

THE CONCEPT OF INDEPENDENCE IN ACCOUNTING

Address of

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Before the

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Mr. Chairman, Gentlemen:

The last time a member of the Commission addressed the annual meeting of this institute was in 1947. To have been invited again so soon may be interpreted as evidence either of your fortitude or of the number of common problems we have which it is mutually advantageous for us to discuss. I should like to assume that it is our common interests which motivated your decision to invite me today.

In 1947 Mr. Caffrey, then Chairman of the Commission, discussed with you the relationship between rigid independence in accounting and the presentation of the facts of business life. Today I should like to elaborate upon a portion of that theme and discuss the basic concept of independence.

During the early years of accountancy, around the turn of the century, the business world had not yet come to recognize the need for this concept. Generally, an accountant's duties consisted of opening and closing books, detecting frauds upon the owners of the enterprise, and straightening accounts which had become charmingly mixed up by amateur bookkeepers. As one writer expressed it, the general notion seemed to prevail that an accountant was "merely a man of figures, a rapid and unerring calculator who could add up two or three columns of figures at a time, could tell you immediately the square or cube root of any given number, or say off-hand, for example, what one dollar put out at six per cent compound interest per annum at the time Columbus discovered America would amount to today."^{1/}

Perhaps the greatest impetus to the new profession was given by the passage of the Sixteenth Amendment in 1913 and the War Revenue Act of 1917. Commercial banking institutions and mercantile creditors were quick to avail themselves of the services of the new profession, and it grew. These creditors required audits and verified financial statements. I believe full maturity was reached upon passage of the Securities Act of 1933, which for the first time imposed the legal requirement that statements be certified by independent accountants.

You will remember that General Carter, who testified on behalf of the accounting profession at the hearings upon that bill, experienced some difficulty in persuading the Senate Committee that there were professionally qualified persons who could and would audit accounts of registrants and express an independent opinion upon their correctness, uninfluenced by the fee they received. Senator Barkley was frankly skeptical about such a procedure and suggested that if an independent audit were really necessary it might better be obtained by the use of accountants employed by the government.

General Carter then observed, in a statement that I am sure was not justified by some of the incomes enjoyed by public accountants in the early thirties, that the government could not afford to employ the necessary number of qualified accountants. The Committee did not then pursue Senator Barkley's suggestion.

^{1/} Anyon, James T., Recollections of the Early Days of American Accountancy, p. 41.

At another point in the hearings Senator Barkley asked whether there was any relationship between the corporate comptrollers, who had testified that they were responsible for the accuracy of the financial statements, and the public accountants. General Carter answered: "None at all. We audit the controllers." Senator Barkley then asked, "Who audits you?" to which General Carter quickly replied, "Our conscience." It is your conscience which is my subject today.

General Carter's reply sums up a substantial part of the concept of independence. It is not tangible, nor even in most instances clearly demonstrable. It represents a state of mind. In the entire field of human relationships it is difficult to find an exact analogy. The independent accountant must combine the impartiality of a judge with the high sense of responsibility of a fiduciary. In addition, he must possess a full knowledge of the tools and methods of his profession. Though hired and fired by management, he must divorce his mental processes from any bias in their direction when making accounting judgments. Such a standard of professional conduct must be maintained if the auditor's certificate is to be more than a snare and a delusion and the public obligation of the accountant satisfied.

Of course, we are all fully aware of the difficulties inherent in enforcing such standards. The influences which may affect accounting judgment are extremely subtle and tenuous. In their most dangerous form it is possible that the accountant himself does not recognize their effect. Under such circumstances an accountant may be lacking in independence despite the highest professional qualifications and the most complete integrity. It is our duty -- both the Institute's and the Commission's -- to guard the public against such unconscious bias.

That is by far the most important purpose of our rules and interpretive opinions governing the qualification of accountants. No serious administrative problem arises in the obvious case, where an accountant is plainly derelict, where he certifies to statements he knows to be misleading, or where he consciously and deliberately falsifies the facts. 2/

Even the common law, with its cultural lag, holds the accountant responsible if he should supply a certification when he knows or should know of its inaccuracies. I am sure you are all familiar with the case of Ultramares v. Touche, decided almost 20 years ago by the New York Court of Appeals. In that case Justice Cardozo, then Chief Judge of that court, made clear that every accountant who certifies a financial statement owes a duty to the public. If he should be grossly negligent in the discharge of that duty, he may be compelled to pay damages to any person who relied upon that statement. That was the first complete articulation of the legal concept of independence, which has now been generally accepted by all the courts which have considered the matter.

The legal liability which flows from this concept was extended and enlarged somewhat by the Securities Act. Section 11 of that Act impose upon the accountant the duty to make a reasonable investigation into the truth and completeness of the statements he certifies. This necessarily 2/ See, e.g., American Terminals and Transit Co., 1 S.E.C. 701 (1936).

implies that the audit should be thorough and that the system of internal controls carefully checked. Such matters as depreciation and obsolescence allowances, legal requirements inhibiting dividend payments, and all similar items requiring the assistance of experts should be carefully scrutinized. The accountant is held to the same standard of care as that required of a prudent man in the management of his own property.

Negligence in this respect is strong evidence of lack of independence. Or, if an accountant, either directly or through an affiliate, enters into an agreement which attempts to immunize the accountant from liability for his negligent acts, I believe he thereby forfeits his independence.

The self-regulation undertaken by the profession has, of course, outstripped the limited concept of legal liability. Five rules of the Institute relate to this concept. They are: Rule 5, which prohibits false or misleading statements; Rule 9, which prohibits, except in limited circumstances, the use of contingent fees to pay for accounting services; Rule 13, which directs accountants to refrain from expressing any opinion upon the statements of any enterprise in which he may have a financial interest; Rule 3, which prohibits the payment of any portion of an accountant's fee to non-accountants or the acceptance of any portion of the fees or profits received by non-accountants from work turned over to them by accountants as an incident of their services to a client; and Rule 4, which discusses occupations incompatible with public accounting.

The Commission has attempted to adapt the concept of independence to the needs of investors. When a registration statement or annual report is filed with the Commission it is designed for use by the public. In lieu of government examination of each financial statement the certificate of an independent accountant is required. I believe that the duties inherent in furnishing such a certificate impress upon the auditor a fiduciary obligation toward the public as well as toward the client if full confidence in the publicly held securities is to be maintained. The Investment Company Act expressly recognizes this obligation by providing that the accountant's certificate "shall be addressed both to the board of directors . . . and to the security holders." If investors are to be fully protected, the accountant-fiduciary must be free of all the entangling alliances which might be engendered by relational or contractual connections with the registrant. He must be free to approach his task with complete objectivity, intent upon a critical examination of all the practices and procedures of the registrants. We have expressed this view in a rule as follows:

"The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct, or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships between the accountant and that registrant, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission." 3/ .

To me that rule means two things. First, it states that independence is a question of fact, and if it can be shown as a matter of fact, regardless of the absence of any business or personal relationship, that an accountant's decisions are controlled or influenced by someone else, that accountant is not independent. Secondly, and this is perhaps of more significance, it points to certain relationships which indicate a lack of independence and provides that when these or similar relationships which might influence an accountant's judgment exist, the accountant cannot be considered independent regardless of the amount of proof available that his judgment was, in fact, uninfluenced.

Proof of the actual abdication of judgment to another is nearly always difficult. The coincidence of the result of a decision with the wishes of another can, in many instances, be explained as the result of independent logical reasoning. It is in the selection of the applicable accounting convention, about which there are sometimes great differences of opinion among the authorities, that judgment must be exercised. Even when the decision cannot be logically justified, who can say whether the error was an honest one? It is in this context that independence is particularly important.

3/ On July 12, 1950, the Commission promulgated for comment a proposal that the rule be amended to read:

The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person, or any affiliate thereof, in whom he has any financial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships between the accountant and that registrant or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

This was intended as a codification of the Commission's rulings upon independence and not as a change in view.

Usually, it is only when the accountant has been foolish enough to venture his personal judgment and it can be shown that this is different from that reflected in the financial statements that absolute proof of lack of independence can be shown. 4/ Even when misleading or fraudulent statements are certified there can be only a strong presumption of lack of independence, which must be coupled with other factors if there is to be clear evidence of actual subservience to management influence.

In the only three cases thus far decided involving lack of independence in which the Commission has taken disciplinary action against accountants the mental state of the accountants could be proved. In the first 5/ the accountants gave management a private audit report materially different from that furnished the public. The public report failed to disclose, among other things, that the client was carrying a trading account in the name of the accountant. Although the accountant protested, he did not take effective steps to stop the practice for two years.

The second case, 6/ a year later, was very much like the first. It differed only in the fact that the accountant knew of the trading account and acted as an accomplice of management in the stock market enterprise. The client and the accountant did not even profit financially from the trading. They suffered substantial losses despite market advice by the president, the secretary-treasurer, and a director of the company. I suppose this proves both the biblical precept that the wicked shall reap no profit from their wickedness and the Wall Street axiom that market speculation should be left only to the professionals.

The third disciplinary action 7/ was not until seven years later, when an accountant blandly certified accounts which carried a leasehold at \$100,000, which was ninety percent of stated assets of the enterprise, although he knew only \$15,000 had been paid for the property the year before and it was assessed at only about \$5,000. Since it was also shown that the accountant assisted in the promotion of the venture, the proof of lack of independence seemed conclusive. Three other disciplinary actions against accountants 8/ raised questions of independence because of the technical incompetence of the accountants there involved, but the Commission's decisions were based principally upon the omission of specific auditing procedures prescribed by Commission rule. The certificates in those cases represented little more than the loan of the

4/ See Metropolitan Personal Loan Co., 2 S.E.C. 803 (1937); A. Hollender & Sons, Inc., 8 S.E.C. 586 (1941); Associated Gas and Electric Co., 11 S.E.C. 975 (1942).

5/ Puder & Puder, Securities Exchange Act Release No. 3073 (1941).

6/ Kenneth v. Logan, 10 S.E.C. 982 (1942).

7/ Accounting Series Release No. 68.

8/ Accounting Series Release No. 48 (1944); Accounting Series Release No. 59 (1947); Accounting Series Release No. 67 (1949).

accountant's name. Therefore, insofar as they pretended to be an objective and critical analysis, they were false and misleading. 9/

The paucity of disciplinary actions and the nature of the offense charged in those cases indicate how reluctant we are to institute such actions. However, I do not believe the profession may assume that appropriate action will not be taken unless there is evidence of corrupt and venal conduct. I believe every accountant is chargeable with the knowledge of the mechanics and the ethics of his profession. They are the rules of the game and their observance is essential if we are both to fulfill our high public trust.

Most of these rules, like those which govern any fiduciary, are prophylactic in nature. They are designed to prevent any conflict from arising between the accountant's duty to the public and his personal interests. Thus, just as a trustee of an estate in reorganization under the Bankruptcy Act may not ally himself with any creditor or stockholder interest in the estate, trade in securities of the estate, or purchase trust property, the accountant may not have any financial interest in a client's enterprise, even if it can be shown that the personal financial stake of the trustee or the accountant will have no effect upon his judgment. As a matter of fact, persons sensitive to their obligations may lean over backwards and act in opposition to their personal interests.

Nevertheless, I believe it is a salutary principle which arbitrarily denies to fiduciaries or people in a quasi-fiduciary position such as accountants the right to risk their independence. Not all people are strong enough to resist temptation, particularly when it may easily be hidden behind a convincing rationalization. Even if there is no conscious attempt to favor a personal interest, unconscious pressures may cause a shift in the normal judgment exercised by the accountant. For both these reasons, and because the public will have greater confidence in certifications when they know there is no conflict between personal desires and professional opinions, the accountant must carefully scrutinize his relationships with his client.

I recognize the impracticality of restricting or denying all intercourse between accountants and their clients. Nor do I believe this is either necessary or desirable. The accountant cannot be an ivory tower examiner, inaccessible to his client and remote from the market place. The nature of his business demands constant communication with management and recognition of all creditor and stockholder interests. In our opinions and interpretations at the Commission we have tried to stake out the safe and unsafe areas which the accountant who wishes to protect his independence should observe.

I assume that all of you are familiar with Accounting Series Releases 22 and 47, in which there are summarized Commission decisions and informal rulings upon the question of independence. Since 1944, when Release 47 was published, five Commission decisions and some one 9/ For other examples of such examinations see National Boston Mines Corp., 2 S.E.C. 226 (1937); Red Bank Oil Co., Securities Exchange Act Releases Nos. 3110, 3770 (1946).

hundred staff opinions have dealt with this problem. Apparently there is still some need for clarification and delineation.

The problems fall, roughly, into three groups. First, there are those instances in which the accountant has a managerial or financial interest in his client such as when he is an officer, director or partner, or when he owns stock in the enterprise. Secondly, there are those instances in which there is a family relationship between the accountant and the client; and thirdly, there are those instances in which the accountant also acts for the client in some capacity other than as an accountant. Many problems, of course, involve more than one of these relationships, and within each classification a single factor may not disqualify an accountant but it may raise sufficient doubt so that if any other similarly inconclusive factor is present the accountant should be disqualified. I believe we may best discuss these problems by referring to our rulings under each of these classifications.

The question most frequently asked us is what constitutes a financial interest. Seven of the twenty illustrative cases which appear in Release 47 deal with this problem. Until recently we have analyzed that interest and if it was substantial we have decided the accountant could not be independent. An interest which exceeded one per cent of the personal fortune of the accountant was considered substantial. Experience has demonstrated, however, that even less than a one per cent financial interest may result in a conflict of interest. For instance, the percentage of net worth might be less than one per cent although the proportion of income represented by the holdings might be substantial; persons may be affected differently by losses or gains or comparatively small sums; often exact values cannot be calculated. Accordingly, we take the view that any financial interest in a client, no matter how small, will disqualify the accountant and it is proposed that Rule 2-01 be revised to reflect this viewpoint. This financial interest may be in the form of a contingent fee contract, or a contract which is expressed in terms of a fixed fee plus a percentage of sales, or an investment in an underwriter, a promoter, an affiliate, a parent or a subsidiary of the client, for the definition of financial interest should be broad enough to insure the complete objectivity of the audit. In this connection I believe it would be wise to adhere strictly to Polonius' injunction, "neither borrower nor lender be" to any client, even if the borrowing or lending is only of office space. 10/

Nor can a firm of accountants be insulated from the holdings or acts of any partner, even if that partner should separate himself from any connection with the audit. Thus, an accounting firm was held to be lacking in independence where the partner who held stock in the client did not participate in the audit and the certificate was signed jointly by the partner who had performed the audit and the firm. 11/ Nor would the situation be remedied by the sale of these shares subsequent to the audit.

10/ See Southeastern Industrial Loan Co., 10 S.E.C. 617 (1941).

11/ See Richard Ramare Gold Mines, Ltd., 2 S.E.C. 377 (1937).

This disqualification will extend even to the audit for years prior to the date when the stock was acquired when a registration statement is filed which includes financial statements for those years, for a certification speaks also as of the date the registration statement becomes effective. Consequently, a financial interest at that time would interfere with the complete objectivity of the entire audit.

Similar problems are presented when an accountant or a partner in an accounting firm serves as a promoter, underwriter, voting trustee, director, or officer of a client, or administrator or executor of an estate with an interest in a client. It seems to me obvious that an accountant should not certify accounts which cover the period of time when he held office. I am continually amazed at the number of requests for an opinion in these circumstances.

In one instance a member of a firm of certifying accountants, although not an officer, consulted with management on accounting matters and exercised some supervisory powers with respect to the corporation's accounting procedures. We held that despite the lack of a formal title, the accountant acted in the capacity of controller and he and his firm were therefore disqualified from certifying the financial statements.

A more difficult problem is presented after the accountant disposes of the financial interest which has disqualified him and resigns his office with the company. It has been urged that since he has cured his disability he should be henceforth fully qualified to exercise an impartial judgment. I believe that if he participated in the formation of significant accounting policies which persisted beyond the year in which he resigned or gave up his financial interest, he should not be permitted to place himself in a position to audit those decisions. A variation of this question is presented where another firm audits the accounts for the years when he was connected with the company and he attempts to rely upon this audit in submitting a certificate covering those, as well as subsequent years, when he had no connection with the client. The Commission has held, properly, that such a certification will not be accepted. The accountant may not rely on others, for part of his certification unless he would be fully qualified to perform that audit himself and did, in fact, supervise it.

This does not mean, however that these earlier years may not be covered by a separate certification by others.

The second category of cases dealing with the independence of accountants on which we are frequently asked to express an opinion deals with family relationships. The typical case is one in which the accountant is the father, son, husband, brother, cousin or uncle of an officer, director, or bookkeeper of a registrant. 12/ In accordance with well recognized legal doctrines governing fiduciaries, we have taken the position that such a relationship disqualifies the accountant. Obviously, if the persons involved live under the same roof and are part of the 12/ See Examiner's report adopted by the Commission in American Metal Mining Co., Securities Exchange Act Release No. 3537 (1944), where the wife of the accountant was bookkeeper for the registrant.

same economic unit, the accountant has a direct interest in the finances of his client. To the extent that the client pays the officer, it contributes directly to the support of the accountant's household. Even if the relative is not part of the same household it would be very unrealistic not to recognize the strong influence exerted upon the accountant by virtue of a close relationship.

Disqualification because of family relationship extends also to instances in which the relative has a financial interest in the client's enterprise. Thus, we ruled that where the wife of an accountant had a 47-1/2 per cent interest in one of three principal underwriters of a proposed issue, the accountant could not be considered independent.

The third category of rulings we have rendered dealing with independence involves non-financial relationships. It is clear, I believe, that membership in the same civic, fraternal or social organizations as a client does not disqualify an accountant. I fully realize that many young men must get their start by enlarging their circle of acquaintances, and membership in organizations is a well-accepted method of accomplishing this. Even when it was shown that an accountant and his client became joint obligors, together with others, upon a mortgage to secure a clubhouse, and that this accountant prepared personal income tax returns and audited the personal books of the principal stockholders of a registrant, it was not considered controlling by the Commission. ^{13/} The possibility of improper influence arises when the relationship becomes more closely connected with either the finances of the accountant or his duties as an auditor.

In one case the stocks and bonds of a registrant, an investment company, were kept in a safety deposit box in a bank, and the members of the accounting firm were given exclusive custody of the key to the box. We ruled that the custodian of portfolio securities could not be considered independent for the purpose of certifying the financial statements. In another instance, it was found that a registrant who proposed to issue preferred stock was indebted to a bank in a substantial sum and the member of the bank's examining committee which reviewed loans requiring special attention was a partner in the accounting firm which proposed to certify the financial statements. I believe the Commission properly ruled that the accountants could not be considered independent.

Finally, included in this category are those cases in which the accountant engages in an occupation incompatible with the concept of independence. Thus, he may not serve as a securities salesman and audit the accounts of brokerage houses or serve as a partner in a law firm engaged by one of his accounting clients to pass upon the legality of securities being registered.

These are the general problems with which we are presented upon the question of independence. They admit of many ramifications, permutations and combinations. Not all are easy of solution.

^{13/} A. Hollander & Sons, Inc., 8 SEC 586, 616 (1941).

All of the factors which might possibly influence the accountant's judgment are considered. Often it is clear that any one factor would be insufficient to affect the honest discharge of an accountant's duties, but that, when taken in combination with others, it would be ground for disqualification. In such circumstances I cannot offer you the certainty of a rule of thumb. I can only suggest several of these to you as pitfalls to be avoided.

Among the most troublesome cases are those dealing with employees of an accounting firm as distinguished from partners. Adequate review procedures should be maintained to guard against employee inefficiency or deliberate falsification. 14/ For a lapse in this regard I believe the firm is responsible. Either it has been negligent or it does not have the minimum knowledge of auditing procedures required of independent accountants. However, when the employee is both efficient and honest but it appears he has some disqualifying interest in the client, a more difficult problem is presented. If he should participate in the audit, it would, of course, invalidate that audit. Assuming, however, that he does not participate in the audit, what should be the effect of his interest? The employee is not in a policy-making position. Presumably, therefore, he has no influence over the accounting judgments exercised. On the other hand, the firm should not be placed in the position where it audits the actions of one of its employees. Certainly the firm may not loan an employee to a client to do bookkeeping, and then be permitted to audit that work. Even when the bookkeeping consisted simply of posting general ledger entries and making closing entries covering a month's work, we have refused to consider the firm employing that accountant independent. The same considerations are applicable where the employee has served as a director or officer of the client. If the accounting firm must audit his decisions, it cannot be independent.

In these cases the employee's interest is considered as one factor and all the surrounding circumstances are examined to determine whether there is any possibility that the accounting judgments might have been swayed. For instance, if another employee was a second cousin of an officer of the client the two factors together might invalidate the audit although neither, alone, might be sufficient. Similarly, if it is shown that the wives of partners in an accounting firm engaged in speculative transactions in a registrant's stock prior to the audit, that fact would adversely affect, if not destroy, the firm's independence. Certainly, if there were also other borderline factors present the firm could not be considered independent.

I know that you in the accounting profession agree with this concept of independence. In fact, credit for the inclusion of that concept in our laws belongs largely to the profession. Nevertheless, some of my friends in the profession have said:

"Oh yes, we believe wholeheartedly in this ideal of independence but it is sometimes impractical. If a client refuses to permit

14/ See Inter-state Hosiery Mills, 4 S.E.C. 706 (1939), where the employee forged checks, falsified the statement of assets and made unverified summaries instead of applying generally accepted auditing procedures.

us to verify inventories or if an inactive partner happens to own a few shares of a client's stock do we have to give up the account? Why can't we simply make full disclosure of the limited nature of the audit or the financial interest in our certificate? The public can then assess those factors for themselves in analyzing the accounts."

To me, that represents a completely erroneous viewpoint of the nature and purpose of the concept of independence. I am reminded of a poem I once learned which ran something like this:

There was a little dachshund once,
So long, he had no notion
How long it took to notify
His tail of his emotion.

And thus it was that while his eyes
Were filled with tears and sadness,
His little tail kept wagging on
Because of previous gladness.

If a qualified certificate were permitted we might very well have a certificate filled with tears and sadness while the financial statements express only the previous gladness. Moreover, it seems to me that such a certification would be no better than no certification at all, for there would be no independent audit such as the Acts and rules of the Commission require. I remember one case in which the certificate had so many exceptions that all but \$35,000 of total stated assets of \$9,000,000 were excluded from the purview of the certificate. 15/

On all these matters which I have discussed the Commission has proceeded slowly, with an eye to the needs of the investing public and a full realization of the effects of its rulings upon the accounting profession. We are thankful for the full measure of support and cooperation you have given us. Without it, I believe our task would be well nigh impossible. We could easily have a system in which accounting was the handmaiden rather than the measure of management. That we do not have such a system is a great credit to a young profession. I will hazard the guess that even Vice President Barkley, who as a Senator was skeptical of the practicality of using an accountant's conscience as his guide, has been convinced by the uniformly impressive achievements of the past seventeen years.

A P P E N D I X

OPINIONS OF THE COMMISSION

Summarized below are the salient facts in all of the decisions of the Commission which deal with the independence of public accountants:

1. Cornucopia Gold Mines, 1 S.E.C. 364 (1936): In a proceeding brought pursuant to Section 8 (d) of the Securities Act, the following facts about the relationship between the registrant and the accountants were adduced:

(a) An employee of the accountants was comptroller of the registrant. He received no salary from the registrant but received his entire remuneration from the accountants.

(b) The actual accounting and audit were performed chiefly by the comptroller of the registrant.

(c) The contract between the accountants and the registrant provided that the accountants were to receive \$5,000 per annum, plus 1% of the gross proceeds of metal sales, in return for which they were to install an accounting system, set it up in proper order, make audits, and furnish office space for use by the registrant.

(d) The comptroller of the registrant, who was employed by the accountants, owned 1760 shares of registrant's stock.

The Commission held:

"The inference from these facts is irresistible that a person in the accountant's position would be apt to approach accounting problems of the registrant as one of its officers and stockholders, and not as an 'independent' accountant. It would be unreasonable to suppose that he could cast aside these relationships and view the accounting problems with the objectivity of an 'independent' accountant criticizing and correcting accounting practices and methods of the corporation's own staff, Furthermore, we conclude that the contract between registrant and the accountants by its very nature clothed the accountants with a disability which prevented them, during the duration of the contract, from being an 'independent' accountant as respects the registrant."

2. American Terminals and Transit Company, 1 S.E.C. 701 (1936): This was a proceeding under Section 8 (d) of the Securities Act to determine whether a stop order should issue suspending the effectiveness of a registration statement. It appeared that the accountants certified to a balance sheet which contained a fictitious cash asset and a fictitious reduction in an equivalent amount for accounts receivable. In addition, there were various other items in the financial statements which did not reflect sound accounting practices. The Commission held that,

"Where the accountant has consciously falsified the facts, as here, an inference of actual absence of independence would seem to be justified. He who, as a result of connivance with, or loyalty or subservience to his client, purposely or recklessly misrepresents the facts, cannot be said to qualify as an 'independent' expert."

3. National Boston Montana Mines Corporation, 2 S.E.C. 226 (1937): In a proceeding brought pursuant to Section 8 (d) of the Securities Act of 1933 the following facts about the relationship between the registrant and the accountants were adduced:

(a) The only books or records available to the accountant in preparing a balance sheet of August 1, 1933, consisted of uncertified consolidated balance sheets of the registrant's predecessor and subsidiaries, dated May 31, 1933, the registrant's minute book, and a cash book of the predecessor from June 1 to August 1, 1933. The accountant had never audited the books of the registrant's predecessor and he had no access to the predecessor's books to verify the items going into the consolidated balance sheet.

(b) The accountant admitted that in determining certain items of the registrant's balance sheet, particularly the item of \$20,000 for accounts payable, he relied entirely upon unverified information furnished by the chairman of the board.

(c) In preparing a balance sheet for September 30, 1934, the accountant relied in great part upon unverified information furnished by the chairman of the board and by other officers and employees of the registrant. He rarely verified items of expenses, even when these expenses amounted to a sizeable part of the total receipts.

(d) The accountant himself set up certain books of account for the registrant but, with the possible exception of a cash book, the books were not posted until the time of the audit when an attempt was made to record what had already happened, in some cases from memory. The Commission held:

"We find that these circumstances cast further grave doubt on the accountant's independence . . . , and in any case establish his reckless disregard of careful accounting procedure."

4. Rickard Ramore Gold Mines, Ltd., 2 S.E.C. 377 (1937): In a proceeding brought pursuant to Section 8 (d) of the Securities Act it appeared that a partner in the accounting firm which certified the financial statements owned 11,000 shares of the registrant. In an apparent effort to avoid conflict an amended financial statement was filed which was prepared by an employee of the accountant and certified jointly by the employee of the accounting firm and the accounting firm. The employee received from the registrant a cash payment for his services and had no other interest in the registrant. The Commission held:

"The purpose and intent of the rule requiring accountants to be independent would be defeated and evaded if the accountant is to be disqualified by its provisions but his partner or employee is not. It must be concluded that the amended balance sheets are not certified by independent accountants."

5. Metropolitan Personal Loan Company, 2 S.E.C. 803 (1937): In a proceeding brought pursuant to Section 8 (d) of the Securities Act the accuracy and sufficiency of the certificate of certain certified public accountants was challenged. It appeared that:

(a) The annual reports of the accountants disclosed the fact that the accountants had failed to visit and examine all offices of the registrant, that there was no verification made of the cash on hand, cash in banks, or loans payable.

(b) The accountant testified that he generally did what his clients requested, completely subordinating his judgment as an accountant to the desires of his client. He further testified that he was not sure of an accountant's function in this respect.

(c) The accountant testified that he knew that a certain credit of \$7,000 to income was improper, but he allowed such credit to be made because the officers of the registrant so ordered.

(d) The accountant testified that he accepted the president's statements as to the worth of accounts and securities with little or no investigation.

(e) The accountant also testified that he exercised "no independent judgment" with respect to the adequacy of reserves. Although the audit reports for 1933, 1934 and 1935 advised that the reserves of \$4,916, \$5,881 and \$5,639, respectively, were inadequate, he testified that he thought a reserve of \$1,835 in 1936 was adequate because the registrant's officers told him so. The Commission held:

"The record shows, and we find, that the accountants herein were not 'independent' . . . , therefore the rule requiring certification by independent accountants was not complied with and the representation that they were independent was misleading."

6. Interstate Hosiery Mills, 4 S.E.C. 706 (1939): In a proceeding brought pursuant to Section 19 (a) (2) of the Securities Exchange Act it appeared that:

(a) An employee of the accountant falsified the financial statements of the registrant by overstating cash, accounts receivable, inventory, and surplus. In addition, this employee also forged several checks drawn on the company's bank account.

(b) The employee of the accounting firm did much of the bookkeeping for the registrant.

(c) The certificates to the final audit designated monthly reports to the client as "monthly detailed audits," when in fact they were merely unverified analyses and summaries of information in the corporate books. The Commission held that:

"The procedure upon which the accountants certified reports were based could not accurately be described as an independent audit . . . We entirely agree with the testimony . . . that an audit should be a check by an outsider of original work done by the client's employees; 'if an accountant is permitted to do original work the whole purpose of the audit is lost.'"

7. A. Hollander & Son, 8 S.E.C. 586 (1941): In a proceeding instituted pursuant to Section 19 (a) (2) of the Securities Exchange Act, the following evidence concerning the relationship between the registrant and the accountants was adduced:

(a) The accountants were guilty of various improprieties in failing to write off the original cost of the acquisition of a subsidiary which became valueless and in concealing the joint venture in which the company lost approximately \$150,000.

(b) Two principal members of the firm and their wives owned stock in the registrant varying in market value between \$78,200 and \$350,000 and from one-half of one per cent to nine per cent of their combined net worth during a four-year period when this stock was held.

(c) A false account showing a balance due the registrant from the accountant was carried on the books to help conceal market operations in the registrant's stock. It also appeared that the accountant knew of a false account and requested and received indemnification against liability from the principal stockholder in the registrant. The accountant permitted the account to be continued for a year following his protests.

(d) Private audit reports submitted to the management differed from the report made public.

(e) The management of registrant and the accountant made substantial loans to one another.

(f) Management and the accountants were fellow members of various civic, fraternal and social organizations, were associated in numerous charity drives, and joined together in signing a bond to secure a mortgage on a clubhouse.

(g) Various personal services were performed by the accounting firm for management in their individual capacities, preparing their personal income tax returns and auditing the books and preparing financial statements of real estate and security holdings of management.

The Commission held that the factors mentioned in (f) and (g) were not necessarily an indication of lack of independence. However, the other factors had considerable probative value upon this issue and the

circumstances of the case. Neither the firm nor the individual partners involved were independent public accountants "within the meaning of our statute and regulations with respect to the financial statements filed by the registrant." Disciplinary action was taken against the accountants in Securities Exchange Act Release No. 3073 (1941).

8. Southeastern Industrial Loan Company, 10 S.E.C. 617 (1941): In a proceeding instituted pursuant to Section 8 (d) of the Securities Act, it developed that the registrant was a segment of a large holding company system with which the accountant was actively associated. The record disclosed that:

(a) The accountant was paid from a pool contributed by all the members of the system.

(b) The accountant was auditor for one of the companies in the system and vice president and director of the entire system.

(c) The accountant had his office located in the same building as two of the companies in the system and had his office rent paid by one of them.

(d) The accountant borrowed money from some of the operating companies in the system.

(e) The accountant performed various acts for the system such as arranging for renewal notes, extending maturity and payments, arranging for refinancing, insurance and printing of stationery, passbooks and stock certificates and distributing funds to various subsidiaries in payment for loans. The Commission held:

"From this mass of facts, only one conclusion is possible: . . . the certified public accountant was not independent as to the registrant or as to any other person or company connected directly or indirectly with the Southeastern system. The registrant was but a segment of the system with which the accountant was actively associated. His close identity with the financial destinies and his personal concern with the managerial policies of the system and its distressed customers were in conflict with the duties of an independent accountant."

9. Kenneth N. Logan, 10 S.E.C. 982 (1942): This was a proceeding instituted under Rule II (e) of the Commission Rules of Practice, to determine whether Kenneth N. Logan, a certified public accountant practicing before the Commission, was lacking either in the requisite qualifications to represent others or in character or integrity, or had engaged in unethical or improper professional conduct. The record in this proceeding shows that:

(a) Logan owned 554 shares of stock in his client, purchased at a total cost of \$10,754.14, which was approximately 8 percent of his net worth. The client had 122,718 shares outstanding.

(b) Logan permitted his name to be used for a deceptive account through which officers of the client traded in the client's stock.

(c) No disclosure was made in any of the financial statements of the trading carried on in that account. The Commission held:

"We think that the record demonstrates beyond question that Logan's conduct in the transactions described herein was grossly improper. We attach great importance to the requirement that financial statements filed with us be certified by independent accountants and that certifications by such accountants state the truth."

10. Associated Gas and Electric Company, 11 S.E.C. 975 (1942): In a proceeding instituted pursuant to Section 19 (a) (2) of the Securities Exchange Act, the record disclosed that:

(a) The accounting firm continually submerged its opinion to that of the registrant about various accounting practices.

(b) The accounting firm failed to make audits sufficiently comprehensive in scope to justify their expressing an opinion as to the financial statements in question.

The question of whether the accountants were independent within the meaning of the Commission rules was not raised in the order or in the hearings, and consequently no finding as to this issue was made. However, the Commission pointed out that "an accountant who consistently submerges his preferences or convictions as to accounting principles to the wishes of his client is not in fact independent."

11. Red Bank Oil Company, Securities Act Release No. 3110, Securities Exchange Act Release No. 3770 (1946): In a consolidated proceeding brought pursuant to Section 8 (d) of the Securities Act and Section 19 (a) (2) of the Securities Exchange Act, it appeared that:

(a) The accounting firm engaged the treasurer and bookkeeper of the registrant to do the detailed auditing work, including the preparation of working papers and draft of financial statements.

(b) The accounting firm engaged another accountant to certify the statements filed with the Commission who did little more than lend his name to the certification.

(c) The accounting firm failed to investigate transactions between the registrant and its parent and affiliates so that there was no disclosure of substantial amounts of receivables and payables which were due from or to the parent and affiliates. The Commission held that:

"The audits for the years under consideration were inadequate and not performed in a manner consistent with generally accepted auditing standards. The issues of independence and scope of audit tend to merge since it is highly doubtful whether an accountant

lacking in independence can ever exercise the objectivity, vigilance and inquisitiveness essential to his task and required by generally accepted auditing standards. . . . Since we have found that the accountants were not independent and that the scope of their audit was inadequate, we further find that the financial statements have not been certified by independent public accountants."

12. F. G. Masquelette & Co. et ano., Accounting Series Release No. 68 (1949): In a proceeding instituted under Rule II (e) of the Commission's Rules of Practice, it appeared that:

(a) The resident partner in charge of one of the offices of the accounting firm conducted an audit and certified a statement valuing a leasehold at \$100,000 which had been acquired for \$15,000, and had been assessed at \$5,250. A note to the balance sheet stated that the values of the leasehold was purely arbitrary and had been acquired at a cost which "exceeded \$2,000."

(b) The balance sheet certified by the firm improperly included various items which had not been verified.

(c) The resident partner of the accounting firm actively participated in the promotion of the registrant.

(d) Although the certificate affixed to the balance sheet stated that the accountants had reviewed the accounting system and procedures of the company, made an audit of the transactions, examined or tested accounting records, and made an examination in accordance with generally accepted auditing standards it appeared that, in fact, the company had no books of account and no accounting system, and had no accounting records other than a few vouchers and rough notes in the accountants' own files.

The Commission found that the certification had not been prepared by an independent accountant and disciplined both the firm and the resident partner who actually made the audit. The Commission overruled the defense asserted by the accounting firm that no disciplinary action was warranted against its branch offices in cities other than the one involved in the proceeding because each branch office was a separate partnership. Some of the partners in the firm were members of every partnership, and no matter what the composition of the firm it used the same firm name in every city.

ACCOUNTING SERIES RELEASES

In addition, six of the Accounting Series releases have dealt, directly or indirectly, with problems which involve the independence of public accountants. They are as follows:

1. Accounting Series Release No. 2 (1937). This is an opinion of the Commission dealing with a case in which a partner in an accounting firm owned stock in a corporation which contemplated registration. The

Commission refused to hold that the firm could be considered independent for the purpose of certifying the financial statements of the corporation.

2. Accounting Series Release No. 22 (1941). This release summarizes several of the opinions of the Commission dealing with the independence of public accountants, discusses the reasons for the requirement that certifying accountants be independent, and rules that indemnification agreements between an accountant and a corporation will prevent the accountant from being recognized as independent.

3. Accounting Series Release No. 47 (1944). This release summarizes a number of those opinions and rulings issued by the Commission and its staff dealing with the independence of public accountants which were issued subsequent to the promulgation of Release No. 22.

4. Accounting Series Release No. 48 (1944). This release contains the opinion of the Commission in a disciplinary action against an accountant who made no audit of the registrant's affairs but accepted without question the financial statements prepared by the registrant's employee. It was held that the accountant was disqualified.

5. Accounting Series Release No. 59 (1947). This release contains the opinion of the Commission in a disciplinary action against a firm of accountants who stated in their certificate that they had audited the books of the registrant in accordance with generally accepted auditing standards when it appeared that, in fact, certain important steps in the auditing procedure had been omitted. Although there is no discussion in the opinion of the question of independence, the requirements of the standard audit are considered in relation to the accountant's obligations to the public.

6. Accounting Series Release No. 67 (1949). This release contains the opinion of the Commission in a disciplinary action against a firm of accountants which certified financial statements without making a physical check of inventories or adequately supervising the audit. The independence of the firm was not challenged but there is a full discussion of the responsibilities of the firm to investors.

7. Accounting Series Release No. 68 (1949). This release contains the opinion of the Commission in a disciplinary action against a firm of accountants and a partner thereof who inflated assets in a balance sheet to which they certified and actively participated in the promotion of the venture in which the registrant was engaged. It was held that in such circumstances the accountants could not be considered independent.

RULINGS OF THE COMMISSION AND ITS STAFF

Summarized below are a number of the informal rulings issued by the Commission or its staff since January 25, 1945, which deal with the independence of certifying accountants. The rulings issued prior to January 25, 1945, have been summarized in Accounting Series Releases 22 and 47.

1. A partner in an accounting firm owned approximately 2% of the preferred stock of a registrant at the time his firm made the audit of the accounts of the registrant. Held, the accounting firm of which this accountant was a partner could not be considered independent for the purpose of certifying the financial statements of the registrant to be filed with the Commission. The sale of such shares subsequent to the completion of the audit did not alter the fact that the firm of accountants was not independent at the time of the audit.

2. In 1937 an accounting firm was held to be lacking in independence with respect to a registrant because a partner in the accounting firm was a director of the registrant. The partner resigned as director and his firm withdrew from the 1937 audit but resumed certification of the registrant's statements for 1938 and subsequent years. In 1944, it was disclosed that the partner in the accounting firm owned 2,153 shares of the registrant of which 963 shares were owned in 1937 and 1,190 shares were acquired in the intervening years. The 2,153 shares represented ownership of 1.025% of the outstanding shares of the registrant. They were carried on the accountant's books at \$15,558 and had a market value of \$27,989. Held, the accounting firm of which this accountant was a partner could not be considered independent for the purpose of certifying the financial statements filed with the Commission.

3. The wives of partners in an accounting firm purchased about one-half of 1% of the outstanding capital stock of the registrant at regular market prices and the funds so invested represented less than 5% of the combined wealth of the partners and wives involved. These shares were held at the time of registration with the Commission. Held, the accounting firm of which these partners were members could not be considered independent for the purpose of certifying financial statements of the registrant filed with the Commission. Held, further, the purchase and sale of a material amount of the registrant's stock by the wives of the partners of the certifying accounting firm during a period immediately prior to registration would adversely affect, if not destroy, the accounting firm's independence. Speculation of this kind in a registrant's stock is incompatible with the maintenance of an objective and impartial viewpoint which is essential to an independent status.

4. In the year of a proposed financing by a registrant, an accountant acquired about 1% of the outstanding shares of capital stock of the registrant for an amount which represented less than 5% of his net worth. After the proposed financing, the shares held by the accountant would have a market value of 10% of his net worth. The accountant had audited the accounts of the registrant for several years prior to the acquisition of the stock. Held, the accountant could not be considered independent for the purpose of certifying financial statements of the registrant for the year in which the stock was acquired or for the two years immediately preceding the year in which the stock was acquired. Held, further, the sale of the stock after the close of the latest fiscal year for which statements are required to be filed would not remedy the situation.

5. The wife of an accountant had a 47-1/2% interest in one of the three principal underwriters of a proposed issue by the registrant.

Held, the accountant could not be considered independent for the purpose of certifying financial statements of the registrant.

6. An accountant who certified the financial statements of a registrant was appointed treasurer of the registrant. Held, the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant filed with the Commission. Held, further, the accountant could not be considered independent for the purpose of certifying the financial statements of another company registered with the Commission, the outstanding shares of which were held in trust by officers of the registrant for the shareholders of the registrant.

7. A partner in an accounting firm had previously been an accountant on the staff of another accounting firm which certified the financial statements of a registrant. While with that firm, the accountant was in charge of the audit of the registrant for 1940 and 1941. On November 1, 1942, the accountant became treasurer of the registrant. He held this position until November 15, 1943. On or about that date, the accountant left the employ of the registrant and organized his own firm which audited the registrant's accounts for 1944. Inquiry was made as to whether in statements to be filed with the Commission the accounting firm of which the former treasurer of the registrant was a partner could certify to the financial statements of the registrant for 1945 and 1944 and refer to the audit made in 1943 by the independent firm, which it was willing to accept. Held, the accounting firm could not be considered independent with respect to the registrant for the purpose of certifying financial statements to be filed with the Commission.

8. In addition to auditing the accounts of a hotel, an accounting firm provided the hotel with the services of a resident auditor, and a food controller who has no control over policies, personnel, or records and is responsible only for gathering statistical data, both of which remained in the employ of the accounting firm. Held, the accounting firm could not be considered independent with respect to the hotel for the purposes of certifying financial statements to be filed with the Commission.

9. A member of the firm of certifying accountants was a director of the registrant, owned stock in the registrant, and was one of the trustees under a testamentary trust which controlled a substantial portion of the stock of the registrant. Inquiry was made as to whether the accounting firm could certify the financial statements of the proposed registrant if the member resigned as director of the corporation, or failing this, whether one of the duly qualified members of the firm could certify if the designation of the accounting firm as accountants for the corporation was cancelled. Held, the accounting firm of which the director was a member and each of the members thereof could not be considered independent for the purpose of certifying the financial statements of the registrant even though the member of the firm resigned his directorship and the accounting firm was not designated accountants for the corporation.

10. From September 1943 until January 31, 1946, a partner in an accounting firm was at all times available for conferences with the registrant on accounting matters. The accountant also exercised some supervisory powers with respect to the corporation's accounting procedures. Held, the accounting firm of which the accountant was a partner could not be considered independent for the purpose of certifying the financial statements of the proposed registrant for the fiscal years ended March 31, 1944, 1945 or 1946 inasmuch as the corporation's accounting procedures were subject to the supervision of the partner acting in the capacity of quasi-controller during part of the 1944 and 1946 years and all of the 1945 year.

11. An accountant was a partner of a registered broker-dealer with a 1% interest in the company. Held, the accountant could not be considered independent for the purpose of certifying the financial statements of the broker-dealer.

12. An accountant was an inactive partner in one firm of accountants, "A", and an active partner in another firm of accountants, "B". The accountant's share of the earnings from firm "A" consisted of an annual payment representing a percentage on his investment. The active partner in firm "A" was formerly the resident manager of an office maintained by an accounting firm which was the predecessor of firm "B". All the partners of "B" were partners in the predecessor firm. The active partner in "A" was a director and owned a small stock interest in the registrant. Inquiry was made as to whether firm "B" could certify the financial statements to be filed with the Commission by the registrant. Held, accounting firm "B" could not be considered independent with respect to the registrant for the purpose of certifying statements to be filed with the Commission. Held, further, the resignation of the active partner of firm "A" as director of the registrant and the sale of his shares in the registrant would not alter the status of firm "B" with respect to the registrant for the period in which he served as director or for any subsequent period if the active partner in "A" had participated in the formation of significant accounting policies persisting beyond the year in which he resigned of such a character as to place firm "B" in the position of auditing his decisions.

13. An accountant who certified to the financial statements of a registrant was the father of the secretary-treasurer of the registrant. The secretary-treasurer was employed by the registrant on a half-time basis. Prior to holding such position, the secretary-treasurer was employed by the registrant as its full-time principal accounting officer. Held, the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant to be filed with the Commission.

14. An accountant certified the financial statements of a brokerage firm in which his brother was a partner. Held, the relationships between the certifying accountant and his brother were such that the accountant could not be considered independent for the purpose of certifying the financial statements of the brokerage firm to be filed with the Commission.

15. A partner in an accounting firm loaned \$600,000 to a former officer of a company which held a significant interest in the registrant. This loan was secured by substantial blocks of stock of the registrant and of an affiliate of the registrant together with options to purchase the shares pledged. The accounting firm of which this partner was a member withdrew from the audit of the registrant. Subsequently, question arose as to whether the accounting firm could certify to financial statements to be filed with this Commission by a subsidiary of the registrant. Held, the accounting firm which was not independent with respect to a parent corporation could not be considered independent with respect to its subsidiary.

16. An accounting firm certified the financial statements of a registered investment company. The stocks and bonds of the registrant were kept in a safety deposit box in a bank and the members of the accounting firm had exclusive custody of the key to the safety deposit box. Held, the accounting firm acting as custodian of the registrant's portfolio securities could not be considered independent for the purpose of certifying the financial statements of the registrant.

17. An accounting firm certified the financial statements of a bank. A partner in the accounting firm acted as representative of the director's examining committee of the bank. In this capacity, he reviewed the loans made by the bank and made reports to the committee with respect to loans requiring special attention. A registrant, which was indebted to the bank for a substantial amount and whose loan had been reviewed by the accountant, intended to issue preferred stock amounting to about 75% of the loan. The preferred stock was to be junior to the bank loan and the proceeds from the sale of the stock were to be used for working capital purposes. The accounting firm of which this partner was a member had been asked to certify the financial statements to be included in the registration statement. Held, the accounting firm of which this partner was a member could not be considered independent for the purpose of certifying the financial statements of the proposed registrant.

18. A partner in an accounting firm which audited registrant's accounts was appointed agent in control of certain buildings by the children of the controlling stockholder of the registrant. In such capacity, the accountant negotiated a lease with the registrant which occupied office space in one of the buildings. The partner in the accounting firm also acted as trustee of a trust of which the wife and children of the controlling stockholder of the registrant were the beneficiaries. Held, the accounting firm of which this accountant was a partner could not be considered independent with respect to the registrant for the purpose of certifying its financial statements to be filed with the Commission.

19. A partner in an accounting firm which certified the financial statements of a registered broker-dealer maintained a cash account with the broker. The accountant effected transactions through the broker and left the securities in his possession. Held, the maintenance of an open account with a broker, represented by cash or securities, or both, by a partner of a certifying accounting firm, casts doubt upon the

independence of the accountant and the firm of which he is a partner with respect to the broker.

20. Two of the partners in an accounting firm certifying the financial statements of a registrant were also partners of a law firm engaged by the registrant to pass upon the legality of the securities which were being registered. Held, the existing relationship was such as to jeopardize the status of the accounting firm in which these individuals were partners with respect to the registrant.

21. A partner in an accounting firm owned an undivided one-third interest in a block of a corporation's stock amounting to approximately 70% of the stock outstanding. The accountant was also an officer-director of the corporation. The accountant's firm did not audit the accounts of the corporation. The block of stock was sold to a registrant, a client of the accountant's firm. The accountant resigned as officer-director of the corporation and the corporation was merged with the registrant. Held, the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant to be filed with the Commission.

22. The bookkeeper-cashier of a registrant entered the armed forces and a junior accountant on the staff of the accounting firm which audited the accounts of the registrant was loaned to the registrant one day a month to perform certain bookkeeping tasks. The following represented the maximum work done in any one month by the junior accountant. He footed the books of original entry, posted to the general ledger, took off trial balances, reconciled bank statements, occasionally made entries in the blotters from company records of purchases and sales, made journal entries for regular monthly accruals, prepared journal entries correcting errors and omissions made by company employees, and prepared and entered closing journal entries at the end of the year at the direction of the registrant. He also prepared balance sheets and profit and loss statements from book figures. Held, the accounting firm of which this junior accountant was a member could not be considered independent with respect to the registrant for the purpose of certifying its financial statements.

23. An accountant certified the financial statements of a registrant which were filed with the Commission. Prior to certification, the accountant posted to the general ledger entries covering a month's transactions and made all the closing entries. Held, the accountant could not be considered independent for the purpose of certifying financial statements filed by the registrant.

24. Members of a firm of certifying accountants set up a registrant's books and maintained them for about six months until the registrant engaged a bookkeeper. Held, the accounting firm could not be considered independent with respect to the registrant for the purpose of certifying its financial statements for the year in which the accountants kept the books.

25. An accountant certified financial statements of securities dealers filed on Form X-17A-5 with the Commission. The accountant was

considering an offer to serve as salesman for one of the securities dealers and inquired as to whether this would affect his independence with respect to dealers other than his prospective employer as to whom he acknowledged his lack of independence. Held, accepting employment as a security salesman would place the accountant in the position of engaging in a line of endeavor incompatible with that of an independent public accountant and would affect his status with respect to certifying financial statements filed with this Commission. In this connection, Rule 4 of the Rules of Professional Conduct of the American Institute of Accountants was cited to the accountant.

26. An accountant who was elected director of a company in which his client held a 30% common stock interest submitted his resignation immediately after he was notified of his election. Inquiry was made as to whether the accountant could withdraw his resignation and, if not, whether his election disqualified him for any period of time. Held, if the client and the company to which the accountant was elected a director were affiliated within the meaning of that term as defined in the General Rules and Regulations under the Securities Act of 1933, then serving as a director of either company would disqualify the accountant from certifying financial statements to be filed with the Commission. With respect to the interval of time during which the accountant served as a director, no question was raised, since it was indicated that the accountant resigned as soon as he was notified of his election and did not participate in a directors meeting or act in that capacity.

27. After the close of the fiscal year October 31, 1946, "A" corporation distributed 250,000 of the 300,000 shares of its wholly owned subsidiary to its shareholders and retained 50,000 shares to use in lieu of cash to discharge some of its obligations. On November 29, 1946, 5,642 shares were given the accounting firm which audited "A" corporation's statements as part payment for fees due it. On December 8, 1947, these shares were sold through a brokerage house for cash. Inquiry was made as to whether the accountant could certify financial statements of "A" corporation for the fiscal year ending October 31, 1947. Held, that since the accountants no longer had any financial or personal interest in either "A" corporation or its former subsidiaries, no question would be raised with respect to the certification. However, in the event of some adverse development in connection with the financial statement filed, the fact that at one time the accountants possessed a financial interest in the corporation would be given further consideration.

28. An accounting firm is paid a retainer for consultation services and to make studies and investigations for a hotel company. Held, the accounting firm may be considered independent for the purpose of certifying the financial statements.

29. From 1940 to September 1946 a partner in an accounting firm was a director of a business corporation and during part of that time served as a member of its executive committee. Inquiry was made as to whether the accounting firm was qualified to certify the financial statements of the firm for the year 1947. Held, that since the audit did not cover any of the time during which the accountant served as a director, no question

would be raised with respect to the certification. However, since the independence of the accountant was a matter of fact, this opinion might be altered if it should develop that the 1947 audit was improperly influenced by the accountant's background of directorship or if any significant accounting policies formulated prior to 1946 persisted beyond that year.

30. A company which was liquidating and held only two blocks of securities had leased for a period not to exceed 18 months one room in a suite of offices held by an accounting firm. The company paid the same rental per square foot as the accounting firm for the remainder of the office space. Inquiry was made concerning the propriety of this arrangement, since the accounting firm certified to the financial statements of the company. Held, arrangements of this type cast doubt upon the independence of the accountant, but in view of the special circumstances of this case the accounting firm would be permitted to certify the company's financial statements.

31. An inspection of a broker-dealer revealed that a member of the accounting firm which certified the financial statements of the broker-dealer also did the bookkeeping work and prepared the financial statements. Held, the accounting firm cannot express an unbiased and objective opinion of work performed by its own staff.

32. An accountant certified financial statements used in a registration statement for the period ending December 31, 1947, under certificate date March 17, 1948. Because of the resignation of the general manager of the company on May 7, 1948, and the general knowledge possessed by the accountant of the company's activities, he was engaged by the directors to reorganize the office and reallocate the duties of the executive personnel. Inquiry was made as to whether the accountant was qualified to certify the financial statements used in the registration statement for the purpose of a post-effective amendment dated June 30, 1948. Held, that the accountants could be considered independent with respect to the financial statements for the period ending December 31, 1947.

33. A partner in an accounting firm responsible for the audit of the financial statements of an oil company and the son of the president of the company jointly acquired a 25 per cent stock interest in an oil equipment company. In connection therewith they obtained a bank loan of \$200,000, signing a joint note and pledging the stock of the oil equipment business as collateral. The president of the oil company indorsed the \$200,000 note and pledged as additional collateral 2,500 shares of the oil company's stock. Inquiry was made as to whether the partner in the accounting firm, who has now resigned from the firm, is qualified to practice before the Commission. Held, that these actions on the part of the accountant prevent his recognition by the Commission as an independent accountant with respect to any financial statements which the oil company has filed or may file covering the period of time when he was a member of the accounting firm which certified those statements.

34. A hotel requested an accounting firm to assign to the hotel one of their senior accountants, experienced in hotel auditing, to make a continuous audit of transactions from day to day. The individual assigned to this work was not to administer the accounting office nor to sign checks of the company, and he would not be required to make any entries in the books of account. The hotel had on its staff another person with the title of chief accountant whose duty it would be to administer the accounting office and to maintain the books of account. Inquiry was made as to whether the accounting firm would be qualified to certify the financial statements filed by the hotel company with the Commission. Held, that under all the circumstances the accounting firm could be considered independent.