and adequately the equities of the various classes of stockholders, and to indicate the status of surplus particularly from a dividend standpoint.

"As required by the regulations of the Commission there should be set forth in the balance sheet for each class of stock (1) the number of shares (a) authorized and (b) outstanding; (2) the par value per share or, if no par value, the stated or assigned value per share, if any; and (3) the aggregate capital stock liability thereof. In addition, it is my opinion that in the case of preferred stock the preferences on involuntary liquidation if other than the par or stated value, and the dividends in arrears, if any, should be shown (preferably in the balance sheet) both per share and in the aggregate for each class of such stock.

"As a means of further disclosure when the excess involved is significant there should be shown in the balance sheet or in footnotes thereto (1) the difference between the aggregate preference on involuntary liquidation and the aggregate par or stated value; (2) a statement that this difference, plus any arrears in dividends, exceeds the sum of the par or stated value of the junior capital and the surplus, if such is the case; and (3) a statement as to the existence of any restrictions upon surplus growing out of the fact that upon involuntary liquidation the preference of the preferred stock exceeds its par or stated value."

The Securities and Exchange Commission also issued today the following statement of administrative policy in connection with the problem discussed in the above opinion.

"In addition to requiring disclosure of the pertinent facts outlined in the above opinion, it is the administrative policy of the Commission when the excess involved is significant to require as a means of further disclosure that there be filed as an exhibit an opinion of counsel as to whether there are any restrictions upon surplus by reason of the difference between the preference of the preferred stock on involuntary liquidation and its par or stated value and also as to any remedies available to security holders before or after the payment of any dividend that would reduce surplus to an amount less than the amount by which the aggregate preference of such stock on involuntary liquidation exceeds its aggregate par or stated value. Such opinion of counsel should set forth any applicable constitutional and statutory provisions and should refer to any decisions which, in the opinion of counsel, are controlling."

RELEASE NO. 10

December 23, 1938

Treatment of unamortized bond discount and expense applicable to bonds retired prior to maturity with proceeds from sale of capital stock.

The Securities and Exchange Commission today made public an opinion in its Accounting Series as to the proper treatment of unamortized bond discount and expense applicable to bonds which, prior to maturity, have been retired out of the proceeds of a sale of capital stock. The opinion, prepared by William W. Werntz, Chief Accountant, follows:

"Question has frequently been raised as to the proper treatment to be accorded unamortized debt discount and expense applicable to bonds which, prior to maturity, have been retired by the use of funds derived from the sale of capital stock. As generally presented, the inquiry relates to the propriety of carrying such unamortized debt discount and expense as a deferred charge and amortizing it over the remaining portion of the original life of the retired bonds.

"While it may be permissable to retain on the books and amortize any balance of discount and expense applicable to bonds refunded by other evidences of indebtedness, similar treatment is not ordinarily acceptable, in my opinion, when funds used to retire the existing bonds are derived from the sale of capital stock. In such cases it is my opinion that, as a general rule, sound and generally accepted accounting principles and practice require that the unamortized balance of the debt discount and expense applicable to the retired bonds should be written off by a charge to earnings or earned surplus, as appropriate, in the accounting period within which the bonds were retired."

RELEASE NO. 11

January 4, 1940

Consolidation of foreign subsidiaries of domestic corporations

The Securities and Exchange Commission today announced the issuance of an additional opinion in its Accounting Series, dealing with the problem of inclusion and exclusion in consolidation of foreign subsidiaries of domestic corporations. The opinion, prepared by William W. Werntz, Chief Accountant, in response to an inquiry, follows:

"Inquiry has been made as to the propriety of including in consolidation with domestic corporations foreign subsidiaries whose operations are effected in terms of restricted foreign currencies, or whose assets and operations are endangered by the war conditions prevailing abroad.

"Foreign currency restrictions and war conditions are of such significance with respect to subsidiaries operating in affected territories as to require, in my opinion, that registrants consider carefully their policy with respect to the inclusion of such subsidiaries in consolidated financial statements. It is my opinion in general that the consolidation of such foreign subsidiaries with the domestic parent and other domestic or foreign subsidiaries may be misleading. However, if, notwithstanding the existence of exchange restrictions and war conditions affecting certain foreign subsidiaries at the time the financial statements are prepared, the inclusion of such foreign subsidiaries in the consolidated statements is considered desirable and in the particular case will not prevent a clear and fair presentation of the financial condition and the results of operations of the registrant and its subsidiaries, their inclusion is ordinarily permissible. If included, however, disclosure should be made as to the effect, insofar as this be reasonably determined, of foreign exchange restrictions and war conditions upon the consolidated financial position and operating results of the registrant and its subsidiaries.

"In any case, the existence of currency restrictions and war conditions requires that careful consideration should also be given to the question of providing, and, if provision appears necessary, the extent of such provision, for impairment of the registrant's investment in such foreign subsidiaries by reason of the prevailing conditions and losses suffered by such subsidiaries."

RELEASE NO. 12*

February 21, 1940

SECURITIES ACT OF 1933
Release No. 2179

SECURITIES EXCHANGE ACT OF 1934
Release No. 2414

Adoption of Regulation S-X—Amendments to Form 15 and Form 17.

RELEASE NO. 13

February 20, 1940

Form of accountants' certificate.

The Securities and Exchange Commission today made public an opinion in its Accounting Series dealing with the form of accountants' certificates. The opinion, prepared by William W. Werntz, Chief Accountant, follows:

"In a recent case a registrant had not maintained cash books, journals, other books of original entry or ledgers during the period covered by the financial statements filed by it with the Commission. Its files, however, contained original underlying data such as canceled checks, check stubs, bank statements, purchase orders, vendors' invoices, sales orders, and duplicate sales invoices.

"In order to prepare financial statements it was deemed necessary by the independent accountants who certified the statements that the cash transactions and sales be recorded in books of original entry and in turn posted to a general ledger and that the books then be adjusted to an accrual basis. The entry and analysis of the transactions in formal books were carried out by one of the firm's junior accountants, loaned on a *per diem* basis, and by an officer of the company. The accountants maintained that this preliminary work consisted merely of classifying and summarizing records of transactions prepared by employees of the company at the time of the transaction. However, in many cases notations as to the purpose of disbursements had not been made on the check stubs contemporaneously with the transaction and accordingly it was necessary to rely in such cases upon the memory of an officer of the registrant in classifying and recording disbursements.

"Upon the completion of this preliminary work the certifying accountants found that satisfactory determination had not been made of the balances in certain of the registrant's asset, liability and income and expense accounts. In the second or audit phase of the engagement the accountants therefore deemed it necessary to undertake work of a special nature and in some instances to make original determinations as to the amounts of such accounts.

"As an illustration of the condition of the accounts, it may be pointed out that in making their examination the accountants determined that certain payments by customers had not been reflected in the accounts. Upon inquiry the accountants learned that the amounts unaccounted for had been received for the account of the registrant by a company affiliated with the registrant, or by an officer of the registrant, or by the registrant's principal vendor. These amounts were thereafter taken into consideration by the accountants in determining the balances due to the affiliate, the officer, and the supplier, as well as in accounting for the proceeds of sales and the balances due from customers. It thus appears that the accountants rather than employees of the registrant made

* Text of release omitted.

the only realistic determination of these particular balances and that such determination was not based solely on underlying records of the registrant made by its employees, contemporaneously with the transaction.

"After thus ascertaining that a balance of $54,000 was owing by the registrant to its affiliate as of December 31, 1938, the accountants requested a written confirmation of this amount from the affiliate. After a confirmation of the amount had been received, the accountants in the course of other necessary work learned of transactions which appeared to reduce the amount owing by the registrant to its affiliate to $39,000. Confirmation of this new amount, $15,000 less than the original balance, was also requested and obtained from the affiliate in due course. This difference was in large part accounted for by a deposit by the registrant with a vendor in connection with a purchase order. Subsequently, the vendor paid over to the registrant's affiliate the amount of the deposit as a refund. However, the officer responsible for the accounts of both the registrant and its affiliate apparently had no knowledge of this transaction until discovered by the accountants and called to his attention. Thus it appears that at no time had either of these companies independently determined the status of the account between them. Similar confusion existed in the registrant's accounts with its officers and with its principal vendor.

"Such circumstances as these led the accountants to extend their investigations to such extent as to approach the character of a detailed audit. Upon the completion of the audit entries were prepared by the accountants for the purpose of adjusting the registrant's accounts to reflect the proper assets and liabilities and to place the accounts on an accrual basis. In my opinion, these entries were of a character and extent that would not ordinarily be effected in the course of an audit such as is contemplated by the form of certificate furnished by these accountants.

"Notwithstanding these unusual circumstances the certificate furnished by the accountants to accompany the financial statements filed with the Commission stated that:

'In connection therewith we examined or tested accounting records of the corporation and other supporting evidence and obtained information and explanations from its officers and employees and made substantial tests of the income and expense accounts for the period under review.'

"The certificate also stated that the financial statements:

'***fairly present in accordance with accepted principles of accounting consistently maintained by the corporation during the period under review its position * * * and the results of its operations. ***.'

"Disclosure of certain of the procedures followed by the accountants was made in notes to the registrant's statement of profit and loss. In addition various notes to the registrant's balance sheet contained partial disclosure as to the scope of the accountants' audit with respect to particular balance sheet accounts.

"In my opinion when a registrant during the period under review has not maintained records adequate for the purpose of preparing comprehensive and dependable financial statements, that fact should be disclosed.[1] If, because of the absence or gross inadequacy of accounting records maintained by a registrant, it is necessary to have essential books of account prepared retroactively and for the accountant to enlarge the scope of the audit to the extent indicated in order to be able to express his opinion, these facts also should be disclosed, and I believe it is misleading, notwithstanding partial disclosure by footnotes as in the instant case, to furnish a certificate which implies that

[1] In this connection it should be noted that under somewhat similar circumstances the Commission in stop-order opinions has previously held that an accountant certifying financial data is under a duty to disclose the existence of areas of information about which there is considerable doubt. See In the Matter of *Livingston Mining Company*, 2 S.E.C. 141, 148; In the Matter of *Platoro Gold Mines, Inc.*, 3 S.E.C. 872 (1938).

the accountant was satisfied to express an opinion based on a test-check audit.[2] Moreover, it is misleading, in my opinion, to state or imply that accepted principles of accounting have been consistently followed by a registrant during the period under review if in fact during such period books of account were not maintained by a registrant or were grossly inadequate, or if it has been necessary for the accountant to make pervasive and extraordinary adjustments of the character under consideration."

RELEASE NO. 14*

February 29, 1940

SECURITIES ACT OF 1933
Release No. 2194

SECURITIES EXCHANGE ACT OF 1934
Release No. 2424

Amendment of rule adopting Regulation S-X.

RELEASE NO. 15

March 16, 1940

Description of surplus accruing subsequent to effective date of quasi-reorganization.

The Securities and Exchange Commission today made public an opinion in its Accounting Series relative to the description of surplus accruing subsequent to the effective date of a quasi-reorganization. The term "quasi-reorganization" has come to be applied in accounting to the corporate procedure in the course of which a company, without the creation of a new corporate entity, is enabled to eliminate a deficit and establish a new earned surplus account for the accumulation of earnings subsequent to the date selected. The opinion, prepared by William W. Werntz, Chief Accountant, follows:

"Question has frequently been raised as to the proper description of the earned surplus account subsequent to the effective date of a quasi-reorganization. By the term "quasi-reorganization" I refer to the corporate procedure in the course of which a deficit is charged to capital surplus previously existing or arising in the course of the quasi-reorganization.

"It is my opinion that sound accounting practice ordinarily requires that a clear report be made to stockholders of the proposed restatements and that their formal consent thereto be obtained. In such a situation it is also essential, in my opinion, that full disclosure of the procedure be made in the financial statements for the fiscal year involved and that any subsquent statements of surplus should designate the point of time from which the new earned surplus dates.

"Furthermore, in view of the importance of such proceedings, I am of the opinion that until such time as the results of operations of the company on the new basis are available for an appropriate period of years (at least 3) any

[2] Although not in question here, the status of accountants as independent experts may be jeopardized when employees of the certifying accountants prepare the registrant's ledgers and books of original entry or when the accountants' work becomes a substitute for management's accounting of its stewardship rather than a check upon that accounting. Cf. In the Matter of *Interstate Hosiery Mills, Inc.*, 4 S.E.C. 706 (1939).

* Text of release omitted.

statement or showing of earned surplus should, in order to provide additional disclosure of the occurrence and the significance of the quasi-reorganization, indicate the total amount of the deficit and any charges that were made to capital surplus in the course of the quasi-reorganization which would otherwise have been required to be made against income or earned surplus.

"Reference is also made to the provisions of Accounting Series Release No. 16 which indicates the further disclosures that in my opinion are necessary when the transfer of a deficit to capital surplus has been effected by resolution of the board of directors but without approval of the stockholders, such action being permissible under the applicable State law."

RELEASE NO. 16

March 16, 1940

Disclosure of charge of deficit to capital surplus without approval of stockholders.

The Securities and Exchange Commission today made public an opinion in its Accounting Series relative to the disclosure which should be made in the financial statements when a company charges a deficit to capital surplus pursuant to a resolution of the board of directors, but without approval of the stockholders, such action being permissible under the applicable State law.

The opinion, prepared by William W. Werntz, Chief Accountant, in connection with an inquiry, follows:

"Inquiry has frequently been made as to the disclosure necessary in financial statements filed with the Commission under the Securities Act of 1933 or the Securities Exchange Act of 1934 when a company has charged a deficit to capital surplus without approval of the stockholders. In a typical case it was indicated that a company on January 1, 1939, had a deficit of $800,000 and a capital surplus of $1,500,000 arising out of the excess of the amount paid in for its stock over the par value thereof and that earned surplus since January 1, 1939, amounted to $100,000. By resolution of the board of directors, dated January 16, 1939, but without approval of the stockholders, the deficit had been charged off to capital surplus. I am informed that under the applicable State law it was permissible to effect this restatement without approval of the stockholders.

"From the facts of this case it appeared that the company sought to effect a quasi-reorganization such as is referred to in Accounting Series Release No. 15. However, as there stated, it is my opinion that in such cases sound accounting practice ordinarily requires that a clear report be made to stockholders of the proposed restatement and that their formal consent thereto be obtained. If, however, under the applicable State law it is permissable to eliminate a deficit without obtaining the formal consent of stockholders and if such consent of stockholders is not obtained, it is necessary in my opinion to make a complete disclosure of all the attendant facts and circumstances and their effect on the company's financial position in each balance sheet and surplus statement filed with the Commission thereafter.

"Under the circumstances of the case cited, it is my opinion that, to effect the minimum appropriate disclosure in the surplus accounts, information should be given in respect of subsequent earned surplus in approximately the following fashion:

Total deficit to Dec. 31, 1939	$700,000	
Less deficit at Jan. 1, 1939, charged to capital surplus by resolution of the board of directors and without approval of stockholders, such action being permissible under the applicable State law	800,000	
Earned surplus since Jan. 1, 1939		$100,000

"As an additional disclosure in situations to which the provisions of this release are applicable it has been the administrative policy of the Commission to require that in the registration statement or other filing containing financial statements first reflecting such action by the directors there be included an explanation of the action taken and an indication of its possible effect on the character of future dividends. As an example of an appropriate disclosure, there may be cited the following paragraph:

" 'It should be noted that on .... by action of the board of directors, without action by the stockholders, the company charged off a $............deficit in earned surplus against its capital surplus. This procedure will permit the company in the future to reflect undistributed earnings subsequent to .... as earned surplus, instead of as a reduction of the deficit charged off to capital surplus. One result of this procedure is to permit the distribution, as ordinary dividends, of earned surplus accruing subsequent to ...., without regard to the deficit charged off to capital surplus. Furthermore, if earnings subsequent to .... are less than the deficit written off, distributions thereof may in effect represent distributions of capital or capital surplus.'

"In view of the fact that no statement of policy in such cases has previously been announced, the policy has been adopted of not insisting upon the additional disclosures outlined in the preceding paragraphs if the restatement involved occured prior to December 31, 1938, or the beginning of the period for which financial statements are required in the particular filing, whichever is earlier."

RELEASE NO. 17

March 18, 1940

Use of natural business year as basis for corporate reporting.

The Securities and Exchange Commission today announced the issuance of an additional release in its Accounting Series relating to the use of the natural business year as a basis for corporate reporting. This question was raised by a registrant which was considering the desirability of changing from the calendar-year basis to the fiscal-year basis for its financial reports and sought to ascertain the attitude of the Commission towards this question. The reply, prepared by William W. Werntz, Chief Accountant, follows:

"You have inquired as to the possibility, under the rules administered by the Commission, of changing from the calendar-year basis currently employed to a fiscal-year basis for your financial statements. You have also inquired as to the method of reflecting the changed fiscal year in the financial reports to be filed with this Commission. In this connection I may point out that the rules of the Commission do not prescribe the use of any particular fiscal year for the financial statements required. However, the advantages to be obtained from the adoption of a fiscal-year-end date which coincides with the lowest point in the annual cycle of operations are clear and to my mind have never been shown to be outweighed by related disadvantages. Among the more important advantages there may be mentioned the probability of obtaining more complete and reliable financial statements since at the close of the natural business year incomplete transactions, and such items as inventories, would ordinarily be at a minimum. Mention may also be made of the fact that the general adoption of the natural business year would facilitate the work of public accountants by permitting them to spread much of their work throughout the calendar year, and thus aid them in rendering the most effective service of their clients.

"In this connection, I call your attention to Rule X-13A-4 of the General Rules and Regulations under the Securities Exchange Act of 1934 which includes, among other things, the following specific provisions as to the character of reports to be filed with the Commission after a change in the fiscal year. In the case of an interim period of less than 3 months no separate report is required. However, in such case, the next annual report is to cover the period up to the close of the following full fiscal year and is to show separate schedules and profit and loss statements for the interim period, as well as for such fiscal year. If the interim period is more than 3 months, a separate report comparable to the annual report is required to be filed. If the interim period is less than 6 months, the financial statements in such report need not be certified. However, if the statements are not certified, the next annual report shall include separate certified financial statements covering the interim period. You will also note that if the fiscal date is changed it is necessary, under the rule, to notify the Commission within 10 days thereafter."

RELEASE NO. 18*

November 19, 1940

SECURITIES ACT OF 1933
Release No. 2398

SECURITIES EXCHANGE ACT OF 1934
Release No. 2692

Amendment of Rule 4–09 of Regulation S–X.

RELEASE NO. 19

December 5, 1940

SECURITIES EXCHANGE ACT OF 1934
Release No. 2707

In the Matter of McKesson & Robbins, Inc.—Summary of findings and conclusions.

File No. 1–1435—Securities Exchange Act of 1934, Section 21 (a).

This is a summary of our report on the McKesson & Robbins hearing held pursuant to our order of December 29, 1938, under Section 21(a) of the Securities Exchange Act of 1934.

The order for the hearing was based upon evidence that the information set forth in the registration statement and annual reports of McKesson & Robbins, Incorporated, especially the financial statements and schedules included therein which were prepared and certified by Price, Waterhouse & Co., was materially false and misleading. We stated our purpose to be to determine:

(1) the character, detail and scope of the audit procedure followed by Price, Waterhouse & Co. in the preparation of the financial statements included in the said registration statement and reports;

(2) the extent to which prevailing and generally accepted standards and requirements of audit procedure were adhered to and applied by Price, Waterhouse & Co. in the preparation of the said financial statements; and

(3) the adequacy of the safeguards inhering in the said generally accepted prac-

* Text of release omitted.

tices and principles of audit procedure to assure reliability and accuracy of financial statements.

As directed, hearings commenced on January 5, 1939, and continued, with some necessary adjournments, through April 25, 1939. Throughout the hearings Price, Waterhouse & Co. were represented by counsel, as were all witnesses who desired counsel. Opportunity was accorded such counsel to examine witnesses called by the Commission and to call their own witnesses. In all, 46 witnesses were examined. Of these, 9 were partners and employees of Price, Waterhouse & Co.; 12 were accountants of other firms called to testify as experts; 1 represented the Controllers Institute of America and 1 the American Institute of Consulting Engineers; 2 were from S.D. Leidesdorf & Co., accountants for the Trustee of McKesson & Robbins; 1 was a person who prepared many of the fictitious documents; 8 were employees of McKesson & Robbins; 11 were McKesson directors; and the last was a Commission investigator, who was called to identify certain documents. Throughout, Price, Waterhouse & Co., the witnesses, and their counsel extended the fullest cooperation in facilitating the conduct of the proceedings. The record of the public hearings is contained in 4,587 pages of testimony and 285 exhibits comprising in excess of 3,000 pages. Copies of the draft of the full report were submitted to Price, Waterhouse & Co. and their counsel, and their criticism and brief thereon were considered by the Commission before issuing this report.

The full report based upon the testimony and the exhibits and our study of recognized authoritative works on auditing consists of five sections in the text and five appendices as follows:

Section I. A summary of our findings and conclusions;

Section II. A brief statement reciting the manner in which the fraud came to the attention of the public and this Commission;

Section III. A description of the manner in which the manipulation of the accounts of McKesson & Robbins was carried out by Coster-Musica and his associates;

Section IV. A description of the audit conducted by Price, Waterhouse & Co.;

Section V. Our conclusions as to the Price, Waterhouse & Co. audit of McKesson & Robbins, Incorporated, and as to the adequacy of the safeguards inhering in generally accepted auditing practices;

Appendix A. A brief summary of action taken subsequent to the discovery of the fraud by accounting organizations and others interested in the work of independent public accountants;

Appendix B. A comparison of those sections of the English Companies Act of 1929 dealing with appointment of auditors and Horace B. Samuel's suggested amendments to those sections of that Act;

Appendix C. Our order for public hearings in this matter;

Appendix D. A list of all witnesses who testified, with the page numbers of their testimony;

Appendix E. A description of all exhibits introduced in the hearings.

A. SUMMARY OF PRINCIPAL FACTS

The securities of McKesson & Robbins, Incorporated (Maryland) were listed and traded on the New York Stock Exchange and registered under the Securities Exchange Act of 1934. Financial statements of the Corporation and its subsidiaries for the year ended December 31, 1937 (the last before the disclosure of the fraud hereinafter described), certified by Price, Waterhouse & Co., filed with this Commission and the New York Stock Exchange, and issued to stockholders reported total consolidated assets in excess of $87 million. Approximately $19 million of these assets are now known to have been entirely fictitious. The fictitious items consisted of inventories, $10 million; accounts receivable, $9 million; and cash in bank, $75,000; and arose out of the operation at the Bridgeport offices of a wholly fictitious foreign crude drug business shown on the books of the Connecticut Division of McKesson & Robbins, Incorporated (Maryland) and McKesson & Robbins, Limited (Canada), one of its subsidiaries. For the year 1937, fictitious sales in these units amounted to $18,247,-

020.60 on which fictitious gross profit of $1,801,390.60 was recorded. At the time of the exposure of the fraud on or about December 5, 1938, the fictitious assets had increased to approximately $21 million.

The fraud was engineered by Frank Donald Coster, president of McKesson & Robbins since its merger with Girard & Co., Inc., in November 1926. In reality Coster was Philip M. Musica who, under the latter name, had been convicted of commercial frauds. In carrying out the fraud Coster, in the later years, was assisted principally by his three brothers: George E. Dietrich, assistant treasurer of the Corporation, who was in reality George Musica; Robert J. Dietrich, head of the shipping, receiving, and warehousing department of McKesson & Robbins at Bridgeport, Connecticut, who was in reality Robert Musica; and George Vernard, who was in reality Arthur Musica and who managed the offices, mailing addresses, bank accounts and other activities of the dummy concerns with whom the McKesson companies supposedly conducted the fictitious business.

To accomplish the deception, purchases were pretended to have been made by the McKesson companies from five Canadian vendors, who thereafter purportedly retained the merchandise at their warehouses for the account of McKesson. Sales were pretended to have been made for McKesson's account by W.W. Smith & Company, Inc., and the goods shipped directly by the latter from the Canadian vendors to the customers. Payments for goods purchased and collections from customers for goods sold were pretended to have been made by the Montreal banking firm of Manning & Company also for the account of McKesson. W.W. Smith & Company, Inc., Manning & Company, and the five Canadian vendors are now known to have been either entirely fictitious or merely blinds used by Coster for the purpose of supporting the fictitious transactions.

Invoices, advices, and other documents prepared on printed forms in the names of these firms were used to give an appearance of reality to the fictitious transactions. In addition to this manufacture of documents, a series of contracts and guarantees with Smith and Manning and forged credit reports on Smith were also utilized. The foreign firms to whom the goods were supposed to have been sold were real but had done no business of the type indicated with McKesson.

The fictitious transactions originated early in the life of Girard & Co., Inc., Coster's predecessor concern, incorporated on January 31, 1923, and increased until they reached the proportions mentioned above. The manner of handling the transactions described above was the one in vogue since the middle of 1935. Prior to that time the fictitious goods were supposed to have been physically received at and reshipped from the Bridgeport plant of McKesson. And prior to 1931 McKesson made cash payments directly for the fictitious purchases, which at the time were supposed to have been made from a group of domestic vendors, but recovered a large part of this cash purportedly as collections on the fictitious sales. The change from using actual cash to the supposed clearance through Manning & Company was not effected abruptly but for some time after 1931 both systems were used. The Canadian vendors, however, were used only in connection with the Manning clearance system. From the report of the accountant for the trustee in reorganization of McKesson & Robbins, Incorporated, it appears that out of an actual cash outgo from the McKesson companies in connection with these fictitious transactions of $24,777,851.90 all but $2,869,482.95 came back to the McKesson companies in collection of fictitious receivables or as cash transfers from the pretended bank of Manning & Company.

B. SUMMARY OF CONCLUSIONS AS TO INDIVIDUAL AUDITING PROCEDURES

Our conclusions as to the individual auditing procedures are developed in detail in Section V of our report. The full discussion of each topic should be consulted for the basis and complete statement of the conclusions which we here summarize.

1. APPOINTMENT AND RESPONSIBILITY OF AUDITORS; DETERMINATION OF THE SCOPE OF THE ENGAGEMENT

All appointments of Price, Waterhouse & Co.

as auditors for Girard & Co., and the successor McKesson companies were made by letter from Coster or the comptroller, McGloon, near the close of the year to be audited. The testimony of the directors is that with rare exceptions members of the board had no part in arranging for the audit and did not know the content either of the letters of engagement or of the long form report addressed to Coster, in which the character of the work was set forth.

While the appointment of Price, Waterhouse & Co. and the method of determining the scope of the engagement in this case was in accord with generally accepted practice, we do not feel that it insures to the auditor, in all cases, that degree of independence which we do deem necessary for the protection of investors. Adoption of the following program, we feel, would aid materially in correcting present conditions:

1. Election of the auditors for the current year by vote of the stockholders at the annual meeting followed immediately by notice to the auditors of their appointment.

2. Establishment of a committee to be selected from nonofficer members of the board of directors which shall make all company or management nominations of auditors and shall be charged with the duty of arranging the details of the engagement.

3. The certificate (sometimes called short-form report or opinion) should be addressed to the stockholders. All other reports should be addressed to the board of directors, and copies delivered by the auditors to each member of the board.

4. The auditors should be required to attend meetings of the stockholders at which their report is presented to answer questions thereon, to state whether or not they have been given all the information and access to all the books and records which they have required, and to have the right to make any statement or explanation they desire with respect to the accounts.

5. If for any reason the auditors do not complete the engagement and render a report thereon, they shall, nevertheless, render a report on the amount of work they have done and the reasons for noncompletion, which report should be sent by the company to all stockholders.

In approaching his work with respect to companies which file with us or in which there is a large public interest, the auditor must realize that, regardless of what his position and obligations might have been when reporting to managers or to owner-managers, he must now recognize fully his responsibility to public investors by including the activities of the management itself within the scope of his work and by reporting thereon to investors. The adoption of a program such as that outlined above should serve to secure recognition of these newly emphasized obligations of the auditor to public investors.

2. ORGANIZATION AND TRAINING OF STAFF

We have found that there is great similarity among accounting firms in the organization of the staff and assignments to engagements. We deplore, as do accounting firms, the necessity for recruiting large numbers of temporary employees during a very short busy season. This condition and the lack of training in the firm's methods which it ordinarily entails are inimical to attaining the best results from the auditors' services. A major improvement in this condition could be made by the general adoption by corporations of the natural business year for accounting purposes.. The recruiting of temparary employees was more aggravated in Price, Waterhouse & Co. than in other comparable firms whose representatives testified as experts. This situation, coupled with the fact that Price, Waterhouse & Co. had a higher ratio of both permanent and peak staff per partner than other firms, leads us to the conclusion that Price, Waterhouse & Co. partners could not have given adequate attention to the training, development, and supervision of their staff.

3. INVESTIGATION OF NEW CLIENTS

The facts of this case suggest that for new and unknown clients some independent investigation should be made of the company and of its principal officers prior to undertaking the work. Such an inquiry should provide a valuable background for interpreting conditions revealed during the audit or, in extreme cases, might lead to a refusal of the engagement.

4. REVIEW OF THE CLIENT'S SYSTEM OF INTERNAL CHECK AND CONTROL

We are convinced by the record that the review of the system of internal check and control at the Bridgeport offices of McKesson & Robbins was carried out in an unsatisfactory manner. The testimony of the experts leads us to the further conclusion that this vital and basic problem of all audits for the purpose of certifying financial statements has been treated in entirely too casual a manner by many accountants. Since in examinations of financial statements of corporations whose securities are publicy owned the procedures of testing and sampling are employed in most cases, it appears to us that the necessity for a comprehensive knowledge of the client's system of internal check and control cannot be overemphasized.

5. CASH

The record is clear that the cash work performed on this engagement by Price, Waterhouse & Co. conformed in scope to the then generally accepted standards of the profession. It is equally clear to us that prior to this case many independent public accountants depended entirely too much upon the verification of cash as the basis for the whole auditing program and hence as underlying proof of the authenticity of all transactions. When, as here, during the final 3 years of the audit, physical contact with the operations of a major portion of the business was limited to examination of supposed documentary evidence of transactions carried on completely offstage through agents unknown to the auditors save in connection with the one engagement, it appears to us that the reliability of these agents must be established by completely independent methods. Confirmation of the bank balance under these circumstances was proven in this case to be an inadequate basis for concluding that all the transactions were authentic.

6. ACCOUNTS RECEIVABLE

Viewed as a whole the audit program for accounts receivable as used by Price, Waterhouse & Co. conformed to then generally accepted procedures for an examination of financial statements although confirmation of the accounts was not included in the program. The facts of this case, however, demonstrated the utility of circularization and the wisdom of the profession in subsequently adopting confirmation of accounts and notes receivable as a required procedure "* * * wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern * * *."

7. INTERCOMPANY ACCOUNTS

The record indicates that it is not enough for auditors to reconcile intercompany balances and that valuable insight into the company's manner of doing business may be gained by a review of the transactions passed through such accounts during the year. Best practice we believe requires the latter procedure. In this case the recommended procedure although employed to some extent, was not applied in a throughgoing and penetrating manner.

8. INVENTORIES

Price, Waterhouse & Co.'s audit program for the verification of inventories was essentially that which was prescribed by generally accepted auditing practice for the period. However, we find that a substantial difference of opinion existed among accountants during this time as to the extent of the auditors' duties and responsibilities in connection with physcal verification of quantities, quality, and condition. Price, Waterhouse & Co., in common with a substantial portion of the profession, took the position that the verification of quantities, quality, and condition of inventories should be confined to the records. There was, however, a substantial body of equally authoritative opinion which supported the view, which we endorse, that auditors should gain physical contact with the inventory either by test counts, by observation of the inventory taking, or by a combination of these methods. Meticulous verification of the inventory was not needed in this case to discover the fraud. We are not satisfied therefore, that even under Price, Waterhouse & Co.'s views other accountants would condone their failure to make inquiries of the employees who actually took the inventory and to determine by inspection whether there was an inventory as represented by the client. We commend the action of the profession in subsequently adopting, as normal, procedures requiring physical contact with client's inventories.

9. OTHER BALANCE SHEET ACCOUNTS

a. The testimony in respect to the auditing of plant accounts suggests that some accountants, including Price, Waterhouse & Co., could, with advantage, devote more attention to physical inspection than has been general practice with them in the past.

b. The work in respect to liabilities was in accord with generally accepted practice but suggests the desirability of independent inquiry when large purchases are made from a very few otherwise unknown suppliers.

c. The record demonstrates the necessity of a through understanding of the client's tax situation which apparently was not obtained by Price, Waterhouse & Co. in regard to the application of the Canadian law.

10. PROFIT AND LOSS ACCOUNTS

We are of the opinion that such analyses of profit and loss accounts as were made applied to improper combinations of departments with the result that significant relationships were concealed. It is our conclusion that the independent accountant is derelict in his duty if he does not insist upon having proper analyses available for his review. It is our opinion that best practice supports this view.

11. THE WHOLESALE HOUSES

It must be emphasized again that although the bulk of this report deals with the two units in which the fraud occurred, which were under the direct charge of the Company's principal officer, some material bearing on the work in the other units, mostly wholesale houses, was introduced at the hearings. As to this portion of the audit, which constituted the larger part of the Price, Waterhouse & Co. engagement, covering for 1937 approximately 70 percent of the reported assets and 85 percent of the net sales, and which occupied approximately 97 percent of the auditors' time, it appears that the work in these other units was carried out in a through fashion in accordance with generally accepted auditing practice prevailing during the periods involved, including limited inspections of inventories but no confirmation of accounts and notes receivable.

12. REVIEW PROCEDURE

The mechanics of the review procedure as carried out by Price, Waterhouse & Co. on this engagement were substantially the same as those of the majority of accounting firms. However, it is our opinion that the partner in charge in this case was not sufficiently familiar with the business practices of the industry in question and was not sufficiently concerned with the basic problems of internal check and control to make the searching review which an engagement requires.

13. THE CERTIFICATE

The form of certificate used by Price, Waterhouse & Co. conformed to generally accepted practice during the period of the Girard-McKesson engagement. We are of the opinion that the form of the accountant's certificate should be amended to include in addition to the descripton of the scope of the audit a clear certification that the audit performed was, or was not, adequate for the purpose of expressing an independent opinion in respect to the financial statements. If any generally accepted procedures are omitted these should be named together with the reasons for their omission. Exceptions to the scope of the audit or to the accounts must be clearly designated as "exceptions."

14. CIRCUMSTANCES AVAILABLE FOR THE AUDITORS' OBSERVATION IN THE PROCEDURES AND RECORDS OF THE GIRARD-McKESSON COMPANIES WHICH MIGHT HAVE LED TO THE DISCOVERY OF THE FRAUD

The firm of Price, Waterhouse & Co. for 14 years served as independent public accountants for F. Donald Coster's enterprises. Within range of the procedures which they followed there were numerous circumstances which, if they had been recognized and carefully investigated by resourceful auditors, should have revealed the gross inflation in the accounts.

We can not and do not say that every one of the items should have been recognized by the auditors as significant and, if investigated, would have led to the exposure of the gross falsification of the financial statements. It is also quite conceivable that for a time many could have been and perhaps were explained away. We do believe, however, that the number of items and the period of time over which some of them repeated themselves gave ample opportunity for detection by alert and inquisitive auditors.

C. CONCLUSION

In conclusion we reproduce the summary from the last section of our report:

"Our conclusion based upon facts revealed by the record, the testimony of the expert witnesses, and the writings of recognized authorities is that the audits performed by Price, Waterhouse & Co. substantially conformed, in form, as to the scope and procedures employed, to what was generally considered mandatory during the period of the Girard-McKesson engagements. Their failure to discover the gross overstatement of assets and of earnings is attributable to the manner in which the audit work was done. In carrying out the work they failed to employ that degree of vigilance, inquisitiveness, and analysis of the evidence available that is necessary in a professional undertaking and is recommended in all well-known and authoritative works on auditing. In addition, the overstatement should have been disclosed if the auditors had corroborated the Company's records by actual observation and independent confirmation through procedures involving regular inspection of inventories and confirmation of accounts receivable, audit steps which, although considered better practice and used by many accountants, were not considered mandatory by the profession prior to our hearings.

"Price, Waterhouse & Co. maintain that a balance sheet examination is not intended and cannot be expected to detect a falsification of records concealing an inflation of assets and of earnings if accomplished by a widespread conspiracy carried on by the president of a corporation, aided by others within and without the recognized ranks of a corporation's operating personnel, and that no practical system of internal check can be devised the effectiveness of which cannot be nullified by criminal collusion on the part of a chief executive and key employees. Such cases are so rare, in their opinion, that there is no economic justification for the amount of auditing work which would be required to increase materially the protection against it.

"The inference to be drawn from this position and from statements made by others in connection with this case is that a detailed audit of all transactions as distinguished from an examination based on tests and samples would have been necessary to reveal the falisfication. However, as we view the situation in this case, a detailed audit of all transactions carried out by the same staff would merely have covered a larger volume of the same kinds of fictitious documents and transactions. While this might have brought under review more instances of what we have listed as circumstances suggesting further investigation, there is little ground for believing that this alone would have raised any greater question as to the authenticity of the transactions.

"Moreover, we believe that, even in balance sheet 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 collusive fraud or otherwise. We believe that alertness on the part of the entire staff, coupled with intellegent 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. Without underestimating the important service rendered by independent public accountants in their review of the accounting principles employed in the preparation of financial statements filed with us and issued to stockholders, we feel that the discovery of gross overstatements in the accounts is a major purpose of such an audit even though it be conceded that it might not disclose every minor defalcation. In short, Price, Waterhouse & Co.'s failure to uncover the gross overstatement of assets and of earnings in this case should not, in our opinion, lead to general condemnation of recognized procedures for the examination of financial statements by means of tests and samples.

"We do feel, however that there should be a material advance in the development of auditing procedures whereby the facts disclosed by the records and documents of the firm being examined are to a greater extent checked by the auditors through physical inspection or independent confirmation. The time has long passed, if it ever existed, when the basis of an audit was restricted to the material appearing in the books and records. For many years accountants have in regularly applied procedures gone outside the records to establish the actual existence of assets and liabilities by physical inspection or independent confirmation. As pointed out repeatedly in this report, there are many ways in which this can be extended. Particularly, it is our opinion that auditing procedures relating to the inspection of inventories and confirmation of receivables, which, prior to our hearings, had been considered optional steps, should, in accordance with the resolutions already adopted by the various accounting societies, be accepted as normal auditing procedures in connection with the presentation of comprehensive and dependable financial statements to investors.

"We have carefully considered the desirability of specific rules and regulations governing the auditing steps to be performed by accountants in certifying financial statements to be filed with us. Action has already been taken by the accounting profession adopting certain of the auditing procedures considered in this case. We have no reason to believe at this time that these extensions will not be maintained or that further extensions of auditing procedures along the lines suggested in this report will not be made. Further, the adoption of the specific recommendations made in this report as to the type of disclosure to be made in the accountant's certificate and as to the election of accountants by stockholders should insure that acceptable standards of auditing procedures will be observed, that specific deviations therefrom may be considered in the particular instances in which they arise, and that accountants will be more independent of management. Until experience should prove the contrary, we feel that this program is preferable to its alternative—the detailed prescription of the scope of and procedures to be followed in the audit for the various types of issuers of securities who file statements with us—and will allow for further consideration of varying audit procedures and for the development of different treatment for specific types of issuers."