ADMINISTRATIVE PROCEEDING
FILE NO. 3-7187

UNITED STATE OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	)
COMBELLICK, REYNOLDS & RUSSELL, INC.	)
RICHARD D. ANGELL	)
RAYMOND R. RUSSELL, JR.	)
(a Private Proceeding)	)

INITIAL DECISION

June 19, 1991
Washington, D.C.

Jerome K. Soffer
Administrative Law Judge

ADMINISTRATIVE PROCEEDING
FILE NO. 3-7187

UNITED STATE OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of COMBELLICK, REYNOLDS & RUSSELL, INC. RICHARD D. ANGELL RAYMOND R. RUSSELL, JR. (a Private Proceeding)	)	INITIAL DECISION

APPEARANCES: John E. Birkenheier and Allison D. Garrett representing the Commission's Office of the Chief Accountant

Timothy M. Rastello (Holland & Hart), Counsel for Respondents

BEFORE: Jerome K. Soffer, Administrative Law Judge

On May 11, 1989, the Commission issued an Order for Private Proceedings ("Order") pursuant to Rule 2(e) of the Commission's Rules of Practice [17 C.F.R. §201(e)] naming as respondents Combellick, Reynolds & Russell, Inc. ("CRR"), Richard D. Angell ("Angell") and Raymond R. Russell, Jr. ("Russell").

The Order is based upon allegations of the Commission's Office of the Chief Accountant ("OCA") that respondents had engaged in improper professional conduct during the audits of George Risk Industries, Inc., ("GRI") for the fiscal years ended April 30, 1983, 1984 and 1985, respectively, resulting in the issuance of unqualified audit reports on financial statements which were incorrect for significantly overstating income. GRI filed these statements with the Commission as part of its FY-1983 through FY-1985 annual reports on Form 10-K.

OCA charges that CRR's examinations were not made in accordance with Generally Accepted Auditing Standards ("GAAS") as certified by CRR, and challenges its further certification that the financial statements were prepared by GRI in conformity with Generally Accepted Accounting Principles ("GAAP").

Based upon these allegations as detailed more fully in the Order, the Commission directed that this private proceeding be instituted to determine whether the specific allegations of the Order were true and, if so, what sanctions, if any, should be imposed as a result thereof.

Evidentiary hearings were commenced on November 14, 1989 and concluded on November 16, 1989. Following the close thereof, the parties successively served and filed their respective Proposed Findings and Fact and Conclusions of Law together with supporting briefs. Thereafter, OCA filed a reply brief and respondents, with permission, filed a supplemental post-hearing brief, as well as several post-hearing exhibits designated

"D" and "E",respectively. The findings and conclusions herein are based upon the evidence as determined from the record and from observing the demeanor of the witnesses. Preponderance of evidence is the standard of proof that has been applied. 1/

The Parties

Respondent CRR is a professional corporation of certified public accountants that, among other things, audits and issues opinions on the financial statements of publicly-traded companies. It is located in Englewood, Colorado, and during the relevant period herein included four partners. All respondents appear and practice before this Commission.

Respondents Angell and Russell are certified public accountants licensed by the state of Colorado. Both are members of the American Institute of Certified Public Accountants (AICPA) and the Colorado Institute of CPAs.

Angell was the manager on the FY-1983 GRI audit and the engagement partner on the FY-1984 and FY-1985 GRI audits. He began auditing financial statements in 1978. He was a partner in CRR from 1984 through 1988 and served as the engagement partner for CRR's audits of publicly traded companies. Angell withdrew from CRR in 1988, and is now in partnership with another certified public accountant.

Russell has been in public accounting for 20 years. 2/ He joined CRR in 1969. He is the managing partner, audit review partner, and the partner in charge of financial reporting at CRR. Russell served as the engagement partner for the FY-1983 GRI audit

---

1/ See Steadman v. S.E.C., 450 U.S. 91 (1981).

2/ Russell is also certified by the State of Nebraska.

and as a reviewing partner for all three GRI audits. As reviewing partner, he examined workpapers to determine that the audit was performed in accordance with GAAS and presented in accordance with GAAP. From time to time Russell has been appointed by AICPA and other professional groups to about a dozen peer review teams and has served as a team captain of peer review committees.

GRI is a Colorado Corporation engaged in the design, manufacture and marketing of computer keyboards and security products, and performed research and development ("R&D") in connection with its own products and those of other companies. Throughout the relevant years, their stock was publicly traded in the over-the-counter market. GRI securities were registered under Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act"), and GRI was required to file periodic financial reports with the Commission.

GRI Research and Development Laboratories, Inc., ("R&D Labs" is a wholly-owned subsidiary of GRI. GRI Telemark Corporation, ("Telemark") is a majority-owned subsidiary of GRI. The FY-1983 GRI consolidated financial statements reported the financial condition of R&D Labs; the FY-1984 and FY-1985 GRI consolidated financial statements reported the condition of both subsidiaries. These statements were filed with the Commission on Form 10K in accordance with statutory requirements.

George Risk, an inventor and engineer for over 50 years, was the major shareholder of GRI prior to his death in 1989. He developed and patented the initial technology for a variable opacity glass ("VOG") window, designed to allow the user to adjust the amount of light transmitted through the glass by the injection or removal of fluid in the glass.

The VOG Tax Shelter

From 1981 through 1983, R&D Labs entered into contracts with dozens of investors to perform research and development for them on some 50 specific components of the VOG window. The contracts offered purchasers the right, in exchange for a fixed price, to the commercial exploitation of one of the VOG components. Each research and development contract required R&D Labs to perform research on a specific component part for that investor, who paid one quarter of the contract price in cash and executed a six-year interest-bearing promissory note for the remainder of the purchase price. 3/

The investors' agreement provided that the promissory notes would be paid off first from sales revenues to be generated from commercial exploration of the VOG window; any balance due would be paid up by the purchaser as their notes became due. The contracts and promissory notes called for a fixed rate of interest of "11.5 % per annum", with no time specified as to when the interest was to be paid. GRI retained a security interest in the plans, specifications, and technological information of the VOG Window. In exchange for the cash and promissory notes, GRI agreed in a general way to perform an unspecified quantum of undefined research and development of the VOG Window components.

The VOG program was offered to investors as a "tax shelter". Thus, in return for giving GRI the cash and promissory note, each investor expected to receive an immediate tax deduction of the entire contract price, some four times greater than his cash payment. The contracts were provided with a fourteen page "tax opinion" by counsel for GRI concluding that the investors would be entitled to federal income tax deductions for the full

---

3/ The agreement allowed the purchaser to extend the due date for two additional three-year periods under specified circumstances including the payment of an additional fee of 10 percent of the principal amount.

purchase price under the then existing laws and regulations.

Purchasers of the contracts were required to meet certain investor suitability standards. Thus, they had to represent that they were in the 50 percent federal income tax bracket and had a net worth of at least $100,000. 4/

R&D Labs raised approximately $840,000 in cash and more than $2.5 million in notes through the sales of VOG tax shelter units. Fifty percent of the cash proceeds were immediately paid out as sales commissions. The balance was transferred to the parent corporation, GRI, ostensibly for R&D work performed by GRI on the VOG project on behalf of its affiliate.

In the summer of 1984, respondents learned that the United States Internal Revenue Service ("IRS") had begun to audit the tax returns of investors in the VOG tax shelter, which could have resulted in the denial of their deductions. In fact, by 1985, the IRS began denying the deductions of some of the investors. The basic questions at issue herein embrace the accounting treatment that GRI afforded the deferred income and interest from VOG contracts sold between 1981 and 1983 (and not due for six years) in the three annual financial statements filed successively thereafter, and in respondents' audit certification thereon.

"Percentage of Completion" versus "Completed Contract"

GAAP provides two methods for accounting for income claimed under long-term contracts: the "percentage-of-completion" ("P-O-C") method and the "completed-contract

---

4/ The tax shelter feature would appeal primarily to one whose income placed him or her in a high tax bracket.

("C-C") method. 5/

Under the P-O-C method, a portion of the income from a long-term contract is recognized as work on the contract progresses. The percentage arrived at is based upon a ratio that the costs incurred to date in carrying out the contract bears to the total anticipated costs. That percentage is then applied to the total anticipated revenues under the contract to arrive at the portion of those revenues which are to be recognized through the end of the current accounting period. Any revenue in excess of that which has been recognized previously is income for that accounting period and is carried as a current asset. 6/

On the other hand, under the C-C method, income from a long-term contract is recognized only when work under the contract has been completed. Until then, costs and revenues associated with the contract would not be carried as current, but rather as accrued costs and deferred revenues, respectively, on the balance sheet. GRI chose to use the P-O-C method to account for the VOG contracts revenues during the fiscal years involved herein. It is the contention of OCA that GRI's use of this method and the handling of interest due violated GAAP and resulted in material misstatements of the consolidated financial statements for fiscal years 1983, 1984, and 1985. It is further charged that

---

5/ AICPA Statement of Position 81-1 ("SOP 81-1"); Accounting Research Bulletin No. 45 ("ARB 45").

6/ For example, if a company had incurred costs of $60 to date under a long-term contract, and has estimated the remaining costs to be $40, the costs incurred ($60) would be divided by the sum of the incurred costs and estimated costs to complete ($60 plus $40 = $100) to arrive at the percentage-of-completion of 60%. Expressed as a formula it would appear thus:

$$\frac{\text{Incurred costs to date}}{\text{Incurred costs to date plus estimated costs to complete}} = \text{Percentage of completion}$$

respondents' unqualified opinion that the financial statements were in conformity with GAAP amounted to a violation on their part of GAAS.

By using the P-O-C method, GRI was able to recognize $964,000 of VOG-related income in FY-1983, a little over $1,011,000 in FY-1984 and more than $1,000,000 in FY-1985. Had the completed-contract method been used, no VOG income would have been recognized as current income in FY-1983 and FY-1984. Assuming the contracts were in fact completed in FY-1985, the total revenues amounting to $3,372,000 would have been recognized in FY 1985 only. 7/

Since these amounts represented so great a part of GRI's total income from R&D during the year involved, the correctness of treating the reported income under the P-O-C method becomes a material factor. Paragraph 23 of SOP 81-1 provides as follows:

> Circumstances Appropriate to the P-O-C Method
>
> 23. The use of the percentage-of-completion method depends on the ability to make reasonably dependable estimates. For the purposes of this statement, "the ability to make reasonably dependable estimates" relates to estimates of the extent of progress toward completion, contract revenues, and contract costs. The division believes that the percentage-of-completion method is preferable as an accounting policy in circumstances in which reasonably dependable estimates can be made and in which all the following conditions exist:
>
> Contracts executed by the parties normally include provisions that clearly specify the enforceable rights regarding goods or services to be provided and received by the parties, the consideration to be exchanged, and the manner and terms of settlement.
>
> - The buyer can be expected to satisfy his obligations under the contract.

7/ By April 1985 GRI announced that it was ceasing further research and development on the VOG window, having determined that economic exploitation was not feasible.

- The contractor can be expected to perform his contractual obligations. (Underlining added).

Moreover, as provided in ¶28 of SOP 81-1, the contract must also be free of "inherent hazards" that would make otherwise reasonably dependable contract estimates doubtful. 8/

Further, reasonably dependable estimates cannot be produced for a contract with unrealistic or ill-defined terms or for a contract between unreliable parties, (SOP 81-1, ¶29).

The C-C method, on the other hand, is preferable in circumstances in which estimates cannot meet the criteria for reasonable dependability or in which there are inherent hazards of the nature discussed above.

It is the contention of the OCA, as contained in the order for proceedings herein, that it should have been apparent to respondents in performing their audits during the years in question that it was impossible under the VOG plan for the contracting parties to produce reasonable estimates or otherwise to meet the conditions delineated in SOP-81 and thus to relegate them to the requirements of ¶30 thereof relating to the C-C method.

OCA describes GRI as a cash-hungry corporation that entered the VOG deals in order to offer to high-income individuals in upper tax brackets a tax shelter in return for some quick cash and that these circumstances surrounding the GRI audits called for a high degree of professional care and audit skepticism on the part of respondents in performing them.

8/ Such hazards may relate, for example, to contracts whose validity is seriously in question (that is, which are less than fully enforceable), to contracts whose completion may be subject to the outcome of pending legislation or pending litigation, or to contracts exposed to the possibility of the condemnation or expropriation of the resulting properties.

GRI's workpapers disclosed that GRI was suffering a shortage of working capital and that this was a subject that was discussed at several meetings of its Board of Directors concerning efforts to obtain bank loans. It had to refinance a major loan from the Small Business Administration and was attempting to make a public offering of the stock of its majority-owned subsidiary, Telemark.

It is clear that GRI applied to the VOG-related sums, representing the 75 percent unpaid balances of the contract prices ostensibly due from the investors at least 6 (or more) years thence, an accounting procedure which enabled it to convert in its books these long-term obligations into current income. 9/ The record suggests various reasons for GRI to seek to improve its financial posture in the face of its many cash-flow problems. Whatever GRI's motives, however, the issue that must be addressed is whether GRI had selected an acceptable, authorized accounting principle by which it recorded the outstanding amounts nominally due under the R&D agreements.

As noted above, the resort to the use of the percentage-of-completion formula required the existence of a number of factors as outlined in SOP 81-1, ¶23, for which reasonably dependable estimates can be made, including a clear specification of the services to be provided.

Analysis of the written agreements between the investors and GRI shows that there was no basis to determine therefrom what services other than some undefined "research and development" of a VOG window was to be performed by GRI. Each contract embraces R&D for just one of some 50 components of a window (such as "Top U Channel", "Left Z channel", "Crank Handle", etc.) based upon sales prices for each of the components varying

---

9/ It is generally understood that an asset (or a liability) is "current" if due (or payable) within one year.

from as low as $20,448 for a "cover, overflow", to $55,200 for a "lower Z channel". None of these amounts are broken down as to the cost of materials, labor, testing, overhead, etc., which would be required to perform the research and to develop the end product. No two items out of the 50 carry the same contract price. Moreover, no price is set forth as a round number (as would be expected from costs based upon estimates), and no specificity concerning the work to be performed other than, as noted, undefined "research and development". Many of the individual parts to be researched and developed appear to be standardized parts as would fit any window (i.e., "brackets," "polarized plugs," "motor parts", etc.), whether equipped with a variable opacity glass or any other type of ordinary glass, and hence not requiring "research" and "development".

These vague contractual terms would have prevented the rendering of reasonably dependable estimates of the progress of the work contracted for. The circumstance surrounding the investments in the VOG program make it abundantly clear that GRI was primarily concerned with the offering of a tax shelter. While it is recognized, as asserted by GRI in its 1982 publication describing the research and development program for the VOG project, 10/ that "research and development, by its nature, precludes definitive statements as to the time required and costs involved in reaching specific objectives", it is this very lack of specificity that prevents the making of reasonably dependable estimates and hence the inapplicability of the percentage-of-completion accounting principle set forth in SOP 81-1.

Moreover, the contract was not free of "inherent hazards", the principal one being the likelihood of rejection of the tax shelter by the Internal Revenue Service. In fact, GRI

10/ Exhibit 53, at page 8 of the section headed "Tax Shelter Investment Program".

specifically warned prospective investors that IRS was increasing the number of audits of partnerships, particularly directed toward tax shelters such as this one. 11/

Simply put, the inherent hazard was the existence of a strong doubt that the investors would have completed their contractual obligations to pay off the balances due under the notes. Since sales of the VOG program occurred between 1981 and 1983, the principal sums would have become due in at least six years (or 1987 through 1989). The agreements provided that the notes would be paid off from the gross proceeds derived from the exploitation of the information developed through the R&D efforts of GRI. George Risk himself announced on April 30, 1985 that GRI's research and development was completed, that economic exploitation was not feasible, and no further cost estimates would be provided. Hence, no revenues could be expected to be earned thereafter in order to pay off the notes. No explanation was given for this sudden announcement calling off further R&D. Surely under these circumstances, it could hardly be expected that investors would throw good money after bad by paying off the notes, as they later become due once it became clear that the VOG program was a failure and would generate no revenues, and that IRS had begun to audit these tax shelters and was denying the tax savings anticipated by investors. Here, again, it appears that reasonably dependable estimates of revenues could not be made since the buyers could not be expected to perform their contractual obligations. Consequently, utilization of the P-O-C method was inappropriate.

Interest

OCA asserts that the accounting treatment accorded the interest to be paid under the terms of the notes resulted in another material misstatement and another violation of

---

11/ Id., at page 20.

GAAP.

The notes signed by the investors provided for the payment of interest of "11 1/2% per annum" on or before the due date of the principal sum. On the financial statements at issue herein, GRI in each year classified the accrued but unpaid interest due on the notes as a "current asset", and hence collectible within one year. 12/ The VOG interest accrued for FY-1983 was approximately $174,000, for FY 1984 was about $215,000 and for FY 1985 about $180,000, amounts deemed material. A total of only six annual payments of interest were made out of a total of some 70-odd investors, and the amounts paid in each of the three years totaled $2,673, $13,844 and $18,344 in FY-1983, and FY-1984 and FY-1985, respectively. By FY-1985, the cumulative interest amounted to over $450,000 or almost 60% of GRI's then current assets.

Respondents assert that there was an ambiguity in the notes resulting from the failure to indicate therein exactly when the accrued interest became payable. They urge that although no due date was stated, the use of the words "per annum" meant that interest was to be paid every year and hence that GRI's treatment thereof as a current asset was proper. This contention is contrary to law.

It is fundamental that:

> In the absence of a specific promise to pay the interest at designated times *** the general rule is that interest does not become due

---

12/ A current asset is one expected to be converted into cash within the normal operating cycle of the company, which is usually within one year. Respondents' expert opined without any substantiation that GSI's cycle was three years. This opinion is rejected.

and payable until the principal sum becomes due and payable***

The term "per annum" in a contract providing for the payment of a certain rate of interest has been held to be intended only as a measure of the rate with respect to time, and as not requiring the payment of interest annually.

> 45 AM. Jur. 2d, Interest and Usury Sec. (1969 & 1991) Supp.) (Footnote omitted). 13/

Respondent's expert witness testified to his "understanding" that the parties intended interest to be paid annually if not sooner, but that language to that effect was inadvertently omitted by the printer of the notes. However, other documents printed at different times provided for the interest payments in much the same language, thus ruling out the existence of an "error" in the printed notes.

Finally, respondents argue that it is unimportant whether interest due be shown as a current or long-term asset since either way the balance sheet's reflection of GRI's total assets would have remained the same. However, this overlooks the importance of the books showing a higher operating ratio (current assets to current liabilities), which is a reflection of a company's liquidity and ability to meet it's debts as they fall due. This would be significant to anyone intending to rely upon GRI's financial posture to govern future business dealings. 14/

13/ See, also, Gustin v. Sun Life Assur. Co. of Canada, 152 F.2d 447, 449, (6th Cir. 1945); and 47 C.J.S. Interest & Usury §30 (1982).

14/ That GRI recognized the significance of including interest as a current asset is found in its annual report (form 10-K) filed with the Commission for FY-1985 wherein the company states, at page 8 under the heading "Liquidity and Capital Resources":

(continued...)

Respondents' contentious

Respondents assert that in carrying out the audits embraced herein, they exercised the due professional care called for in AU Section 230, 15/ sufficient to give them the ability to make the reasonably dependable estimates required for the use of the P-O-C method.

They argue that at the time the VOG program was set up, the IRS had not then cracked down on tax shelters and, in fact, they were commonly being approved by IRS. They claim they had reason to believe and had reasonably competent audit evidence to support their opinion that the notes signed by the investors were fully collectible as to principal and interest. Such evidence consisted of the 14-page letter from GRI's attorney, which had been furnished to all of the investors opining the legality of the VOG program as a tax shelter. In FY-1983 and FY-1984, they sought confirmations from the VOG program investors, of which some 70 to 80 percent were returned, recognizing their obligation under the tax shelter scheme to make payment in full when the notes became due some six years later.

Respondents further point out that when they learned in 1984 that the IRS had begun auditing the tax returns of VOG investors and that such investigation might result in the denial of the tax deductions, they required GRI to set up an allowance for doubtful

---

14/(...continued)

> During the year.... the liquidity of GRI and Subsidiaries improved. The working capital ratio increased from 1.38 to 1.... to 2.14 1... largely due to the notes receivable. The interest is currently due and the company is actively pursuing collection. (underlining added).

15/ "AU" Refers to the AICPA's Codification of Statements on Auditing Standards (1989).

accounts of 12 1/2 percent of the outstanding notes, or approximately $540,000, and an allowance for FY-1985 of 37.5 percent of the outstanding notes which amounted to more than 1.1 million dollars. 16/ They urge that these allowances were sufficient to offset the notes that investors might not honor, thereby rectifying any problem resulting from the use of the P-O-C method.

In addition to the above, respondents claim they did the following: audited and accumulated the costs incurred on the VOG project; obtained from George Risk his best estimate of the cost to complete R & D; obtained from George Risk his best estimate of the percentage of the research completed to date; checked Risk's estimates of the costs to complete and percentage completion with the company controller; determined, without naming the sources, that GRI and Risk had the experience and ability to make reasonably dependable estimates based on their experience in and their knowledge of the VOG project, and reviewed the R & D contracts and promissory notes by obtaining in writing directly from the investors confirmations of their intention to pay on the promissory notes.

Discussion and Conclusions

The primary issue embraced in this proceeding is not whether the R&D program was a lawful tax shelter, or when interest was payable under the terms of the notes. Rather, the issues as set forth in the Order for Proceedings herein are whether the use by GRI of the P-O-C method conformed to GAAP; whether respondents planned and performed audit procedures necessary to determine that GRI had a reasonable basis for so doing; and, as a consequence, whether respondents failed to comply with GAAS; and, if so, whether this

---

16/ During the FY-1986 audit GRI increased the reserve for doubtful accounts to 75 percent of the principal and interest owed under the VOG notes, and in FY-1987 to 100 percent.

failure constituted improper professional conduct within the meaning of Rule 2(e), 17 C.F.R. 201.2(e). 17/

It has already been noted herein that the requirements of SOP 81-1 stand for a basic proposition that the use of the P-O-C method depends on the ability to make reasonably dependable estimates of the extent of progress toward completion of contract revenues, and of contract costs. The arguments advanced by respondents are not very persuasive as to the validity of the accounting procedures adopted by them. While it may be true (although not clearly established) that IRS had not cracked down on tax shelters of this type at the time the VOG contracts were being sold in the 1980 through 1983, by the time the audits were being made for FY-1984 and FY-1985, it was then known that IRS had called in VOG investors and was denying some the deductibility for the tax shelter. This, then, should have alerted respondents to the fact that the estimates of income as well as the collectability of the principal and/or interest on the notes were too indefinite and unreliable and prevented the rendering of reasonably dependable estimates of income.

The audits step that respondents did take only added to an uncertainty which would preclude the use of the P-O-C formulation. Thus, confirmations were sent to the investors but the fact that from 70 to 80 percent answered in the affirmative should not have been accorded the normal importance attached to confirmations since the VOG investors had no alternative but to admit their liability in order to protect their attempt to shelter taxes. In fact, the 20 to 30 percent who did not respond to the confirmations constituted a significant number and a source of doubt as to the availability of responsible estimates as

---

17/ Rule 2(e) (1) provides that the Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person where the Commission finds, inter alia, that the respondents have "engaged in.... improper professional conduct"

required under the P-O-C method. There is no evidence that any attempt was made to follow up the failure to confirm by so large a group.

Further, having felt the need to require GRI to set up allowances for doubtful accounts in 1984 and 1985, although for considerably less than the amount of outstanding notes, raises a question as to why they did not reexamine the propriety of continuing the use of P-O-C method since the estimates theretofore used turned out to be unreliable. 18/

Respondents contend that even had the completion of construction method of accounting been used, all of the VOG income would have in any event been recognized in 1985 rather then over three year period 1983-1985. Hence, they conclude that the allowances that were set up would have balanced out the revenues claimed by that time. However, since the allowances were not set up for the full contract price, the P-O-C method showed income instead of a loss from operations in 1985.

For the most part respondents relied upon the advice of George Risk as to his best estimates of the cost to complete R&D and of the percentage of the research completed at the end of each fiscal year. It appears that throughout these audits, respondent in other instances placed reliance solely upon management representations. These statements were oral and uncorroborated by written evidence or in the workpapers. While representations from management are part of the evidential matter that the independent auditor obtains, they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for his opinion on the financial statements. See AICPA, Codification of Statement on Auditing Standards, AU Section 333.02.

18/ The Allowances were offset against "notes receivable" , a non-current asset, leaving the full amount of the VOG estimated income to continue to appear on the balance sheet as a current asset.

Respondents urge in defense that they had relied upon the opinion of "outside counsel" in forming their judgment as to the legality of the VOG tax shelter, collectability of the notes, and as to when interest was payable.

The extent of respondent's reliance upon counsel appears to be a reading of the 14-page tax shelter opinion and conversations with GRI's lawyers not otherwise documented. It does not appear that respondents sought advice from independent counsel to whom they made full disclosure of all the facts. Hence, this defence is unavailable. 19/ Moreover, the tax shelter opinion is replete with warnings and disclaimers as to create serious doubt about the interpretation made.

The issues herein have recently been the subject of the Commission's attention in a strikingly similar situation involving a tax shelter based upon research and development contracts. In Matter of Petrofab International, Inc., 48 S.E.C. 988 (1988), the Commission stated (at pages 1002-1003):

> Petitioners argued that the R&D contract at issue is governed by Statement of Position 81-1("SOP 81-1"), promulgated by the American Institute of Certified Public Accountants, which assertedly authorizes the use of the POC method of accounting. SOP 81-1 deals with the financial reporting for construction-type and certain production-type contracts, and evaluates the two generally accepted methods for recognizing revenue under such contracts, POC and completed contract ("CC"). The CC method recognizes income only when a contract is completed, or substantially so. We have already concluded that Petrofab's R&D contract should have been accounted for as a financing transaction and, therefore, that POC accounting was improper. . . . The question then would be whether, in accordance with the provision of SOP 81-1, revenue should be recognized under the POC or CC method of accounting. The answer to that question is clear. Use of the former method would not be appropriate since the R&D contract did not meet the criteria for POC treatment. SOP 81-1 expressly provides that the use of POC accounting depends on the ability to make "reasonably dependable estimates" of the extent of progress toward completion of the contract and of the costs to be incurred in achieving that result. It states that the CC method is preferable when the "lack of dependable

---

19/ See Matter of C.E. Carlson, Inc., et al., 48 S.E.C. 564, 568 (1986).

estimates . . . . cause(s) forecasts to be doubtful," and that reasonably dependable estimates cannot be produced for a contract with "unrealistic or ill-defined terms."

As the law judge noted, the R&D contract describes the work "only in the most general terms." It contains no specifications or performance standards governing the system that PRI was supposed to design and develop. . . . there was no way to substantiate the estimated costs to be incurred. In view of the vagueness of the contract's specifications, Petrofab could hardly make reasonably dependable cost estimates. Thus POC accounting was wholly inappropriate under SOP 81-1. (underlining added). 20/

GAAS is a body of generally accepted auditing standards as approved and adopted by the membership of AICPA. The third General Standard requires that "Due professional care is to be exercised in the performance of the examination and in the preparation of the report". The third Standard of Field Work provides that" sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination". (AU Section 150.02; AU Section 326.01)

The financial statements of a company are prepared by its managers and constitute assertions made by management that the statements are truthful presentations of the company's financial condition and the result of its financial operation. The purpose of an audit is to make an examination that will, in accordance with GAAS, put the auditor in a position to express an opinion as to whether the financial statements are presented fairly and in conformity with GAAP, applied on a consistent basis. (SAS I, AU 350.1) 22/

Most of the auditor's work during an audit consists of obtaining and evaluating

---

20/ Petrofab also stands for the proposition that financial statements prepared in accordance with accounting principles for which there is no substantial authoritative support are presumed to be misleading regardless of footnote or other disclosure (Ibid., P. 1003).

22/ "SAS" refers to Statements on Auditing Standards promulgated by the Auditing Standards Board of AICPA.

evidential matter concerning the assertions in the financial statements. The relationship between clients and accountants during the audit process is one of healthy skepticism. In this proceeding, it is clear that the auditors unduly relied upon the representations of GRI's management with respect to matters of major significance in the audits. They must find more evidence than only management assertions to support all significant aspects of the financial statements being examined. Such reliance of management herein is found in such matters as estimates of costs, revenues, work performed, time of completion, etc., for which there is admittedly no adequate documentation. 23/

SAS 19 states that:

> "Representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for his opinion on the financial statements"

Respondents knew or had reason to know that in the prior year's audit for FY-1982, the percentage of completion formula was not used although sales of the R&D contracts had been in effect for almost three years, that GRI was experiencing financial difficulties; that the entire arrangement was a bare tax shelter; and that the proposed research and development for the 50 or 60 parts that made up a VOG window was unsupported by documental evidential matter; that the confirmations from customers were unreliable not only because they had to admit liability in order to protect their attempts at a tax shelter but because a substantial number of them chose not to confirm; and that the treatment of

---

23/ Thus, respondents accepted the verbal estimate by George Risk in 1983 that the project was from 30% to 50% completed, which they merely averaged out to a 40% completion, that in 1984 that completion totaled 70%, and in 1985 that it totaled 100%. These estimates were not tested as to their reliability by such acts as seeing the work that had been performed. In fact, all of the claimed R&D work was totally undocumented.

the VOG interest was not in conformity with the law as to when it was payable.

Respondents, of course, contest these and the other items heretofore discussed, and contend that they acted appropriately under the circumstances.

They point to the fact that they had required GRI to write off in FY-1984 and FY-1985 a portion of the claimed revenues by setting up reserves against the uncollectablilty of the outstanding notes. However, they did not require off-sets for the full amounts of the notes still unpaid, although at about this time IRS had begun investigating tax shelters, and the entire VOG income was at stake. Nor did they make any allowance against the moneys due in the FY-1983 financial statements. 24/ Having deemed it necessary to require setting up of the reserves, the question remains of whether the P-O-C method of recording sales income should have been dropped since it relied upon inaccurate estimates of income.

Respondents point to the number of confirmations received from purchasers of the VOG shelters as an evidentiary audit step providing support for the estimates of income. Apart from the fact that it became highly unlikely that the investors would ever make good on these notes at maturity several years later, respondents admit that in the FY-1985 audit year, a substantial number of VOG note holders did fail to confirm their obligations under the promissory notes.

Respondents assert that in several instances they relied upon the opinions of "outside counsel" in forming their own opinion as to the ambiguity in fixing a due date for interest payments, the collectability of notes and the legality of the tax shelter. However, the accuracy and reliability of these opinions from counsel employed by GRI were long in doubt by the time of the FY-1985 audit and probably in FY-1984 as well.

24/ The entire unpaid principal and interest on the VOG notes was written off in The FY-1987 financial statements.

Under all of the circumstance herein, it is concluded that to the extent that GRI financial statements were based upon the P-O-C method they did not conform to GAAP, that by certifying that they did respondents did not comply with the requirements of GAAS in the audits performed for GRI in FY-1983, FY-1984 and FY-1985, and that the failure to do so, under all of the circumstance described, constitutes improper professional conduct as that term is understood under Rule 2(e).

Public Interest

The authority of the Commission to discipline accountants and bar them from practice before the Commission under Rule 2(e) has been expressly upheld in the federal courts. See Davy V. S.E.C., 792 F. 2nd. 1418, 1421 (9th Cir. 1986) citing Touche Ross V. S.E.C., 609 F. 2nd. 570 (2nd Cir. 1979). It does not appear herein that respondents are challenging such authority in the Commission.

The Court of Appeals in Touche Ross, in sustaining the validity of the Rule as a necessary adjunct to the commission's power to protect the integrity of its administrative procedures and the public in general, stated, at page 581:

> " . . . the Commission necessarily must rely heavily on both the accounting and legal professions to perform their tasks diligently and responsibly. Breaches of professional responsibility jeopardize the achievement of the objectives of the securities laws and can inflict great damage on public investors"

It having been determined that respondents engaged in improper professional conduct within the meaning of Rule 2(e), it becomes necessary to consider what disciplinary action is appropriate in the public interest. In imposing administrative sanctions, the Commission may take into account such factors as:

> " . . . the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful

nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations."

> Steadman v. S.E.C., 603 F. 2nd 1126, 1140(5th cir. 1979), aff'd. on other grounds, 450 U.S. 91 (1981).

Steadman also tells us that when the agencies seeks to impose drastic disciplinary action, such as a bar from practice, it has the burden of demonstrating that less drastic sanctions will not suffice to protect the public interest (page 1129 of 603 F. 2nd).

The Commission relies very heavily on the competence and integrity of the independent auditors who practice before it in order to fulfill its statutory responsibilities. This reliance is in recognition of the unique responsibility independent auditors have and their role in preserving the integrity of the securities markets. The independent auditor assumes a public responsibility transcending any employment relationship with the client, and breaches thereof jeopardize the achievement of the objectives of the securities laws and can inflict great damage on public investors (U.S. v. Arthur Young & Company, 465 U.S. 805, 817-18 (1983); and Touche Ross, supra, at page 581 of 609 F.2d).

The OCA seeks a sanction denying respondents the privilege of appearing and practicing before the Commission for a period of five years, as being necessary to protect the investing public and to preserve the Commission's processes, and to deter others from engaging in similar misconduct. In the light of the standards set forth in the Steadman case, it is concluded that the OCA has failed to establish that the circumstances justify so harsh a sanction.

It is recognized that during the audits of FY-1984 and FY-1985 respondents required GRI to set up off-setting (albeit insufficient) reserves against the amounts due for principal and interest under the promissory notes, that in connection with GRI's 10-K report for FY-1986 respondents required GRI to restate in its FY-1985 financial statements the accrued

interest as a long-term asset, that the terminology in the VOG promissory notes with respect to when interest was to be paid was not that clearly stated, and that there is no proof in this record connecting GRI's conduct with any loss to any individual.

It is also noted that respondents comprise a very small practice office and that the type of sanction requested by the OCA might harm the individuals beyond that which would be necessary to deter them from repeating the violations found herein and to deter others from the same conduct.

Accordingly, it is concluded that a proper sanction in the public interest would be to bar the respondents from appearing and practicing before the Commission for a period of three months.

Miscellaneous Matters

1. Respondents assert that the firm of Combellick, Reynolds and Russell, Inc., has ceased doing business and, consequently, that the corporation should be dismissed as a party-respondent in this case. In support thereof, they attached to their post-hearing brief a copy of a corporate resolution wherein the corporate directors voted unanimously to cease doing business as of October 31, 1989. However, unless the corporation has been formally dissolved there is nothing to prevent it from resuming its former business practices. Hence, the motion to dismiss CRR as a respondent in this case is denied. 25/

2. On the first day of the evidentiary hearing, November 14, 1989, the counsel for OCA had moved into evidence Exhibits 48 and 49, transcripts of the investigative testimony of Russell and Reynolds some 18 months prior. Respondents requested counsel for OCA

25/ Moreover, the Commission has held that where, as here, a firm of public accountants permits a report or certificate to be executed in its name, it will be held responsible therefor. Matter of Ernst & Ernst, 46 S.E.C. 12343, 1271 (1978).

to designate those parts of the transcripts that they intended to rely upon in their case in chief. Copies of these transcripts had been in the possession of the respondents' counsel for many months prior to the hearing. OCA insisted that the entire contents of the transcripts (each ranging between 100 and 150 pages in length) go into evidence along with some 5 boxes of respondents' workpapers (Exhibits 1 through 42). At that point, the hearing was scheduled to proceed through the entire week and conclude on Friday of that week. Counsel for respondents agreed to review all the papers and transcripts and to try to respond to them during the course of the week.

When respondents continued during of the course of the hearing to ask for time to examine these documents, I indicated that I would not hold the Friday November 17, 1989 completion as an absolute finish of the case, but that if respondents needed time to respond we would come back. However, the understanding was that we would come back over the weekend following the then anticipated close on Friday.

Although respondents had all of the papers in their possession for several months prior and the hearing having been closed on Thursday, November 16, 1989, respondents did not then ask for a continuation of the hearing for the presentation of additional proof but waited until some four months later when they submitted their initial proposed findings of fact and conclusions of law and brief in support thereof, which was some two months after service of OCA's similar pleading. Moreover, in making this request, respondents have made no effort to indicate what the purpose of reopening at this stage would be, what portion of OCA's proof they wished to rebut, what witnesses, if any, they intended to call or recall and for what purpose, and any other information as to what need would be served by reopening and what additional proof would result therefrom. Instead, respondents merely make this general application to reopen the hearing based upon our colloquy on the

first day of the hearing. 26/

What is most significant in this matter is the fact that at respondents' request they were permitted to file a supplemental brief following the reply brief served by OCA. This is an unusual procedure which is not normally afforded to respondents and not provided for in the Commission's Rules of Practice.

Respondents in due course filed a supplemental reply brief on April 19, 1990, by which time they had been served with OCA's initial filings and reply filing. Thus they had ample opportunity to dispute any information that may have been gleaned from the exhibits in question and to set forth what additional evidence they proposed to present before this re-opened and the relevancy thereof.

In view of the fact that respondents have not demonstrated any prejudice, have failed to take advantage of the opportunity to request a hearing reopening for many months, and has had the opportunity by way of its supplemental brief plus its initial brief to contest or comment upon any aspect of the exhibits theretofore received, the request to reopen the hearing would serve no useful purpose and, therefore, is denied.

3. Respondents also have requested in their brief rather than by motion that in my discretion I hear oral argument by the parties. 27/ For the reasons set forth hereinabove concerning reopening the hearing, and particularly the very unusual opportunity accorded respondents to submit a supplemental brief, it does not appear that oral argument would add anything to that which is already contained in the thorough and well-researched post-hearing pleadings submitted by the parties. This request is, therefore, denied.

26/ Respondents have offered to waive this request to reopen the record if I have decided not to sanction them.

27/ Rule 16(g), Rules of Practice.

During the hearing, each side called an expert witness both of whom are highly qualified individuals. In many instances there was no conflict in their testimony particularly with respect to GAAP and GAAS requirements. Although no specific reference to their testimony has been is made in this decision, careful consideration has been made to their testimony and to the opinions expressed, which have been incorporated in the findings and conclusions made herein. Further discussion is not deemed necessary. 28/

ORDER

For the forgoing reasons and pursuant to Rule 2(e) of the Commission's Rules of Practice (17 C.F.R. Section 201.1(e)):

IT IS ORDERED that respondents Combellick, Reynolds, and Russell, Inc, Richard D. Angell and Raymond R. Russell, Jr. is each denied the privilege of appearing or practicing before the Commission in any way, or from accepting or undertaking any new professional engagement which can be expected to result in filings, submissions or certifications with the Commission, for a period of three months from the effective date hereof. Nothing herein shall be construed to affect the right or obligation of respondents to continue to perform their normal functions and services for existing clients or

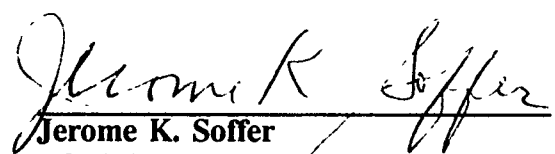
---

28/ The expert witness for OCA, Professor Leonard M. Savoie is the chairman of the department of accountancy at the University of Notre Dame. His previous experience included work as an auditor with a major accounting firm, served as chairman of this firm's accounting committee and was responsible for the firm's nationwide program of professional education. Professor Savoie served for five years as an executive vice president of AICPA and joined the faculty of Notre Dame in 1979. The respondents called as their expert Dr. Jerome Kesselman of the University of Denver. He has been a certified public accountant for 41 years, is on the board of directors of five publicly held companies and is a member of the audit committee of three of them. He lectured extensively on GAAP and GAAS. His previous experience included 17 years of full time auditing. He is a member of several professional committees and lectures at the University of Denver in a number of accounting areas including auditing.

engagements. 29/

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice.

Pursuant to Rule 17(f), this initial decision shall become the final decision of the Commission as to each party who has not, within fifteen days after service of this initial decision upon him, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.



Jerome K. Soffer
Administrative Law Judge

June 19, 1991
Washington, D.C.

29/ In their briefs and arguments, the parties have requested the Administrative Law Judge to make findings of fact and have advanced arguments in support of their respective positions other than those heretofore set forth. All such arguments have been fully considered and the Judge concludes that they are without merit, or that further discussion is unnecessary in view of the findings herein.