RELEASE NO. 54*

March 30, 1946

SECURITIES ACT OF 1933
Release No. 3127

SECURITIES EXCHANGE ACT OF 1934
Release No. 3804

Amendment to Caption 16 of Rule 5–03 of Regulation S–X to provide for special disclosure of war costs, losses and expenses.

RELEASE NO. 55*

May 22, 1946

INVESTMENT COMPANY ACT OF 1940
Release No. 892

SECURITIES ACT OF 1933
Release No. 3135

SECURITIES EXCHANGE ACT OF 1934
Release No. 3815

Announcement of public conference date to consider proposed revision of Article 6 of Regulation S–X.

RELEASE NO. 56

November 27, 1946

SECURITIES ACT OF 1933
Release No. 3172

SECURITIES EXCHANGE ACT OF 1934
Release No. 3882

INVESTMENT COMPANY ACT OF 1940
Release No. 967

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.

The Securities and Exchange Commission today announced the issuance of a release in its Accounting Series discussing a problem that may face management investment companies in complying with the requirements of the recently revised Article 6 of Regulation S–X which governs the form and content of financial statements filed with the Commission by management investment companies. The release outlines certain procedures which may be followed in allocating past dividends so as to arrive at (1) the balance of undistributed net income (excluding gain or loss on investments); and (2) accumulated net realized gain or loss on investments. The release, prepared by William W. Werntz, Chief Accountant, follows:

"Inquiry has been made as to the procedure to be followed where a management investment company has not heretofore shown separately in its accounts (1) the balance of undistributed net income (excluding gain or loss on investments); and (2) accumulated net realized gain or loss on investments. Subdivision into these two categories is required of management investment companies

* Text of release omitted

by Rule 6-03-21 (a) (2) and (3) of the recently revised Article 6 of Regulation S-X, governing the form and content of financial statements filed by such companies. A principal problem in such segregation relates to dividends heretofore paid without any designation as between these two sources of income.

Section 19 of the Investment Company Act of 1940 requires such segregation to be made in connection with dividends declared after the effective date of that Act. In connection with the promulgation on February 21, 1941, of Rule N-19-1 which implements Section 19, there was simultaneously published an interpretive letter [1] dealing with the treatment of past dividends.

"In my opinion, it would be appropriate to employ the methods and principles set forth in that letter in arriving at the segregated balances required by the new Rule 6-03-21 (a) (2) and (3) of Regulation S-X. The pertinent portion of the letter reads as follows:

"In connection with Section 19 of the Investment Company Act and the recent Rule N-19-1 adopted pursuant to it, you have raised some questions of interpretation.

"Section 19 provides in effect that dividend payments made by a registered investment company must be accompanied by written statements adequately disclosing the source of the dividend if the dividend is paid wholly or partly from any source other than—

"(1) such company's accumulated undistributed net income, determined in accordance with good accounting practice and not including profits or losses realized upon the sale of securities or other properties; or

"(2) such company's net income so determined for the current or preceding fiscal year.

Rule N-19-1, among other things, provides in effect for the segregation of certain designated sources of dividend payments for the purpose of disclosure.

"Your first inquiry, as I understand it, relates to the problem of ascertaining the presently available balances of the sources designated in Section 19 and Rule N-19-1. You point out that, prior to the time the Investment Company Act went into effect, an investment company may not have segregated its income and surplus in a way contemplated by that Section and the recently adopted rule; therefore, dividend payments in the past may not have been allocated according to the sources designated therein. You are concerned as to the method companies in this situation may use in determining *now* the sources against which past dividends are to be charged in order to determine the balances of 'accumulated undistributed net income' and other sources available for the purposes of Section 19.

"Where, prior to November 1, 1940 (the effective date of the Investment Company Act) any legal allocation of dividend payments has been made on the books or by resolution of the board of directors, or in some other appropriate manner, to one of the sources set out in Rule N-19-1, in my opinion, such allocation need not be changed. As to past dividends not so allocated, it is my opinion that the following allocation should normally be followed: The total amount of such dividends accrued and declared in any fiscal year should be charged first to the accumulated undistributed net income, if any, at the close of such year, and any excess should be charged to the accumulated net profits from the sale of securities or other properties, if any, at the close of such year, and any excess thereafter should be charged to paid-in surplus or other capital source. The determination of accumulated net profits from the sale of securities or other properties should be made in accordance with the company's financial accounts rather than its tax accounts.

"Your second inquiry bears on the same problem. In examining the past to make the necessary determination of available balances now, transactions must be reviewed in the light of 'good accounting practice,' the standard set up in Section 19. Your problem is whether that standard is the good accounting practice of the present day or that of the date of any particular transaction. In my opinion, it is the latter."

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[1] The letter dated February 21, 1941, signed by David Schenker, then director, addressed to Paul Bartholet, then executive director, National Committee of Investment Companies.

RELEASE NO. 57

November 27, 1946

INVESTMENT COMPANY ACT OF 1940
Release No. 968

SECURITIES ACT OF 1933
Release No. 3173

SECURITIES EXCHANGE ACT OF 1934
Release No. 3883

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.

The Securities and Exchange Commission today announced a general revision of its requirements as to the form and content of financial statements filed by management investment companies other than those which are issuers of periodic payment plan certificates. The revised requirements are applicable to all financial statements filed by such companies under the Investment Company Act of 1940, the Securities Act of 1933 and the Securities Exchange Act of 1934. The action taken resulted in a complete restatement of Article 6 of Regulation S–X and in major changes in the related supplementary schedules contained in Rules 12–19, 12–20, 12–21 and 12–22 of Article 12 of Regulation S–X. In addition, as a result of the restatement of Article 6 certain related changes have been made in Rules 4–10 and 11–01 and in caption 1(a) of Rule 11–02.

The Commission also made public a statement reviewing the development of the revised Article 6 and setting forth its conclusions as to certain of the problems with which the rules deal.

The amendments of Regulation S–X become effective on December 31, 1946: *Provided,* That any financial statements included in a report required to be filed prior to March 15, 1947, need only comply with the provisions of Regulation S–X as in effect immediately prior to the adoption of these rules and: *Provided further,* That rules prescribing the accounting treatment for any transaction or adjustment of the accounts shall be effective only as to transactions or adjustments of accounts for fiscal years commencing on or after December 31, 1946.

The statement and new rules are attached.

Statement of the Securities and Exchange Commission upon the promulgation of a general revision of Article 6 of Regulation S–X, governing the form and content of financial statements filed by management investment companies other than those which are issuers of periodic payment plan certificates.—

Our promulgation today of the general revision of Article 6 of Regulation S–X governing the form and content of financial statements filed by management investment companies was preceded by such extended discussions that it might well be thought that further elaboration of the subject is unnecessary. However, in view of the importance of the subject, it seems appropriate to outline briefly the history of the problem, to discuss generally our conclusions, and to discuss certain provisions of the rules as to which certain of those participating in the discussions indicated some objections or reservations.

HISTORY OF THE PROBLEM

Experience gained during the past several years from a critical review of financial statements filed by management investment companies under the 1933, 1934 and 1940 Acts has indicated that certain changes might profitably be made in the rules under Article 6 of Regulation S–X to provide, pursuant to Section 31(c) of the Investment Company Act of 1940, for a reasonable degree of uniformity in the accounting policies and principles to be followed by registered management investment companies in preparing financial statements filed with this Commission. The review indicated also that the financial statements might be prepared in a manner which would bring more forcefully to the attention of the investor the special characteristics of this type of company and

the significant aspects of its financial condition and results of operation.

The problems encountered have been the subject of many discussions with numerous representatives of investment companies, with the National Association of Investment Companies and with accountants, attorneys and other interested persons. Following a series of preliminary discussions, the National Association of Investment Companies drafted a series of recommendations dealing with financial statements which were given extended consideration by the staff. Later, in 1944, the staff drafted a thorough-going revision of Article 6 of Regulation S–X which was submitted for comment to all registered management investment companies, to the National Association of Investment Companies, to a number of accounting and professional societies, and to many individual accountants and others who had evinced an interest in the problem. This circularization resulted in the receipt of many comments and led to many individual and round-table conferences.

At this point, the staff reviewed its preliminary proposals, and with the benefit of the comments and conferences mentioned prepared a revised draft which gave effect to many of the suggestions received and incorporated a number of solutions of issues which had theretofore been controversial. However, in a number of important respects the staff's revised proposals did not give effect to the recommendations of those from whom comments had been received.

In view of the importance and significance of the changes proposed by the staff and of the divergence in opinion on certain points, the Commission on May 22, 1946, directed a public conference be held on July 9, 1946, for the purpose of ascertaining the views of all interested persons with respect to the staff proposal. For the convenience of those interested, the staff prepared a report on the revision of Article 6 which described in detail the changes proposed to be made and the more important considerations which it believed required these changes.

Copies of the proposed revision of Article 6 and of the staff report were sent to all management investment companies, and to those persons to whom the draft dated May 31, 1944, was sent for comment, and to numerous other accountants, attorneys and other interested persons who had requested a copy of the staff report.

At the public conference, representatives of the National Association of Investment Companies appeared to voice their objections to certain of the changes proposed by the staff. A number of written comments were received and were placed in the record of the conference.

Subsequent to the conference, representatives of the Association and of the staff of the Commission discussed the principal differences which had been brought out at the conference. As a result of these discussions, mutually agreeable solutions were worked out as to most of these differences. We will discuss the remaining points later on.

GENERAL CONCLUSIONS

After considering the staff report, the comments received from time to time, and the record made at the public conference on July 9, 1946, we are of the opinion that the attached amendments to Regulation S–X should result in a reasonable degree of uniformity in the accounting policies and principles followed by the registered investment companies subject to the new rules and should also result in financial statements of a more informative and useful nature than those heretofore required under the old rules. In reaching this conclusion, we have also drawn heavily on our experience with the individual cases that have arisen from time to time and we have benefited in a very material way from the discussions of these problems that we have had with representatives of the N.A.I.C. and of many of the companies that will be subject to these rules. In view of the breadth of the area of agreement on the new rules we do not believe it necessary to seek to restate here the considerations which underlie most of the changes from the preexisting rules. Those matters were dealt with in detail in the staff report in May 1946, referred to earlier and with which we, in general, concur. We shall, however, outline briefly our conclusions on the very few points as to which the staff and the N.A.I.C. representatives were unable to find a mutually agreeable solution.

1. Applicability of these rules to financial statements included in reports to stockholders.

Section 30(d) of the 1940 Act requires that financial statements included in stockholders reports "shall not be misleading in any material respect in the light of the reports required to be filed" with the Commission. The representatives

of the N.A.I.C. in commenting on the new rules expressly stated that they were considering them only as rules governing statements to be filed with the Commission and were not prepared or authorized to discuss the question of what differences or what omissions therefrom might be considered to make stockholders reports misleading. At the public conference, our staff suggested that that problem was not included in the present proposals and ought to be reserved for further consideration later on. As a general matter, we concur in that conclusion. However, we wish to point out that it would not in our opinion be consonant with the provisions of Section 30(d) for a company to file a report with us following, with respect to certain transactions, the accounting principles prescribed in the new rules and at the same time to issue reports to stockholders in which entirely different accounting principles are followed.

2. The definition of "affiliates" (Rule 6-02-4):

This rule defines the term "affiliate" to mean an "affiliated person" as defined in Section 2(a)(3) of the Investment Company Act of 1940. Thus the term as used in Article 6 of Regulation S-X includes a company of which the registrant owns directly or indirectly 5 percent to 25 percent of the outstanding voting securities. Under this definition data as to such companies is required by several of the amended rules to be shown separately in financial statements filed with the Commission.

The National Association of Investment Companies as well as a number of investment companies objected to the classification of investments in 5 to 25 percent owned companies as "affiliates" in financial statements on the grounds, first, that for the purposes of the financial statements such investments are not different in any fundamental way from general portfolio investments, and second, that such investments do not have the characteristic attributes ordinarily associated with investments in "affiliates" in the usual sense of that word. It was also pointed out that the 1933, 1934 and 1940 Acts contain no definition of the word "affiliate;" and, therefore, it cannot be said that the classification of investments in financial statements of 5 to 25 percent owned companies is required by statute; that the term "affiliated person" as defined in the 1940 Act was occasioned primarily by Section 17 of the Act which relates to self-dealing and has nothing to do with accounting rules; that the term "affiliate" connotes a measure of control as indicated by the definition we have adopted in certain rules under the 1933 Act; that the term "affiliated person" under the 1940 Act is being applied to the 1933 and 1934 Acts when such Acts do not refer to the term "affiliated person;" and that there is nothing in the 1940 Act which requires the Commission for the purposes of Article 6 to include investments in 5 to 25 percent owned companies in the definition of "affiliates." It was therefore urged that the Commission consider the matter on the sole ground of whether the information called for as to "affiliates" in Article 6 should also be furnished as to the 5 percent to 25 percent group.

The fact remains that Section 2(a)(3) of the 1940 Act does clearly relate to companies in which the registrant owns 5 percent or more of the outstanding voting securities. It seems clear that Congress had a definite purpose in referring to such class of investments. Even if the Act sets up the 5-25 percent group primarily for the purposes of Section 17 which relates to self-dealing, as is contended, it seems clear that this does not preclude the Commission from requiring the separate disclosure of financial information as to such companies if that information is material to investors. This is, indeed, the very point made by N.A.I.C. that we should get these disclosures only if we feel the data is material.

As to the merits, we feel that where a registrant owns a large percentage of the securities of a company the investment and the fruits thereof are worthy of separate attention by investors and investment analysts. Whether a 5 percent minimum cut-off is appropriate is, of course, in many respects an arbitrary judgment. The fact is that in its consideration of investment company problems Congress deemed it wise for certain purposes to establish a 5 percent to 25 percent group. We feel that there is no sound basis for establishing a new and different category for the purpose of financial statements and we feel that investments in single companies to the extent of 25 percent of its voting control and on down to some lower percentage are items sufficiently dissimilar in nature to general portfolio investments as to warrant separate disclosure.

It should be pointed out that a company in preparing its financial statements has the right under the amended rules to describe the 5 percent to 25 percent companies in such a way as in its

opinion will be adequately informative. Thus where the amended rule requires investments in affiliates to be segregated in the balance sheet a company can describe each category of investment for exactly what it is; namely, majority owned (over 50 percent), other controlled affiliates (over 25 percent, but not more than 50 percent owned), and companies in which over 5 percent but not more than 25 percent is owned and as to which control is denied. The manner of describing the latter category should be sufficient to avoid any misconception as to its relationship with the reporting company.

As to the contention that the 1933 and 1934 Acts do not contain a statutory category comparable to the 5 percent to 25 percent test, the Acts do contain provisions permitting the Commission to obtain information in addition to that specified, for example, in Schedule A. We feel that the intent of Congress as later indicated in the 1940 Act furnishes a satisfactory basis for the Commission to require this information with respect to filings under the two earlier Acts.

We conclude, therefore, that the disclosures required by the amended rules as to this 5–25 percent group of companies are material information and are in the public interest and appropriate for the protection of investors.

8. Disclosures as to the capital and surplus accounts—Caption 21 of Rule 6–03 and Rules 6–07, 6–08, and 6–09.

Of all the problems encountered in our study, perhaps the most persistent has been the scope and nature of the disclosures to be made as to the capital and surplus accounts of management investment companies. Objections have been raised on this score both as to our requirements under the old rules and as to the proposals of the staff. These have been vigorously continued and indeed a good portion of the public conference was devoted to them. The final rules or requirements on the point, however, are in our opinion excellent evidence of the advantages and possibilities of thorough discussion of a problem by those holding different views on the subject. In the final rules we have adopted a great part of the suggestions made by members of the industry but we have at the same time found means to retain, in a form that we think will be quite generally acceptable, the fundamental disclosures urged by the staff.

It is generally recognized, we think, that a fair disclosure of corporate financial affairs at a given date includes a disclosure of the amount of stated capital, the amount of paid-in surplus, the balance of earned surplus, and the balances in any other surplus accounts. In addition, an analysis of the changes in any of these surplus balances since the next preceding report is essential as a means of informing the reader of the nature of changes occurring during the period.

As to management investment companies it has been urged that this "breakdown" of net assets into the various capital and surplus accounts is of questionable usefulness and under some circumstances might make misleading inferences possible. In general, as we understand it the argument made is founded on the belief that an investor in a management investment company is not interested in the source of the present net assets but rather in the *amount* of his *pro rata* interest in such assets at various dates and in the distributions made from time to time. It was pointed out that in such companies the difference between the realized security profits or losses which result from disposition of portfolio securities and the unrealized appreciation or depreciation, which results from changes in the market value of portfolio securities not sold is of relatively minor importance. Also, the incidence of the special tax laws applicable to such companies resulted in the practical necessity of distributing annual realized gains even though such gains were insufficient to offset prior realized losses. These factors it was claimed destroyed the significance ordinarily attaching to surplus balances.

As is pointed out in the staff report of May 1946 these several points are characteristic peculiarities of this type of business. However, we are disposed to agree with the conclusion of the staff as developed in detail in Appendix B of their report that these peculiarities are not such as to destroy the significance of either the breakdown into the various capital and surplus accounts or the analysis of changes in surplus accounts occurring during the period of report. For one thing these surplus balances are important in the application of Section 19 of the Act. We note also in this connection the position taken by many prominent accountants that the portrayal of a breakdown into the various capital and surplus accounts is

of great importance as the connecting link between a "value" balance sheet and the "cost" basis on which the book records are kept. On the other hand, we feel that every effort ought to be made to adapt the format of disclosure and the descriptive captions employed to the peculiarities of this kind of company.

The rules now being adopted meet and, we feel, solve the problem satisfactorily in this way:

1. Companies reflecting assets at value may show the breakdown of the various capital and surplus accounts in a separate statement.

2. The captions of the several surplus accounts are adapted to the peculiarities of this kind of company and are in conformity with the language of Section 19 of the Act and the usages long customary among many of the companies. It may be noted that the customary "earned surplus" account is not provided for but its two constituent elements "balance of undistributed net income (excluding gain or loss on investments)" and "net realized gain or loss on investments" are shown as separate items.

3. Companies reflecting assets at value may under Rule 6–08 omit the analyses of the several surplus accounts if there is furnished a "statement of changes in net assets" comparable to that used for some time by many companies.

4. Open-end companies may under Rule 6–09 use a special form of statement in lieu of the customary capital and surplus breakdown. In this statement capital and capital surplus are combined under a special caption, with par or stated capital shown parenthetically. It is interesting to note that this statement is modeled after a proposal which was introduced for the first time at the public conference.

MISCELLANEOUS MATTERS—THE FINALITY OF THE AMENDED RULES

As has been pointed out, we feel the new rules should do much to secure a reasonable degree of uniformity in the accounting practices of these companies and to obtain more informative and useful financial statements. However, in many respects the proposed forms of financial statement are novel and in some respects experimental in nature. Consequently, we are in entire agreement with the statement made on behalf of the N.A.I.C. that "All of us will know more about the new rules after operating under them. If experience shows that any of the rules are impracticable or subject to improvement, we should like the opportunity to say so at some future date." We also expect our staff to observe the operation of the new rules in practice and to report to us as to their effectiveness and as to any improvements that may be indicated.

EFFECTIVE DATE OF THE NEW RULES

Due to the wide circulation accorded drafts of the new rules it is probable that most companies and their accountants have already become reasonably familiar with them. We also understand that in some recent interim reports certain of the changes proposed have already been effected. However, the departures from the preexisting rules are such that we feel adequate time should be given for companies to accomplish such adaptation in their reporting procedures as may be necessary. Accordingly, we have set the effective date generally as December 31, 1946, with the proviso that any report required to be filed within 4 months of the date on which these rules are adopted need only comply with our requirements as in effect immediately prior thereto. Since most of the companies affected have fiscal years ending at December 31, this will give such companies at least 5 months in which to make the necessary adjustments and in any case will give all companies at least 4 months. In addition, such of the new rules as prescribe the accounting principles to be followed with respect to certain transactions or adjustments of the accounts will be applicable only as to transactions or adjustments falling in fiscal years beginning on or after December 31, 1946.

RELEASE NO. 58*

December 9, 1946

INVESTMENT COMPANY ACT OF 1940
Release No. 984

SECURITIES ACT OF 1933
Release No. 3178

SECURITIES EXCHANGE ACT OF 1934
Release No. 3886

Amendment of Regulation S–X redesignating Rule 6–10 of Article 6A as Rule 6–10A.

RELEASE NO. 59

January 23, 1947

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.

ACCOUNTING—PRACTICE AND PROCEDURE
Suspension of Accountant from Practice before Commission

In proceeding under Rule II(e) of Commission's Rules of Practice where firm of accountants stated in certificate filed with Commission under Rule X-17A–5 of the Securities Exchange Act of 1934 that it had audited books and records of registered broker-dealer in accordance with the Commission's audit requirements and with generally accepted auditing standards applicable in the circumstances, when in fact such audit had not been made in accordance with such standards and had omitted certain of such requirements, *held*, that such firm has engaged in improper professional conduct and its privilege to practice before the Commission should be suspended for 1 year.

APPEARANCES:

A. Marvin Lungren of the Denver Regional Office, for the Trading and Exchange Division.

FINDINGS AND OPINION OF THE COMMISSION

This is a proceeding under Rule II(e) of our Rules of Practice to determine whether respondent Williams & Kingsolver, a firm of certified public accountants of Colorado Springs, Colo., or any of its members, should be disqualified from or denied, temporarily or permanently, the privilege of appearing or practicing before this Commission.[1]

The proceeding was instituted by a notice of hearing which alleged that in connection with audits made by respondent in 1943 and 1944 of the books and records of E. W. Hughes & Company ("registrant"), a registered broker-dealer:

(1) Respondent prepared and certified two statements of registrant's financial condition as of September 30, 1943, and August 31, 1944, which statements registrant filed with us as part of its

* Text of release omitted.

[1] Rule II(e) reads as follows:

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

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

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

Practice before the Commission is defined under subsection (g) of Rule II to "include the preparation of any statement, opinion or other paper by any attorney, accountant, engineer or other expert, filed with the Commission in any registration statement, application, report or other document with the consent of such attorney, accountant, engineer or other expert."

annual financial reports pursuant to Rule X-17A-5 under the Securities Exchange Act of 1934. Respondent represented that these statements had been prepared and certified upon the basis of audits of registrant's books and records made in accordance with the generally accepted auditing procedures which an independent accountant would ordinarily employ, when in fact respondent in conducting its examinations omitted certain of the Commission's minimum auditing requirements as set forth in the General Instructions to Form X-17A-5 and failed to comply with generally accepted auditing standards applicable in the circumstances in the following respects:

(a) Physical examination and comparison with the books and records of all securities on hand or otherwise in the physical possession of registrant were not made.

(b) Registrant's position in all securities was not balanced.

(c) Written confirmations of customers' accounts were not obtained.

(d) Bank balances were not reconciled at a date subsequent to the date of the audit.

(e) The "personal trading account" of Mrs. Arleen W. Hughes, the sole proprietress of registrant, was not audited.

(2) Respondent prepared and signed the accountant's certificates filed with registrant's financial reports, which stated that

> "Without making a detailed audit of transactions, we have examined or tested accounting records and other supporting evidence by methods and to the extent we deemed appropriate under the circumstances and in accordance with the audit requirements of the Securities and Exchange Commission. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances, and included all procedures which we considered necessary."

when, in fact, such examination had not been made in accordance with generally accepted auditing standards applicable in the circumstances and had omitted certain of the Commission's minimum audit requirements.

A hearing was held in Denver, Colo., before Commissioner McEntire, at which respondent did not appear. Counsel for the Trading and Exchange Division, however, introduced into evidence an "answer" signed by both of respondent's partners which (1) acknowledged service of the notice of hearing, (2) waived hearing, (3) admitted certain matters set forth in the notice of hearing, and (4) consented to entry of an order temporarily or permanently disqualifying respondent from or denying it the privilege of practicing as an accountant before the Commission.

Respondent's answer admitted that in connection with the audits:

(1) Physical examination and comparison with the books and records of all securities on hand or otherwise in registrant's physical possession were not made, but that only a spot or test check was made by examination of securities held for the accounts of some of registrant's customers and that a comparison with registrant's books and records was made only as to the securities so spot or test checked. Safety deposit boxes held by registrant containing such securities were not sealed during the audit.

(2) Registrant's position in some but not all securities was balanced.

(3) Written confirmations of customers' accounts were not obtained.

(4) Bank balances subsequent to the date of the audits may not have been reconciled until the end of the year, at which time any checks outstanding at the date of the audit were reconciled with the audit.

(5) Securities held by Arleen W. Hughes as personal holdings and not used in registrant's business were not checked against her personal records nor were her personal records audited.

Respondent admitted preparation and signing of the accountant's certificates described above, but referred to the following additional statement in the 1944 certificate:

"At your request, we are now making a special detailed audit of customers' securities, including direct confirmation with customers, for the purpose of verifying in detail all information already on your control records."

Respondent also admitted, however, that in making the "special audit" safety deposit boxes held by registrant and containing customers' securities were not sealed. It stated that the letters sent out to confirm customers' accounts were

dictated by a member of respondent's staff to a stenographer employed by registrant, were mailed out on registrant's stationery, that the customers mailed their replies to registrant, and that such replies were examined in registrant's office by a member of respondent's staff.

The General Instructions to Form X-17A-5 set forth certain minimum requirements for an audit of a broker-dealer's books and records. Respondent has admitted in its answer that its audits omitted a number of these requirements. Despite the requirement that a physical examination and comparison with the books and records of all securities be made, respondent did no more than spot check certain of the accounts, and during the making of such spot check failed to seal safety deposit boxes. A similar omission occurred in the failure to balance registrant's position in *all* securities. The specific directions that written confirmations of customers' accounts be obtained and that bank balances be reconciled at a date subsequent to the audit were ignored. The failure to audit Mrs. Hughes' "personal trading account" meant that one phase of registrant's activities was not examined.[2] The purported reconciliation of the bank balances several months after the audit had been completed and the report filed clearly does not comply with our requirement for a second cash reconciliation. Moreover, the special audit undertaken to correct a glaring deficiency in the original work, namely the failure to obtain written confirmation of customers' accounts, was itself carried out in a wholly improper manner, since respondent did not establish control over registrant's securities or over the dispatch and receipt of customer confirmations.

It is clear that these audits were not conducted in accordance with the generally accepted auditing standards which an independent accountant would ordinarily observe and omitted many of our specific minimum requirements. Respondent's statements that the audits were made in conformity with the requirements of the Securities and Exchange Commission and with generally accepted auditing standards were accordingly false and misleading.

We think that respondent's conduct in connection with these audits was grossly improper. Our auditing requirements call for a thorough financial examination of a broker-dealer's affairs. An audit such as respondent conducted falls so far short of meeting this purpose as to deny to the public the protection which our rules were designed to achieve. We find that by its violations of our auditing requirements and its false and misleading certifications, respondent has engaged in improper professional conduct within the meaning of Rule II(e) of our Rules of Practice.

Respondent in its answer stated that J. D. Kingsolver, one of its two partners, was in military service at the time these audits were made and in no way participated therein. There is no evidence to the contrary and we accordingly find that J. D. Kingsolver was not personally guilty of any improper professional conduct in connection with these transactions, and we shall take no action against him personally.

On the basis of the foregoing, we think it necessary and appropriate to suspend the privilege of respondent and of Oliver M. Williams, one of its members, to appear and practice before this Commission for a period of 1 year.

An appropriate order will issue.

By the Commission: (Chairman CAFFREY and Commissioners MCCONNAUGHEY, MCENTIRE and HANRAHAN).

ORVAL L. DUBOIS,
Secretary.

[2] In a sole proprietorship, a so-called "personal trading account" of the proprietor is merely one of the trading accounts of the propreitorship.

RELEASE NO. 60*

March 20, 1947

INVESTMENT COMPANY ACT OF 1940
Release No. 1032

SECURITIES ACT OF 1933
Release No. 3204

SECURITIES EXCHANGE ACT OF 1934
Release No. 3931

Amendment to Rule 6–10 of Regulation S–X.

RELEASE NO. 61

May 15, 1947

SECURITIES ACT OF 1933
Release No. 3217

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.

Notice is hereby given that the Securities and Exchange Commission has under consideration a proposal to issue a release, pursuant to the Securities Act of 1933, particularly Sections 6, 7, 8, 10 and 19(a), in its Accounting Series indicating the circumstances under which independent 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.

As its name implies, a summary earnings table is a highly condensed form of profit and loss statement designed to apprise the investor, in a convenient fashion, of the financial results of the operation of the business for a reasonable number of years. Such a summary is not required by the Commission's rules to be certified by independent public or independent certified public accountants but it is, nevertheless, common practice for the registrant to include a summary in the registration statement with the explanation that it has been "reviewed" by independent accountants. This use of accountants' names is designed and tends to give added authority to the material presented. It is important, therefore, to consider the extent of the examination to be made by the accountants in such cases and the extent of the responsibility which they as experts can properly assume.

Persons desiring to comment on the proposed release may obtain copies from the principal office of the Commission at the address indicated below.

All interested persons may submit data, views and comments in writing to Earle C. King, Chief Accountant, Securities and Exchange Commission, 18th and Locust Streets, Philadelphia 3, Pa., on or before June 10, 1947.

By the Commission.

ORVAL L. DUBOIS,
Secretary.

* Text of release omitted.

RELEASE NO. 62

June 27, 1947

SECURITIES ACT OF 1933
Release No. 3234

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 under the Securities Act of 1933.

The Securities and Exchange Commission today announced the issuance of an opinion in its Accounting Series indicating the 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. The opinion, prepared by Earle C. King, Chief Accountant, follows:

"Inquiry has been made from time to time as to the circumstances under which independent accountants may properly express an opinion with respect to a summary earnings table to be included in a registration statement filed under the Securities Act of 1933.

"As its name implies, the summary earnings table is a highly condensed form of profit and loss statement designed to apprise the investor, in a convenient fashion, of the financial results of the operation of the business for a reasonable period.[1] Such tables have been of particular importance in recent years as a means of comparing the operation of the business in the pre-war, war, and post-war periods.[2] To accomplish this purpose the tables usually embrace a suitable span of years and set forth in comparative form for each year appropriate information with respect to the major income and expense categories applicable to the business.[3] Since such summaries are presented in the light of the circumstances existing at the date of registration it is often necessary and appropriate to recast the figures originally reported for earlier years to give effect to transactions or adjustments which were recorded in the more recent years but which are clearly applicable to the operations of the earlier years included in the summary.

"In order that investors may make proper use of the summary earnings table and to prevent the possibility of misleading inferences, certain explanatory data are usually necessary. If, for example, the reported earnings reflect the results of unusual conditions, or in certain years include significant nonrecurring items of income or expenses, an appropriate disclosure of such conditions or items is made either in the summary or in footnotes thereto. Where applicable, there are also shown in an appropriate manner the anticipated annual fixed interest charges and preferred dividend requirements at the date of registration, after giving effect to any proposed changes in the nature and amount of outstanding indebtedness or securities. It is not, however, necessary to include footnotes covering all of the information required by Regulation S-X with respect to the more

[1] Ordinarily, the summary earnings table will reflect the operations of the registrant, or of the registrant and its subsidiaries, during the period covered. However, under special circumstances, as where the registrant has succeeded to the business of one or more predecessors, it may be necessary for the summary to be specially constructed so as to reflect as far as possible for the period covered the earnings applicable to the enterprise now represented by the registrant. Where, for example, a predecessor operated as a partnership it is ordinarily necessary to indicate in an appropriate manner the adjustments required to place the partnership income on a corporate basis. In other unusual cases there may have been such violent and radical changes in the business of the registrant that a long summary of past earnings might be of very little or no value and might well be misleading. In several such cases, the registrant has been requested either to delete the summary entirely or to furnish only a brief statement of the overall, aggregate results, without a breakdown as between the several years. In any case, where special and unusual circumstances exist, a decision as to the content of the summary and as to whether or not a summary should be furnished at all can only be reached after careful appraisal of the particular facts of each case.

[2] For a discussion by the Commission on the use of earnings statements in evaluating the future prospects of a company, see Part VI of Accounting Series Release No. 53, November 16, 1945. (See p. 81 of this publication.)

[3] In the case of public utility companies, most of the summaries have been given in detail comparable to the formal income statements.

detailed financial statements unless, in a particular case, certain information is of such special significance in appraising the summary that its omission would be likely to give rise to misleading inferences.

"Summary earnings tables included in registrations statements are not required by the Commission's rules to be certified by independent public or independent certified public accountants. It is, nevertheless, common practice to introduce the summary with language indicating that it has been 'reviewed' by independent accountants.

"This use of an accountant's name in connection with a summary earnings table is designed and tends to give added authority to the material presented. It is important, therefore, to consider the extent of the examination to be made by the accountant in such cases and the extent of the responsibility which he as an expert accountant can properly assume.

"Financial statements filed for the registrant and its subsidiaries have been recognized by this Commission and by public accountants generally as representations of management upon whom rests the primary responsibility for their propriety and accuracy. Thus, In the Matter of *Interstate Hosiery Mills, Inc.*, the Commission stated:

" 'The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable.'[4]

"Along the same lines, the Committee on Auditing Procedure of the American Institute of Accountants has said:

" 'Management itself has the direct responsibility for the maintenance of an adequate and effective system of accounts, for the proper recording of transactions in the books of account, and for the safeguarding of the assets of a concern. It is also charged with the primary responsibility to stockholders and to creditors for the substantial accuracy and adequacy of statements of position and operations. . . .'

" 'It should be borne in mind that the financial statements, with all supplemental descriptive and explanatory data, including footnotes, are regarded as representations of the client. It is upon all these representations that the independent certified public accountant renders his opinion. If he considers explanations essential or desirable, and they have not been made in the financial statements, it will be necessary for him to make such explanations in a separate paragraph of his report.'[5]

"It is an obvious corollary of this principle that, as was also said in the *Interstate Hosiery* opinion:

" 'Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting.'[6]

"This same principle has been stated in more detail by the Institute's Committee on Auditing Procedure as follows:

" 'The function of the independent certified public accountant is to examine a concern's accounting records and supporting data, in certain matters to obtain outside confirmations, and to require and consider supplementary explanations and information from the management and employees, to the extent necessary to enable him to form an opinion as to whether or not the financial statements as submitted present fairly the position and the results of periodic operations. Generally speaking, his function is limited to reporting upon situations arising out of business transactions that have taken place in the past. In no sense is he an insurer or guarantor. In offering his opinion, the independent certified public accountant assumes heavy responsibilities. He must be skilled in his professional work and must have made a reasonable examination of the accounts in order to warrant his expression of an opinion. He must state his opinion clearly and unequivocally.'[7]

"In my opinion, it follows from these statements

[4] See 4 S.E.C. 706, 721.

[5] Statement No. 1, pp. 4, 10, October 1939; see also Statements Nos. 4 (March, 1941) and 22 (May, 1945). To the same effect, Bulletin No. 1 issued by the Committee on Accounting Procedure of the Institute in September, 1939 states: "At the base of all committee pronouncements is the further understanding that the accounts of a company are primarily the responsibility of its officers."

[6] The value of this check is obviously lost if the accountant is not fully independent. See Accounting Series Releases Nos. 2, 22, 28, 37, 44, and 47 and cases therein.

[7] Statement No. 1, p. 3. See also editorial "Whose balance sheet is it ?" 69 Journal of Accountancy 338 (1940).

of principle that summary earnings tables, as a species of financial statements, are primarily representations of management and that the proper function of the independent accountant with respect to them is necessarily limited to an expression of his expert and professional opinion.

"It has long been recognized, however, that an independent accountant in his capacity as such cannot properly undertake to express an opinion as to representations in financial statements except on the basis of an adequate examination conducted with professional skill and acumen.[8] Indeed, the Rules of Professional Conduct of the American Institute of Accountants make it an 'act discreditable to the profession' if the auditor in expressing his opinion 'fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion'; or if he 'fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.'[9] This general obligation may be summarized in this way—that an independent accountant is not in a position to express an opinion except on the basis of an examination made in accordance with generally accepted auditing standards applicable in the circumstances and including all procedures which he deemed necessary in view of the circumstances of the particular case.[10] Clearly, the mere summarization of detailed financial data prepared or presented by others does not involve most of the fundamental accounting and auditing skills customarily and properly relied upon as giving additional weight to financial statements certified by independent public accountants and adds nothing to the reliability of the underlying information.

"In view of the foregoing it is my opinion that it is generally improper and misleading for an accountant to permit his name to be used in connection with any period covered by a summary earnings table or to undertake to express his professional opinion as to the fairness of the representations made for such period in a summary earnings table unless he has made an examination for such period in accordance with generally accepted auditing standards applicable in the circumstances. When the independent accountant has been the auditor for the company throughout the entire period covered by the summary, and his several examinations conformed to generally accepted auditing standards, he would ordinarily need to make only such additional review as would be necessary to satisfy himself as to whether any recasting of the statements originally prepared would be necessary to reflect transactions and adjustments recorded in later years but clearly applicable to prior operations. If the instant work represents the first engagement of the accountant by the registrant and he is to express his expert opinion with respect to the earlier periods contained in the summary, it would, in my opinion, be necessary for him to apply to the operations and transactions of each of the earlier periods with respect to which he is to express an opinion substantially the same auditing procedures as those employed with respect to the first 2 years of the 3-year certified profit and loss or income statement included in the registration statement.[11]

"In cases where the accountant has performed sufficient work to make it appropriate for him to permit the use of his name in connection with a summary earnings table there remains to be considered the form in which he should indicate his opinion. Under the rules promulgated by this Commission, the customary method used by accountants in expressing their expert opinion takes the form of a certificate conforming to the requirements of Rule 2-02 of Regulation S-X. Such certificates make appropriate representations as to the work done, state the opinion of the accountants as to the fairness of the statements presented, and describe clearly any exceptions which the accountants may wish to take. Since, as pointed out earlier, summary earnings tables are a

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[8] *Cf.* In the Matter of *Red Bank Oil Company* (Securities Act Release No. 3110, January 4, 1946).

[9] Rule 5 pars. (d) and (e). Similar rules have been adopted by many State societies of certified public accountants.

[10] *Cf.* Regulation S-X, Rule 2-02 (b).

[11] It is recognized that some auditing procedures commonly applicable in the examination of financial statements for the latest year for which a certified profit and loss statement is filed, such as the independent confirmation of accounts receivable or the observation of inventory-taking, are either impracticable or impossible to perform with respect to the financial statements of the earlier years and, hence, would not be considered applicable in the circumstances.

species of income statement it would appear that the accountant's certificate thereon should assume a comparable form, and should be included with the summary or made a part of his report as to the 3-year certified statement.[12] If exceptions have been taken by the accountant with respect to any of the information contained in the summary earnings table, special care should be exercised in selecting the language used to introduce the summary to indicate clearly that such exceptions exist and to direct attention to the opinion of the accountant."

[12] Where the accounts for all the periods covered by a summary earnings table have not been examined by the same accountant, the certificate of each accountant whose name is used in connection with the table should be included in the registration statement for such part of the table as he has examined.

RELEASE NO. 63*

August 5, 1947

INVESTMENT COMPANY ACT OF 1940
Release No. 1095

SECURITIES ACT OF 1933
Release No. 3244

SECURITIES EXCHANGE ACT OF 1934
Release No. 3983

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.

* Text of release omitted.

RELEASE NO. 64

March 15, 1948

SECURITIES ACT OF 1933
Release No. 3277

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.

INTRODUCTION

This is a report on the results of our investigation, pursuant to the authority conferred upon us by Section 8(e) of the Securities Act of 1933, to determine whether or not a registration statement filed with the Commission under that Act by Drayer-Hanson, Incorporated, in respect of a proposed public offering of 80,529 shares of its class A stock, contained untrue statements of material facts or omitted to state material facts necessary to make the facts disclosed in the registration statement not misleading. As we will indicate more fully later, our investigation disclosed that the registration statement, when it became effective on December 11, 1946, did contain such misstatements and omissions.[1] Briefly, the more important of these misstatements and omissions concerned the financial statements and a new product of the company called Airtopia, a reverse cycle heating and cooling unit. Although the Airtopia unit was described in the registration

[1] Commission's exhibits are referred to as CX— and references to transcript of testimony are noted at T —.

statement as improved and standardized, the prospectus did not disclose that, prior to marketing the unit, the company had no field experience as to its operation under varying conditions. In addition, the prospectus did not disclose that mechanical defects[2] had resulted in dealer dissatisfaction with the product which, prior to the effective date of the registration statement, caused such dealers to cancel their orders and exclusive selling agreements with the company, and also created servicing and manufacturing costs which ultimately produced a serious drain upon the company's working capital. With respect to the financial statements of the predecessor partnership as of April 30, 1946, certified by Barrow, Wade, Guthrie & Co., independent certified public accountants, they were deficient in that the net worth of the predecessor partnership and its earnings, computed on a corporate basis, were substantially overstated. The representation in the certificate of such auditors in respect of such financial statements to the effect that they had no reasons to believe that the inventories as set forth in such statements were unfairly stated was without justification. Finally, unaudited financial statements of the company as of September 30, and October 31, 1946, contained in the registration statement were misleading in that they failed to make adequate provision for losses due to servicing and other costs incurred in connection with Airtopia units.

The company has agreed to mail a copy of this report to each person who purchased class A stock offered pursuant to the registration statement. Since the essential purpose of the Securities Act, to insure disclosure of information adequate to inform investors of their rights, would appear in this case to be accomplished by the distribution of the report, we have determined not to employ the more usual remedy, i.e. the institution of proceedings under Section 8(d) of the Securities Act to suspend the effectiveness of the registration statement. For the convenience of class A shareholders and other interested persons, a copy of the record of this investigation has been made available for inspection during business hours at the Los Angeles offices of the Commission, Room 1737, U.S. Post Office and Courthouse, 312 North Spring Street, Los Angeles 12, California.

The company is also forwarding to such class A shareholders for their consideration a proposed plan for its financial rehabilitation. As an aspect of such plan each class A shareholder who assents to it is required to release the company, its directors and officers, the independent certified public accountants and the underwriters and others from any liability such persons may have to such shareholders at common law or under the Securities Act of 1933 or other statutory law. The plan will become effective only if accepted by the holders of at least 85 percent of the class A shares sold by the company to the public.[3] On the basis of the information contained in this report and the information supplied to him by the company in respect of its proposed plan, each shareholder will have to use his own business judgment in evaluating the merits of the plan to him as against the possibility of effectively enforcing by legal proceedings the possible liability to him at common law, under the Securities Act of 1933 or other statutory law, which may exist upon the part of the company, its directors and officers, the underwriters, the certified public accountants and others. *We wish to emphasize that we have not passed upon the merits of this plan. We have no jurisdiction so to do. No one can represent that we have made any determination whatsoever in respect of the plan.*

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[2] The above reference to mechanical defects does not imply defects in basic design. No conclusion is expressed herein as to the merits of the basic design.

[3] The more important provisions of the plan are these: Each holder of class A shares is to release the company, the underwriters, the certified public accountants, the directors and officers and others from all liability to him under the Securities Act or otherwise. Subject to the procurement of such releases from the holders of at least 85 percent of the class A shares, Barrow, Wade, Guthrie & Co. has agreed to pay $87,500 to the company; three directors have agreed to invest $50,000 in class A shares of the company; and Maxwell, Marshall & Co. has agreed to loan $50,000 to the company, the loan to be evidenced by a note due in 5 years. Unsecured creditors of the company holding claims of approximately $319,000 out of a total of $358,808 of such claims have agreed, if the plan becomes effective, to accept payment of 25 percent of their claims within 90 days after the plan becomes effective and to accept payment of the balance of their claims in installments payable within 1 year. However, five of the largest creditors (holding more than two-fifths in amount of unsecured claims at January 31, 1948) have also agreed that, as to their own claims, they will further modify their demands to the extent that, after payment to them of the initial 25 percent, the balance owing to them need only be paid out of profits of the Company.

In order to acquaint shareholders with the liabilities imposed by the Securities Act, we will briefly discuss the applicable provisions of the Act. Thereafter we will describe the background of the financing and the nature of the material misstatements of facts in the registration statement as well as of the omissions of material facts necessary to be stated in order to make the facts stated in the registration statement not misleading.

Speaking generally, Section 11 of the Securities Act creates a right of action upon the part of an investor to recover damages he may have suffered as a result of his investment if he can prove that as of its effective date the registration statement pertaining to the security which he acquired contained material misstatements of facts or omitted material facts necessary to be stated in order to make the facts stated not misleading. It is not necessary for the investor to prove that he acted in reliance upon such misstatements or omissions. The right of action exists against (1) the company; (2) every person who signed the registration statement; (3) any expert upon whose authority statements were made in the registration statement with his consent, but only in respect of such statements; (4) the directors; and (5) the underwriters. The company can defend itself against such right of action only to the extent that it can sustain the burden of proof that the decline in value of the investor's security was not the result of its misstatements or omissions in the registration statement. In addition to this defense which is also available to the other persons named above, they will not be liable if they can sustain the burden of proof that, based upon the standard of conduct of a reasonably prudent man in the administration of his own affairs, they, after reasonable investigation, had reasonable ground to believe and did believe at the time the registration statement became effective that the statements therein were true and that there was no omission of material facts necessary to be stated in order to make the facts stated not misleading.

Section 12 (2) of the Act provides, in part, that any person who sells a security by use of the mails or any facility of interstate commerce by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary to make the statements in the light of the circumstances under which they are made not misleading, and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon upon tender of such security, or for damages, if he no longer owns the security.

Section 13 of the Act provides, in part, that no action shall be maintained to enforce any liability created under Section 11 or Section 12 (2) unless brought within 1 year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence.[4] In no event shall any such action be brought to enforce a liability created under Section 11 more than 3 years after the security was offered to the public or under Section 12(2) more than 3 years after the sale.

BACKGROUND OF THE FINANCING AND INVESTIGATION

The company was incorporated on April 29, 1946, to acquire the assets of a partnership composed of R. E. Ristow, James G. Lombardi, Albert Hanson and Martin J. Burke.[5] The partnership, the business of which was continued by the company, was engaged in the business of designing, manufacturing and selling heat transmission equipment for use in heating, ventilating, refrigeration and air conditioning. Products now manufactured by the company and which were manufactured by its predecessors[6] include coils, condensers, air conditioning units, drinking water coolers and related apparatus. In addition, prior to the incorporation of the company, its predecessor had been engaged in developing a new product called Airtopia which was designed to be a fully

[4] In this connection consideration should be given, among other things, to any information disclosed at an adjourned stockholders' meeting held August 14, 1947, and to a report of the registrant to its stockholders dated October 23, 1947.

[5] The company upon its acquisition of the assets of the partnership issued 19,471 shares of its class A stock in satisfaction of certain indebtedness of the partnership.

[6] Prior to the partnership, the enterprise had been carried on by a corporation and a partnership predecessor of such corporation.

automatic single unit capable both of heating and cooling homes, offices, stores and small industrial plants. The unique feature in the design of Airtopia, upon which a patent application (assigned to the company) has been filed and is pending, was an automatic switch valve. The valve automatically switches the apparatus from a heating cycle to a cooling cycle and vice versa, according to variations in the temperature of the space to be conditioned.

To finance the development of Airtopia and to purchase inventories of supplies and materials for its production and the manufacture of other products, the partnership had contracted substantial bank loans. Early in 1946 negotiations were begun between the partners and Maxwell, Marshall & Co., a Los Angeles investment banking firm, in respect of a possible refinancing in whole or in part of these bank loans and provisions for further working capital. On March 31, 1946, Maxwell, Marshall & Co. loaned the partnership $100,000 in order to supply the partnership with additional working capital. In July of 1946 Maxwell, Marshall & Co. accepted 15,000 shares of the company's common stock as payment of $30,000 of this debt. The remaining $70,000 was paid out of the proceeds of the sales of the class A shares.

As a step in the accomplishment of the proposed financing the company was to be formed to acquire the partnership assets and to sell its class A shares to the public. The partners in consideration of the transfer of the partnership assets were to receive common stock of the company.[7]

The prewar and wartime record of earnings of the company's predecessors, recomputed on a corporate basis, were insufficient in any year prior to 1945 to cover the dividend requirements on the class A shares which would have been outstanding after giving effect to the financing.[8] In the course of the negotiations between the company and Maxwell, Marshall & Co., an oral understanding was reached to the effect that the bankers would not undertake the financing operation unless the result of an audit by Barrow, Wade, Guthrie & Co. of the financial statements of the partnership for the 10 months ending April 30, 1946, computed as though the partnership had been a corporation, indicated net income at least equal to one and one-half times the annual dividend requirement on all of the class A shares which would be outstanding after giving effect to the sale of approximately 80,000 shares of class A stock to the public. The underwriting house also stipulated that the audited balance sheet of the partnership as of April 30, 1946, must show a net worth to be transferred to the company of at least $250,000.

An audit by Barrow, Wade, Guthrie & Co. of the partnership accounts as of April 30, 1946, represented the partnership net worth to be approximately $260,000. Similarly such audit represented net earnings of the partnership for the 10 months ended April 30, 1946, to be approximately $181,000 for the partnership, and approximately $91,000 when computed as though the partnership had been a corporation. The latter amount was slightly in excess of one and one-half times the annual dividend requirements on all of the class A shares which would have been outstanding if all of the class A shares to be offered publicly were to be sold. The prospectus, following its summary of earnings, specifically stated the annual dividend requirements to be $60,000.

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[7] The class A shares were entitled to receive cumulative dividends at the rate of 60 cents per annum, were convertible into one and six-tenths common shares, were entitled to one vote per share, were entitled to receive on any liquidation of the company the sum of $10 per share before any participation in assets upon the part of the common shares and were redeemable at $12 per share. As already indicated 19,471 class A shares had been issued in satisfaction of indebtedness of the partnership upon the purchase by the company of the partnership's assets.

[8] Annual dividend requirements on the 100,000 class A shares which were to be outstanding amounted to $60,000. Net income of the predecessor corporation for the period 1936 to 1944, inclusive, and for the 6 months ended June 30, 1945, were as follows:

Year	*Net Profit (Loss)*
1936	$(4,144.69)
1937	(20,395.42)
1938	(5,777.69)
1939	986.47
1940	9,011.45
1941	16,418.57
1942	17,622.97
1943	7,201.22
1944	26,914.10
Six months ended 6/30/45	25,922.09

As will appear later in this report concerning the accounting errors, the net worth of the company actually did not equal $250,000 and the earnings did not equal one and one-half times the dividend requirements. Sales of the class A stock ceased on April 16, 1947. These accounting errors were ascertained in June of 1947.

As already indicated, on April 29, 1946, the company was formed. In consideration of the acquisition of the partnership assets, the company issued 125,000 shares of common stock to the partners in consideration of $250,000 book value of such assets and entered upon its books a liability to the partners of $10,068 in consideration of the remainder of the partnership net worth.

On November 9, 1946, Frank O. Maxwell, a partner of Maxwell, Marshall & Co. was elected to the board of directors of the company. On December 11, 1946, the registration statement became effective in respect of the 80,529 shares of class A stock proposed to be offered. Maxwell, Marshall & Co. agreed with the company to purchase 20,000 of such shares and to use its best efforts to sell the remaining 60,529 shares. The proceeds, estimated at approximately $695,000, were to be applied as follows: $390,000 toward payment of accounts payable; $70,000 to payment in full of the indebtedness to Maxwell, Marshall & Co.; and approximately $235,000 toward payment of bank loan.

As at September 30, 1946, even if all of the shares were to be sold at the offering price of $10 a share and the proceeds devoted to retirement of debt, there would still have been outstanding $400,000 due to banks on demand. Moreover, on that date the company's current liabilities exceeded its current assets by approximately $81,000. This precarious financial position was described in the registration statement. However, as we will hereafter indicate, the registration statement was silent as to facts which would have informed the investor of circumstances which would adversely affect its future working capital position.

Between December 16, 1946 and April 16, 1947, a total of 59,030 shares of class A stock out of the 80,529 shares offered by the company and Maxwell, Marshall & Co. were sold to the public.

Some time in June of 1947 the company and its auditors Barrow, Wade, Guthrie & Co. informed us that the company's comptroller had discovered an error had been made in the balance sheet as of April 30, 1946, and the partnership income statement for the 10 months ending that date, certified by Barrow, Wade, Guthrie & Co. and contained in the registration statement and prospectus. The error consisted of an over-statement of approximately $97,000 in an inventory item designated "work in process and fabricated parts." This resulted in an over-statement of the partnership net worth at April 30, 1946, and partnership net income for the 10 months ended April 30, 1946, in the same amount. The error in the earnings, computed as though the partnership had been a corporation, for the 10 months ended April 30, 1946, was an over-statement of approximately $30,000. The company further stated that recheck of the item was being made by Barrow, Wade, Guthrie & Co., and that the final results would be reported to the Commission. Subsequently, the company also retained Thomas & Moore, of Los Angeles, California, a firm of independent certified public accountants, to make a recheck. Some weeks later, registrant reported the results of the recheck (which did not vary much from the amount originally indicated) and also reported that the losses of the registrant for the fiscal year ended April 30, 1947, would be in excess of $400,000 according to the latest available figures. In view of these substantial errors in the certified financial statements included in the prospectus and the subsequent losses of the company, we deemed it advisable to make the investigation which is the subject of this report.

The important matters disclosed by our investigation may be conveniently divided into two subdivisions: (1) misrepresentations and omissions in respect of Airtopia and (2) misrepresentations and omissions in the financial statements of the company and its predecessors, and in the certificate of the independent accountants. We turn now to a discussion of our findings under these categories.

MISREPRESENTATIONS AND OMISSIONS IN RESPECT OF AIRTOPIA

As we have already indicated, the registration statement contained financial statements certified by Barrow, Wade, Guthrie & Co. which represented earnings for the 10 months ended April 30, 1946, of approximately $181,000 for the partnership, and approximately $91,000 when computed as though the partnership was a corporation. The

latter amount was one and one-half times the dividend requirements of the class A shares which would be outstanding if the financing were completely successful. These reported earnings were almost entirely due to sources other than Airtopia, the sale of which commenced in March of 1946.[9]

A substantial portion of the description of the business and prospects of the company in the registration statement was devoted to Airtopia and its alleged performance as a combination automatic heating and cooling unit. For example, among other things, the registration statement recited the following:

"The Airtopia unit is a new development of the company and is a fully automatic air conditioning machine for all year use." (prospectus page 5).

* * * * * * *

"The company and other manufacturers and air conditioning contractors have built in the past a total of approximately 25 to 30 specially designed larger installations which use the reverse-cycle principle [the principle of Airtopia] and which have proven satisfactory for both heating and cooling over a period of time as long as 8 years. The company's first reverse-cycle installation was completed in 1938 as one of three ordered for its local offices by the Southern California Edison Company, Ltd., and it has given good service since that date. Although the company manufactured air conditioning equipment during the war, initial deliveries of the *improved and standardized 'Airtopia' units* did not commence until March 1946." (prospectus page 6.)[10]

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"In 1939 the company commenced building automatic year round air conditioning units and component parts thereof for special installations. This work was discontinued during the war and resumed in the fall of 1945 when the design was *improved and standardized*[10] into the present 'Airtopia' units. Initial deliveries of 'Airtopia' units were made in March of 1946. As of November 1, 1946, the company had manufactured 254 'Airtopia' units." (prospectus page 9.)

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" 'Airtopia' units are guaranteed by the company against defects in materials, parts or workmanship for a period of 1 year following the date of installation and the company maintains a field engineering service department at the factory, at the present time composed of six men who are qualified to make repairs and replacement of defective parts" (prospectus page 6).

From the above statements and others contained in the registration statement when it became effective we believe an investor would have been justified in concluding that the "improved and standardized" Airtopia unit had performed and would have performed satisfactorily when installed on the premises of customers. The record of our investigation, on the contrary, demonstrated clearly that, on the effective date of the registration statement, the management knew or should have known, upon reasonable investigation, that numerous mechanical defects (although not necessarily defects in basic design) had been discovered in the Airtopia units delivered prior to the effective date of the registration statement which had resulted in cancellation by dealers of the great majority of the orders for Airtopia, an expense to the company which probably would increase substantially in the future, and which had or would seriously affect its working capital position.

The first "improved and standardized" Airtopia unit, a test model, was built in October 1945 and installed in the offices of the company. A second unit was built in December 1945 and was used for demonstration purposes. On January 4, 1946, without further field testing of the "standardized" unit, the company commenced the production of 26 units and as work on the units was completed they were shipped to dealers to resale to consum-

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[9] While it is true that the registration statement stated that the company had operated at a loss of approximately $41,000 for the 6 months ended October 31, 1946, it contained the following on this point:

"The company and its predecessors have experienced difficulty in obtaining regular shipments of the raw materials required by the business. Deliveries of critical items such as electric motors and controls, and compressors in some sizes, have been far behind schedule. This situation has been aggravated by strikes in the plants of suppliers and by strikes in the steel, copper, aluminum and electrical equipment industries. Notwithstanding difficulties in obtaining supplies, the company's net sales for the 6 months from May to October 1946, both inclusive, exceeded $1,480,000 although the company sustained an operating loss of approximately $41,200 during these months."

[10] Material in brackets and italics ours.

ers. William L. Holladay, an engineer formerly employed by the company, testified that it was becoming apparent to him in November of 1946 that the company did not have sufficient field experience with the unit to warrant marketing it on a major scale.[11] In a report dated October 15, 1946, made to Maxwell, Marshall & Co., the underwriter, by one of its salesmen who interviewed both dealers in and purchasers of Airtopia units, a similar statement was made.[12]

As we have already indicated, the first Airtopia unit was delivered in March 1946. At the end of August of the same year it was already apparent that numerous mechanical defects existed in the delivered units. The majority of the difficulties occurred in respect of the automatic switching valve, the compressor, the check and expansion valves, and the solenoids in the liquid lines, all of which were important to the satisfactory operation of the units. Up to the end of November 1946, the registrant had replaced 26 automatic switching valves in the 81 installations for which servicing records were available. In the fall of 1946, the company was considering a redesign of the automatic switching valve to overcome its operating difficulties.[13] Up to the end of November 1946 the registrant had replaced 23 check valves in the same 81 installations. In order to overcome this source of trouble, the company's engineers prior to the effective date of the registration statement were already considering a redesign of the unit to eliminate these valves.[14]

As early as August 1946 the registrant organized a department consisting of 10 men and a supervisor "to rework or change the units in the field that they will operate in accordance with the representation that had been made for them." Later these changes were referred to as "modernization" in order to avoid any implication that the units were defective. In 1946 the "modernization" was applied only to those units that had developed some trouble. On January 11, 1947, registrant decided to "modernize" or "modify" (the term "modification" was later substituted for "modernization") all units to be shipped thereafter, and in the early part of February 1947 registrant found it necessary and finally decided to modify all units in the field whether or not the units gave trouble. The modification program of 1947 included three changes in addition to those encompassed in the modification program of 1946.[15] The cost of modifying a unit ranged between $200 and $400.[16]

The defective performance of the units also adversely affected the registrant's relations with its dealers. Prior to October 8, 1946, the distribution of Airtopia had been exclusively in the hands of Airtopia Distributors, Inc., which was organized for that specific purpose. The stock of Airtopia Distributors, Inc. originally was held by Ristow, Lombardi, Burke and Hanson, the partners in the partnership predecessor of the company, and Gay Engineering Company. On July 3, 1946, complete control of Airtopia Distributors, Inc. was acquired by these four individuals who at that time and thereafter were directors and officers of the company. Airtopia Distributors, Inc. had entered into contracts with approximately 11 different dealers giving each an exclusive right to market the units in a designated territory. Among other things, the contracts committed the dealers to purchase a specified dollar amount of units during the year 1946. However, in a number of the

[11] The testimony of the witness reads in part as follows:

"A. Well, it is obvious, I believe, to us now, that the company did not have sufficient field experience to go into a major program of field sales. It is very hard to say whether we realized that at the time this was going on. I recall at least one conference with Mr. Beebe, where my attitude was that they were simply normal bugs as would be expected from any new product and the thing to do was to get them fixed, but not be too disturbed about them . . .

"A. My personal opinion was probably veering by November to feeling it should have been done on a slower production basis which would allow more time for field testing. I can recall having expressed that opinion." (T649 and 650).

[12] The report, which includes numerous testimonials of satisfied consumers, nevertheless states:

"I believe that Drayer-Hanson has *potentially the finest* marketable air conditioning system available *today*. The Company has taken the lead in the field, but unfortunately has not or has not been able to field test the unit sufficiently before putting it on the market." (CX 80).

[13] On December 10, 1946, the company wrote Dr. R. N. Kemler, head of the Engineering Research Division of Southern Research Institute, to which a unit had been sent for tests, that "The switching valve is now being redesigned and we do not believe there will be any further operating difficulties with this part of the unit." (CX 37).

[14] In the letter to Dr. Kemler, (*Supra* n. 11) the registrant wrote that "Future design calls for the elimination of the check valves thus removing one of the sources of incorrect operation."

[15] T 632.

[16] CX 47.

contracts the commitment to purchase a specified dollar amount of units was nullified by an insert or addendum providing that the dealer need only buy the number of units he specifically ordered. The contracts also required dealers to put up a deposit of 10 percent of the commitment, except that in the case of Gay Engineering Co., the largest dealer and also a stockholder in Airtopia Distributors, Inc., the required deposit was only 7½ percent. Where contracts had the addendum above referred to, the deposit was based on the commitment that would have applied except for the addendum. The deposits were to be returned to dealers by means of credits on account of purchases. All contracts also permitted the dealer to cancel the contracts at the end of any quarterly period, if the dealer took his quota of units to the end of the quarter and paid all sums then due.[17]

On October 8, 1946, the arrangement with Airtopia Distributors, Inc., was terminated and the company took over the distribution and sale of the units. By July and August of 1946, however, the more important of the exclusive dealers were expressing sharp dissatisfaction with the defective performance of the Airtopia units that they had sold to customers. At least half of the number of such dealers demanded the cancellation of their contracts or of their orders and the return of their deposits. By October 8, 1946, Airtopia Distributors, Inc., had agreed to the cancellation of several of these exclusive dealer contracts and to repay on or before December 31, 1946, deposits not applied to accepted orders for the units by the dealers.

On the subject of its relationship with its exclusive distributors, the company in its registration statement as it became effective on December 11, 1946, stated:

> "Since taking over the distribution and sale of 'Airtopia' units on October 8, 1946, the company has given notice of cancellation effective on or before December 31, 1946, of the exclusive territory contracts with eight of the former Airtopia Distributors, Inc. dealers in the States of California, Nevada, Arizona and Texas. The company is presently engaged in appointing approximately 40 authorized dealers in these areas on a nonexclusive territory basis. As of November 8, 1946, 20 such authorized dealers had been appointed, 4 of them being former "Airtopia" dealers. In addition, the company is renewing contracts with the 3 former exclusive territory dealers in Oklahoma, Alabama and Florida whereby these dealers become distributors with minimum annual purchase quotas, but without making cash deposits. These distributors will appoint authorized dealers in their territories. The deposits on hand from the 8 exclusive dealers whose contracts have been cancelled amounted to $144,133 as of November 1, 1946, and this sum will be credited on purchases or repaid by the company on or before December 31, 1946. Orders on hand from these 8 dealers totaled $1,924,850 at November 1, 1946, but are not included in the company's backlog figures stated above, since upon cancellation of their exclusive territory contracts with Airtopia Distributors, Inc., they were given the right to cancel their orders and the majority of them are expected to do so.

This statement in the light of the record of our investigation was materially misleading in its failure to disclose the facts in respect of the distributors, which we have already described. It omits to state that cancellations were initiated not by the company but by dealers prior to October 8, 1946, and that the reason for the cancellations was the defective performance of the Airtopia units. It also fails to disclose that in contrast to the expectation that the orders of such dealers would be cancelled, most of such orders had, to the knowledge of the management, in fact been cancelled prior to October 8, 1946.

Finally, Note E to the financial statements of the partnership predecessor as of April 30, 1946, included in the registration statement contained the following statement:

> "At April 30, 1946, the partnership had aggregate firm orders for approximately 1,000 units of all models of 'Airtopia.' In the opinion of the partners a major redesign of the product will not be required before completion and delivery of these orders. Accordingly, the policy established by the partnership and continued by the successor corporation is to amortize the amount of all deferred expenses applicable to 'Airtopia' at the rate of $140.00 per unit, which it is estimated, will absorb the entire costs now

[17] CX 60A.

accumulated (together with costs expected to be incurred within several months) over the sale of the first 1,000 units."

With respect to the first sentence of this statement, as we have already indicated, substantial cancellations of orders for Airtopia by dealers had occurred to the knowledge of the company and its management prior to the effective date of the registration statement.[18]

With respect to the second sentence of the foregoing quotation, while it is true our record indicates that no substantial basic redesign of the Airtopia unit in an engineering sense was ever required, fairness to the ordinary investor would seem to have required a disclosure of the mechanical defects which were known to exist in many of the installations on the effective date of the registration statement and the possible consequences thereof to the registrant. In fact, on January 11, 1947, a month after the effective date of the registration statement, the company instituted a program to modify all Airtopia units to be shipped thereafter. This modification program embraced recruiting of coils, elimination of the need for solenoid valves in the liquid lines; replacement of switching valve piston assemblies with those of new design; and replacement of compressors on certain models with units of higher capacities. All of these changes represented the results of complaints known to the registrant prior to the effective date of the registration statement.

Notwithstanding that the company had decided on January 11, 1947, to engage in this modification program, and that the comptroller of the company had reported to the board of directors at a meeting held on January 20, 1947 (at which Frank O. Maxwell, a director of the company and also a partner of the underwriter, was present) that, although indications were that 1947 as a whole would probably be a very profitable year, January operations would result in a loss due to lower sales volume and higher charges in connection with the servicing and modification of Airtopia units, no amendment to the registration statement or supplement to the prospectus used in selling the class A shares was filed with this Commission even though the underwriter was then still engaged in distributing class A shares.[19]

As a result of the failure to disclose in the registration statement and prospectus the foregoing facts and circumstances which were known or upon reasonable investigation should have been known to those concerned with the sale of the class A shares, it was impossible for investors to judge the possible adverse effects upon the company which resulted from its production and sales of the Airtopia unit. For the fiscal year ended April 30, 1947, the company incurred a net loss of $479,617.[20] Of this amount more than $250,000 was attributable to its experience with the Airtopia units. The sum of $83,000 was expended between August 1946 and April 1947 for servicing defective units in fulfillment of the company's guaranty of performance, and in modifying all units. Of this amount approximately $26,000 was expended between August and December 1946. As of April 30, 1947, the sum of $86,000 was set aside as a reserve for subsequent servicing and modification of Airtopia units (of which $66,795 was expended in the succeeding 6 months). In addition, the sum of $81,169, of which $75,297 represented costs and expenses incurred in development of Airtopia, was charged to income for the period ending April 30, 1947, and a further sum of $51,476 was set aside as a reserve for losses on the disposition of inventory items considered to be in excess of requirements or obsolete,[20] most of which

[18] At April 30, 1946, the unshipped balance of orders from dealers aggregated $1,896,000. The number of units on order as of that date was determined by dividing this dollar balance by $1,910, the approximate average price per unit. However, the contracts with three of the dealers, the unshipped "orders" of whom aggregated $700,000, contained a provision to take and pay only for such units the delivery of which was requested. No liability to accept units not requested by the dealers was imposed. In view of this fact, the characterization of these orders in Note E to the financial statements as "firm" may be questioned.

[19] After January 20, 1947, approximately 6,000 class A shares were sold to the public.

[20] According to a report of Thomas & Moore, independent certified public accountants, based upon a limited audit of the books completed subsequent to the closing of the hearings in this matter (which is attached to Registrant's Exhibit F), the losses for the fiscal year ended April 30, 1947, amounted to $542,082 and the provision for losses on the disposition of inventory items considered to be in excess of requirements or obsolete amounted to $66,476. This latter amount includes,

items consisted of parts for Airtopia. Moreover, the Airtopia modification program created an unusual demand on the working capital of the company, which resulted in deferring the payment of trade debts. Consequently, on April 30, 1947, the company was in need of additional working capital.

MISREPRESENTATIONS AND OMISSIONS IN THE FINANCIAL STATEMENTS OF THE COMPANY AND ITS PREDECESSORS AND IN THE CERTIFICATE OF THE INDEPENDENT ACCOUNTANTS

We have commented earlier in this report on the 1-year guarantee in the sale of Airtopia units. In our opinion the income statement for the 5 months ended September 30, 1946, and the summary of earnings for the 6 months ended October 31, 1946, which included sales of Airtopia units, were materially misleading by reason of the failure to include a provision for unrecoverable costs which might arise under the company's guarantee of its product. As indicated heretofore, the management became aware (prior to September 30, 1946) of the defects in its product and of the necessity for making expenditures to correct these defects.

We have also referred to the statement in Note E to the financial statements which contains a representation of the policy established by the partnership and continued by the successor corporation in the amortization of deferred expenses applicable to Airtopia. This policy contemplated the amortization of such deferred expenses over the sale of the first 1,000 units of Airtopia in respect of which it was represented that "at April 30, 1946, the partnership had aggregate firm orders for approximately 1,000 units . . . ." Assuming that the partnership and the successor corporation had firm orders for 1,000 units as of April 30, 1946, or that it expected as of that date to sell 1,000 units within a reasonable time, nevertheless it was apparent to the management in August and September 1946, that its orders had been materially reduced by cancellations and as a result thereof the amortization rate should have been increased. Such increase in amortization would have substantially increased the net loss shown in the income statement for the 5 months ending September 30, 1946, and in the summary of earnings for the 6 months ending October 31, 1946.

The balance sheet of Drayer-Hanson (a co-partnership) as of April 30, 1946, and the pro-forma balance sheet of Drayer-Hanson, Incorporated, (successor to the co-partnership) as of May 1, 1946, which were certified to by Barrow, Wade, Guthrie & Co. (hereinafter referred to as the auditors) and made a part of amendment No. 8 to the registration statement filed by the registrant included under the caption "Inventories" an item "Work-in-process and fabricated parts—$244,331.60." With respect to this item the auditors' certificate dated August 5, 1946, contains the following paragraph:

> "We were present only during the taking of a physical inventory, which did not include work in process, as at March 31, 1946, and satisfied ourselves as to the procedures followed in the determination of inventory quantities as of that date. We were not in attendance at the physical count of the inventories taken at the close of each of the years 1942, 1943 and 1944 and we were informed that such procedures were not performed by any other independent public accountant. In the absence of a physical inventory of work in process at March 31, 1946, we subsequently made test inspections of selected items to assure ourselves as to the existence of the inventory and the adequacy of

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in part, certain adjustments made by the management. However, we wish to point out that the accountants qualified their report in the following manner:

"(A) Inasmuch as our engagement was subsequent to May 1, 1946, and April 30, 1947, we were not present at the taking of physical inventories. We were present and observed the taking of the physical inventory at July 31, 1947, which was taken by your employees on August 1st and 2nd, 1947, during the close-down period. We have accepted the valuation of inventories as shown by your records for May 1, 1946, and April 30, 1947, except as to Work in Process at May 1, 1946. As a special engagement we reviewed in detail the data supporting the inventory of Work in Process at May 1, 1946, and found such inventories to be overstated by $105,378.57. However, $6,212.29 of this amount was determined by the management to be properly reclassified as 'Deferred Products Development.' These adjustments have been reflected as of May 1, 1946.

"(B) We are unable to express an opinion as to (1) The period to which the extraordinary reserves and write-offs made as of April 30, 1947, are applicable; (2) Whether errors in inventory of April 30, 1947, if any, may have resulted in an overstatement or understatement of operating results as between the two periods; (3) The adequacy of the reserve for losses on disposition of inventory considered to be in excess of requirements or obsolete.

"These exceptions are taken for the following reasons: (a) That our engagement was undertaken considerably subsequent to July 31, 1947; (b) There is a lack of perpetual inventory records; and (c) The other general accounting procedures, while appearing adequate, were poorly administered."

the related accounting data. The inventories at the close of each of the years 1942 and 1944 were reviewed by us as to the basis of pricing and clerical accuracy and we inquired into the methods used by the corporation employees in determining physical quantities to ascertain that methods were employed which would assure reasonable accuracy. We were informed that an inventory was taken as at December 31, 1943, but we were advised that such inventory was lost and therefore not available for our inspection. We were informed that no physical inventory was taken as of June 30, 1945. On the basis of the examinations and tests made by us, we have no reason to believe that the inventories as set forth in the accompanying statements are unfairly stated."

In May 1947 representatives of the registrant reported to the auditors that they believed that the part of the inventory represented by work-in-process as of April 30, 1946, was overstated approximately $97,000. Thereupon the auditors made a further examination of work-in-process inventory, and as a result concluded that there was an overstatement of $85,313.97,[21] or approximately one-third of the net worth of the co-partnership, and an overstatement of like amount in the Net Income ($181,500) shown by the Profit and Loss Statement of the co-partnership for the 10 months ended April 30, 1946, included in the registration statement.

The error in the work-in-process inventory resulted principally from the failure of the registrant to give effect to all partial shipments on the job cost sheets from which the work-in-process inventory was compiled and on the general ledger.

A brief description of the method of accounting for work-in-process and in particular partial shipments will aid in understanding how the above described error occurred. The registrant, a manufacturing concern, operated what purported to be a job lot cost accounting system.

Under this system of accounting costs of raw materials, labor and overhead relating to jobs in process were accumulated on job cost sheets maintained in the cost accounting department. Until such time as a job was complete the applicable job cost sheet did not contain any data with respect to quantities. Factory operations were controlled by production orders issued by the production and control departments. Such production control consisted in keeping a statistical record of the production orders issued, the number of units required to be manufactured and the number of units completed on each production order and their disposition.

It was the practice of the registrant to make partial as well as complete deliveries of job orders, both to customers and to stock, and it appears that the records pertaining to these transactions were maintained properly in the production and control department. However, the job cost sheets maintained in the cost department in some instances were not relieved of the accumulated costs applicable to partial deliveries, either to customers or to stock, until the entire job was completed.

On March 31, 1946, a physical inventory of raw materials, fabricated parts and finished goods was taken by the registrant and observed by the auditors. However, no physical inventory of work-in-process was taken; instead, a list showing the accumulated cost of each job in process was prepared by the registrant. The total of this list, $219,501.96, was found to be $54,189.09 less than the work-in-process inventory of $273,691.05 shown by the general ledger. The registrant then made an adjusting entry, bringing the work-in-process account on the general ledger into agreement with the adjusted-accumulated cost of the production orders in process as shown by the list. (Further discussion of this $54,189.09 adjusting entry made as of March 31, 1946, and other inventory adjusting entries appear at page 123). This list was then presented to the auditors as an inventory of work-in-process at March 31, 1946.

The balance sheet as at April 30, 1946, contained in the registration statement showed total assets of $1,517,426 which included inventories aggregating $737,760. Of this amount $244,331 represented work-in-process and a minor amount of fabricated parts. Net assets amounted to $260,068.

Complete physical inventories were taken by the registrant as at the close of 1942, 1943 and 1944 but not in the presence of the auditors or any other independent accountants. No complete inventory was taken at the close of 1945. As stated previously, a physical count of all inventories *except work-in-process* was taken as at March 31,

[21] According to the report of Thomas & Moore referred to in n. 20, the overstatement amounts to $89,097.79.

1946, which was observed by the auditors. Thus no physical inventory of work-in-process had been taken by the registrant since December 31, 1944.[22] Furthermore, although according to the certificate of the auditors previously referred to "the inventories at the close of each of the years 1942 and 1944 were reviewed by ... [them] as to the basis of pricing and clerical accuracy and ... [they] inquired into the methods used by the corporation employees in determining physical quantities to ascertain that methods were employed which would assure reasonable accuracy," their certificate also indicated that they "were informed that an inventory was taken as at December 31, 1943, but ... [they] were advised that such inventory was lost and therefore not available for ... [their] inspection."

Notwithstanding these circumstances, and the fact that no examination of the accounts of the registrant or the predecessor co-partnership had been made by any independent accountant prior to that made by the auditors as at April 30, 1946, the registrant's determination not to take a physical inventory of work-in-process as at March 31, 1946, was not objected to by the auditors.

The determination not to insist upon a physical inventory of work-in-process as at March 31, 1946, was made by Henry H. Dalton, manager of the Los Angeles, California, office of the auditors, on March 27, 1946, after a discussion with M. J. Burke, an officer of the registrant who represented that the registrant maintained a job cost system, pursuant to which Dalton inspected "the bookkeeping machine which maintained the cost." And "... [he] made a cursory examination of these records" which took "about 30 minutes." He made no inquires concerning the registrant's system of internal control, and no tests which would indicate whether the alleged job cost system was adequate or whether it was actually in operation.

Everett L. Mangam, a senior accountant on the auditor's staff, assumed direct charge of the audit of registrant's accounts on April 1, 1946. He had no part in making the arrangements for the audit or in the decision that work-in-process would not be inventoried physically and he was not present when the inventories of raw materials and finished goods were taken.[23] One of his first procedures was to make a review of "the system and the controls" over a fairly long period as a result of which he found, among others, the following "deficiencies": (1) there was no tie-in between units in the plant and the dollar amounts of inventories; (2) the raw material account was not supported by a detailed stores record in dollars; (3) the segregation of material in the plant was not entirely adequate; (4) requisitions were not being prepared for all material withdrawn from stores and frequent retroactive requisitions "necessary ... to bring the costs up to the proper material consumption" were noted; (5) no record was kept in the accounting department or the cost department of the units manufactured to date; (6) while a job was still open, the applicable job cost sheet in the cost department would not show how many units had been produced, or shipped, applicable to that job to any particular date; (7) no record was kept on the job cost sheets of units and dollars transferred to finished goods either for partially or entirely completed jobs; and (8) many instances were noted where no record was made on the job cost sheets of partial shipments, either to customers or stock. He concluded that there was "necessity for the revision of the cost system in general" but he, nevertheless, believed that he would be able to use alternative procedures to assure himself with respect to work-in-process "that the inventory was

[22] Notwithstanding that on July 1, 1946, the form of the enterprise was changed from a corporation to a partnership and then to another corporation on May 1, 1946; and a new venture (the production of Airtopia) was launched, of a magnitude greater than the organization had handled previously.

[23] His testimony reads in part as follows:

"Q. * * * Were you present when Mr. Dalton made arrangements for the audit?

"A. No, I was not.

"Q. Did you discuss the arrangements with Mr. Dalton before you began the audit?

"A. Yes, before I began the audit.

"Q. What was the nature of those discussions?

"A. Well, our discussions were somewhat informal. I had just come out from the East and although I arrived in California before the 1st of April, before the inventory was taken, I did not start with Barrow, Wade until April 1st, that would be a Monday. I was told what had been done and what was to be done; what type of examination it would probably be. Outside of an explanation which Mr. Dalton gave me as to the field we were to cover, the period of time we were to cover, what we probably would encounter, there was very little more said. It was understood I would pick it up on the job."

there." He did, however, express concern "because of the additional responsibility and the amount of difficulty in making an examination of an inventory where a physical inventory is not available for a check" and indicated his feeling that, under the circumstances, "to get an exact picture of the work-in-process" he "would have to review very carefully almost all of the [open] jobs" of which, he stated, there were approximately 300 as at March 31, 1946.

The audit procedures employed by the auditors to satisfy themselves as to the correctness of the list, purported to be the work-in-process inventory as at March 31, 1946, presented to them by the registrant were as follows:

1. Approximately 75 (out of approximately 300) of the production orders in process at March 31, 1946, were examined to determine the amounts of raw material which should have been charged to each job and the applicable job cost sheets in the cost department were examined to make sure that the materials were in fact so charged.

2. They "made an attempt to remove all of the nonproductive jobs or the jobs which were not in process for the purpose of producing a product which could be sold or a part which could be used later in the product which would be sold."

3. They "inquired regarding the method of accumulation and the method of removing the partial shipments shown therein," and

4. They made a physical test of work-in-process on May 8, 1946, "in an effort to ascertain whether the balances at April 30 were reasonable."

Concerning the scope of this physical test, Mangam testified in part as follows:

> . . . "Since the balance sheet was to be dated April 30, 1946, and since the work-in-process listing at March 31, 1946, was merely a book listing, we decided to use the listing of work-in-process jobs at April 30, 1946. We therefore were obliged to check the entries and transactions for the month of April as they affected work-in-process. We were also obliged to prepare our own list of costs applicable to open jobs in work-in-process because the company did not run a list of its own at that date. We used that list prepared by us as of April 30th as a basis for all of our subsequent checks on work-in-process balances.
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> * * * * *
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> "We also, on May 8th, spent approximately one day in the plant testing items in various departments by observation or actual count. We were accompanied at that time by the production control manager. We tested the result of our inspection tour against the records of the production control department.
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> * * * * *
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> "The work sheet shows that we checked 17 job orders. . . . I believe there were approximately 300, I haven't counted them. . . . It appears that the total accumulated cost on the job orders checked by us was approximately $70,000.
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> * * * * *
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> "Two of us selected items in the plant which were in process. We reconciled the balances which we found in production with the records kept in the production control department. We referred to the job order to see that there was a job order, we made subsequent reviews of the cost to see that the cost was normal for the particular unit being produced, that the requisitions were properly applicable thereto and that the labor charges were also proper.
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> * * * * *
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> "We went through the plant, starting at the primary departments, and selected various jobs in process in that department at that time. We would select large items, count them, get a description of them, obtain the job number to which they applied, and make a note of it on our sheets, and move on to another department to select items in that department by the same method.
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> * * * * *
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> "We believed that at March 31st the partial shipments had been recorded against the accounts, against the open job orders. We believed that the adjusting entry in April [see below] was wholly a means of correcting a situation in which the company found itself at that date, where they had to have a proper classification of inventory.
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> * * * * *
>
> "The tests indicated that partial shipments had been made. On the basis of our tests, we estimated approximately how much of a credit we needed for partial shipments."

These procedures disclosed no differences warranting adjustment, and no change was made, in the amount of work-in-process as shown by the list originally prepared by the registrant.

As stated previously, the registrant found it necessary to make periodic entries, substantial in amount, adjusting the work-in-process account on the general ledger. Such an entry credited approximately $31,000 to work-in-process and charged a like amount to finished goods as at April 30, 1946. The auditors saw this entry and considered its purpose to be "to bring the finished goods inventory account into agreement with a physical inventory taken on April 30, 1946, of finished goods, and to transfer the excess credit in that account to work-in-process. The credit was to represent the amount of partial shipments or the estimated cost of the partial shipments made from jobs still open in work-in-process account . . . It indicated to us that the system of crediting work-in-process for the month of April was not satisfactory; it represented a stop gap entry."

Notwithstanding the purported nature and amount of this entry, the auditors did not analyze the entry or even check into the supporting work papers. Furthermore, there were similar adjusting entries, involving substantial amounts, recorded in August and October 1945, and in January, February and March 1946. They likewise did not attempt to analyze or to verify the correctness of these entries.

A further indication that the purported cost system was not functioning properly was the occurrence of red (credit) balances in the Finished Goods—Inventory account in the general ledger in October 1945 and January and April 1946. There is no evidence to show that the auditors gave heed to this unusual situation.

In our opinion the taking of a physical inventory of work-in-process at the time other inventories are counted is, except in rare instances, a necessity. We can find no extenuating circumstances which might justify the failure of the registrant in this instance to take such an inventory as at March 31, 1946. Indeed, in light of the conditions which, as shown by the record, existed as at that date there was a demonstrated need for a complete and painstaking inventory.

It seems clear, also, that the representatives of the auditors should have made a more thorough examination of the registrant's system of internal control and its cost system, and should have determined that they were being operated effectively before acquiescing in the omission of a physical inventory of work-in-process as at March 31, 1946. And once they found, as they did in the course of their examination, that there was, in fact, no effective system of internal control and the alleged job cost system existed more in theory than in fact, they should have insisted that a work-in-process inventory be taken as at April 30, 1946. Notwithstanding these conditions the company represented that there was in operation a controlled job cost system[24] and the auditors represented in their certificate that they satisfied themselves as to the adequacy of such system[25] and the dependability of the company's system of internal control.[26] We find these misrepresentations to be misleading.[27] It seems to us, however, that the auditors' dereliction in these respects is overshadowed by the inadequate manner in which they employed alternative auditing procedures in the absence of a physical inventory.

As stated previously, they had grave doubts as to the dependability of the registrant's cost system, particularly with respect to the accounting for partial shipments, yet they failed to check, even by test, any of the individual job cost sheets from which the list purported to represent work-in-process as at March 31, 1946, was prepared, to determine that accumulated costs applicable to partial shipments had been eliminated. Nor did they make such a check as at April 30, 1946. In fact the accumulated cost of approximately $20,000 shown for one of the jobs included in the physical test check of 17 jobs as at April 30, 1946,

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[24] Note "B" to the Notes to Financial Statements stated "An inventory of work-in-process and fabricated parts has not been taken, the amounts on the balance-sheet as at April 30, and September 30, 1946, being the accumulated cost of all work-in-process at the respective dates determined from the individual job cost records as controlled by the general accounts."

[25] See *supra*, p. 119.

[26] The certificate, dated August 5, 1946, stated ". . . we have reviewed the systems of internal control and the accounting procedures . . . and . . . have examined or tested accounting records . . . and other supporting evidence by methods and to the extent we deemed appropriate."

[27] Statement No. 1 issued in October 1939 by the Committee on Auditing Procedure of the American Institute of Accountants states, on page 9, "Obviously, also, it would be erroneous to mention internal control if none existed."

referred to on page 122, was found (in the subsequent reexamination made in May 1947) to have been overstated approximately $13,000 due to the failure to eliminate costs applicable to partial shipments.

There can be no doubt that the auditors knew of the registrant's practice of making partial shipments for, as stated on page 122, they "inquired regarding ... the method of removing partial shipments shown ... [from the job sheets]." Furthermore the periodic journal entries referred to on page 122 which effected adjustments with respect to partial shipments were seen by the auditors although they failed to grasp their significance for they did not even examine into the supporting work papers.

It would not have been an involved procedure to test check the job cost sheets to determine that partial shipments had been accounted for properly. It meant merely the scrutiny of the production orders maintained in the production and control department, or a representative number of them to determine whether partial shipments were indicated thereon, and the examination of the applicable job cost sheets in the cost department to see that they were relieved of the accumulated cost with respect to the partial shipments. No such procedure was followed, however.

Under these circumstances we think it clear that the statement in the certificate of Barrow, Wade, Guthrie & Co., pertaining to the financial statements as at April 30, 1946, which was included in the registration statement, that "... [the auditors] have no reason to believe that the inventories as set forth in accompanying statements are unfairly stated" is entirely without justification.

It is our conclusion that here again as we stated with reference to the auditing procedures followed in another case "... [the accountants'] 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 the 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."[28]

CONCLUSION

It is our conclusion, based on our examination of the record, that the registration statement of Drayer-Hanson, Inc., which became effective on December 11, 1946, was deficient (in the respects we have indicated) in its description of its product Airtopia and that the financial statements as of April 30, 1946, and for the periods ended that date including the certificate of Barrow, Wade, Guthrie & Co., pertaining thereto, and the unaudited financial statements of the company as of September 30 and October 31, 1946, and for the periods ended at such dates were inaccurate and misleading.

By the Commission (Commissioners McConnaughey, McEntire, Hanrahan and McDonald).

Orval L. DuBois,
Secretary.

[28] In the Matter of McKesson & Robbins, Inc.: Report on Investigation (p. 443).

RELEASE NO. 65*

June 21, 1948

SECURITIES ACT OF 1933
Release No. 3294

SECURITIES EXCHANGE ACT OF 1934
Release No. 4108

Notice of Proposal to Amend Regulation S–X

* Text of release omitted.