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United States. Securities and Exchange Commission

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For Release in MORNING Newspapers of Tuesday, January 25, 1944

SECURITIES AND EXCHANGE COMMISSION
Philadelphia

SECURITIES ACT OF 1933

Release No. 2973

SECURITIES EXCHANGE ACT OF 1934

Release No. 3526

INVESTMENT COMPANY ACT OF 1940

Release No. 615

ACCOUNTING SERIES

Release No. 47

The Securities and Exchange Commission today announced the publication of an additional release in its Accounting Series dealing with the independence of certifying accountants.

Various statutes administered by the Securities and Exchange Commission recognize the necessity of independence on the part of an accountant who certifies financial statements. In administering these Acts the Commission has consistently held that the question of independence is one of fact, to be determined in the light of all the pertinent circumstances in a particular case. For this reason it has not been practicable, and the Commission has made no attempt, to catalog all of the relationships or situations that might prevent an accountant from being independent. However, in Rule 2-01 (b) of Regulation S-X the Commission has indicated certain relationships such as those of officer, director, or employee which it believes are so likely to prevent a completely objective review of the financial statements of a registrant as to preclude its recognizing an accountant occupying such a position as independent.

In addition to summarizing past releases of the Commission on the question of independence, the new release includes a compilation of hitherto unpublished rulings in cases or inquiries arising under the Securities Act of 1933, the Securities Exchange Act of 1934, or the Investment Company Act of 1940. Preparation of this compilation, announced in Accounting Series Release No. 44, was undertaken as a result of a suggestion by representatives of professional accounting societies that knowledge of informal rulings would be of particular assistance to accountants and others interested in determining the circumstances under which a certifying accountant is likely to be considered to be not in fact independent.

The release, prepared by William W. Werntz, Chief Accountant, follows:

"The requirement of the Securities and Exchange Commission that an accountant be in fact independent with respect to a company whose financial statements he certifies is grounded on the conviction that the existence of certain types of relationships between a company and its certifying accountant might bias the accountant's judgment on accounting and auditing matters. Certain relationships between an accountant and his client appear so apt to prevent the accountant from reviewing the **financial** statements and accounting procedures of a registrant with complete objectivity that the Commission has taken the position that existence of these relationships will preclude its finding that the accountant is, in fact, independent. Accordingly, Rule 2-01 (b) of Regulation S-X provides that '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 addition, Accounting Series Release No. 2 indicated that an accountant was not to be considered independent with respect to a particular company when his holdings of the capital stock of that company were substantial in amount and were significant with respect to the company's total capital or the accountant's personal fortune. A test of 1% was suggested in the latter connection. Also, Accounting Series Release No. 22 indicated that an accountant would not be considered to be independent if the company whose financial statements he certified had indemnified him against all losses, claims, and damages arising out of such certification other than as a result of the accountant's willful misstatements or omissions.

"In a number of its *Findings and Opinions* the Commission had occasion to discuss the question of independence in the light of the facts of a particular case. The earlier Commission decisions and releases have been summarized in Accounting Series Release No. 22. Subsequent to the issuance of this release several other decisions involving the question of independence have been issued. In *In the Matter of Southeastern Industrial Loan Company* (Securities Act of 1933, Release No. 2726) it was held that the nature of the business relationships between the accountant on the one hand and the registrant, its parents, and its affiliates on the other were such as to destroy the accountant's independence. In *In the Matter of Kenneth N. Logan* (Securities Exchange Act of 1934, Release No. 3111; Accounting Series Release No. 28) the Commission held an accountant to be not independent where he had a substantial investment in the registrant, the cost of which amounted to about 8% of his net worth, and where he had approved or acquiesced in procedures that were designed to conceal a speculative use to which funds of the registrant had been put. While in *In the Matter of Associated Gas and Electric Company* (Securities Exchange Act of 1934, Release No. 3285A) the question of the independence of the certifying accountants was not raised in the order for hearing and so no finding was made on this point, yet the Commission did state in the course of its discussion 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." Finally, in adopting Rule 2-01 (c) of Regulation S-X, the Commission said in Accounting Series Release No. 37 1/: 'Perhaps the most critical test of the actuality of an accountant's independence is the strength of his insistence upon full disclosure of transactions between the company and members of its management as individuals ...'

"In the case of the great majority of financial statements filed with the Commission no question has been raised as to the independence of the certifying accountant. However, in addition to the formal decisions referred to above there have been many informal rulings in cases arising under the Securities Act of 1933, the Securities Exchange Act of 1934, or the Investment Company Act of 1940. It is not feasible to present adequately in summarized form the circumstances existing in particular cases in which it was determined not to question an accountant's independence. The following compilation therefore includes only representative examples of cases in which an accountant was considered not to be independent with respect to a particular company.

1/ The language of Rule 2-01 (c) was subsequently clarified by an amendment announced in Accounting Series Release No. 44 (1943).

- "1. An accountant held an investment of about \$200,000 in the capital stock of a registrant. This investment constituted about 25% of the accountant's personal fortune and was about 2% of the company's total outstanding capital stock. *Held*, the accountant could not be considered independent for the purpose of certifying the financial statements of this registrant.
- "2. An accountant's wife held a trust certificate issued by an investment trust on which had been paid an amount equal to 3% of the combined personal fortunes of the accountant and his wife. The withdrawal value of the trust certificate was less than \$1,000 and was about 1-1/2% of their personal fortunes. The accountant certified the financial statements of the investment trust as well as the financial statements of the corporation that sponsored the trust. The sponsor had no equity in the assets of the trust, but derived virtually all of its income from its activities as sponsor. *Held*, the accountant could not be considered independent with respect to the investment trust. *Held*, the facts given tended to indicate that the accountant was not independent with respect to the sponsoring corporation.
- "3. An accountant had some years earlier invested a substantial amount of money in securities of a registrant. The fair current value of this investment exceeded 50% of the accountant's personal fortune. *Held*, the accountant could not be considered independent for the purpose of certifying the financial statements of this registrant.
- "4. An accountant had loaned \$5,000 to a registrant. A business associate of the accountant had loaned an additional \$15,000 to the registrant. These loans bore interest and were secured by a 2-1/2% share in the net profits of the registrant. A son of the accountant was an officer of the registrant. *Held*, the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant.
- "5. An accountant had for some time endeavored to persuade a department store that was his client to add a new department to its business. The registrant finally agreed to set up the department provided the accountant would finance the cost thereof. The accountant advanced the necessary funds and the department proved successful. The new department contributed less than 5% of the total revenues of the registrant. *Held*, the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant.
- "6. An accounting firm had rendered services to a registrant for which the registrant had not been able to pay. To guarantee payment of the account the registrant had pledged shares of its own stock. In addition it had given the accountants an option to purchase the pledged securities at the market price existing at the date the option was given. *Held*, the accounting firm could no longer be considered independent for the purpose of certifying the financial statements of the registrant.
- "7. A registrant owned a small percentage of the stock of a sales company that sold some of the registrant's products. The accountant who certified the financial statements of the registrant was the treasurer and one of the stockholders of the sales company. *Held*, if the shares held by the

registrant and the nature of the sales relationship were such as to give the registrant a significant element of indirect control over the sales company, the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant.

"8. A partner in an accounting firm was serving as a member of the board of directors of a registrant. This accountant did not participate in any way in the accounting firm's audit of the registrant. *Held*, the accounting firm could not be considered independent for the purpose of certifying the financial statements of the registrant.

"9. A partner in an accounting firm was serving as a member of the board of directors of a registrant. Another partner in the same accounting firm conducted the audit of the registrant and certified the financial statements in his own name, not the firm name. *Held*, the certifying accountant could not be considered independent for the purpose of certifying the financial statements of the registrant.

"10. A partner in an accounting firm had served on the board of directors of a registrant but had resigned from that position prior to the close of the most recent fiscal year. This accountant had not participated in any way in the accounting firm's audits of the registrant. *Held*, that the accounting firm could not be considered independent for the purpose of certifying financial statements of the registrant covering any period during which a partner of the accounting firm was a director of the registrant.

"11. A partner in an accounting firm was serving as a member of the board of directors of a registrant, having been appointed to that position by a Federal court following a reorganization. *Held*, the accounting firm of which this individual was a member could not be considered independent for the purpose of certifying the financial statements of the registrant.

"12. A partner in an accounting firm was a member of the board of directors of a registrant and was also one of the voting trustees of the registrant's stock. The voting trust had been established at the request of a lending bank that desired thereby to assure continuity of the registrant's management. *Held*, the accounting firm of which this accountant was a member could not be considered independent for the purpose of certifying the financial statements of this registrant.

"13. A partner in an accounting firm was one of three trustees of a voting trust in which shares of preferred stock of a registrant had been deposited. Dividends had not been paid on the preferred stock and it had become entitled to elect a majority of the board of directors. The voting trust had been set up to assure continuity of the existing management, and was in a position to exercise ultimate control over the registrant. *Held*, the accounting firm, of which one of the voting trustees was a member, could not be considered independent for the purpose of certifying the financial statements of the registrant.

"14. The board of directors of a registrant had established an 'operating committee' in which had been vested all powers necessary and appropriate to the supervision of the management of the business. It was intended that the principal duty of the committee would be the making of recommendations to the board of directors. The committee consisted of two members of the board of directors and a member of the accounting firm that regularly certified the financial statements of the registrant. *Held*, neither the individual accountant nor his firm could be considered independent for the purpose of certifying the financial statements of the registrant.

"15. A registrant filed certified financial statements of two subsidiary companies. The financial statements of one subsidiary had been certified by a member of an accounting firm who also served as assistant secretary of the subsidiary. The financial statements of the other subsidiary had been certified by a member of another accounting firm who served as assistant secretary and assistant treasurer of that subsidiary. Neither accountant received any remuneration for serving as officers of these subsidiaries. *Held*, the accounting firms involved could not be considered independent for the purpose of certifying the financial statements of the company in which one of their members served as an officer.

"16. An individual serving as assistant treasurer and chief accountant of a registrant was the son of a partner in the accounting firm that certified the financial statements of the registrant. The son was living with his father at the time. The son served the registrant under the direction and supervision of the treasurer of the company. *Held*, the accounting firm could not be considered independent for the purpose of certifying the financial statements of the registrant.

"17. A senior staff member of an accounting firm was appointed controller of a registrant as successor to a controller who had entered the armed forces of the United States during the war emergency. This employee, who had formerly been in charge of the audit of the registrant, remained on the staff of the accounting firm but relinquished all responsibility for the audit of the registrant, and did no work for the accounting firm in connection therewith. *Held*, the accounting firm could not be considered independent for the purpose of certifying the financial statements of this registrant. *Held*, further, the accounting firm could not be considered independent for the purpose of certifying the financial statements of the registrant if the senior staff member were to leave the employ of the accounting firm and be paid by the registrant, but this arrangement were subject to the understanding among the several parties that upon the termination of the war emergency he would return to the staff of the accounting firm.

"18. The accountant who audited the financial statements of an investment trust had been given office space in the office of the sponsor of the investment trust. The accountant regularly gave advice concerning the internal accounting policies of the trust. The sponsor of the trust had agreed to pay the accountant a stipulated amount per year less whatever the accountant was able to earn from the investment trust and his other clients. *Held*, the accountant could not be considered independent for the purpose of certifying the financial statements of the investment trust.

"19. The accounting firm that certified the financial statements of a particular registrant had in the past followed the practice of drawing up the monthly journal records of the company from underlying documents that had been prepared by the registrant's staff. These journal records were posted to the appropriate ledgers by the certifying accountants. At the end of the year the audit engagement was undertaken by personnel of the certifying accountant that was not connected with the original recording of the accounting data. *Held*, the accounting firm could not be considered independent for the purpose of certifying the financial statements of this registrant.

"20. A small loan company kept its accounting records on a cash basis. The primary records of the company consisted of daily cash reports that were prepared by the cashier and signed by the manager. The accountant who certified the financial statements of this company took no part in the preparation of these basic records. However, he did audit these cash reports each month and then proceeded to enter the totals in a summary record which he in turn posted to the general ledger. The certifying accountant also made adjusting journal entries each month with respect to insurance, taxes, depreciation, and similar items. The company was small and did not require the services of a full-time bookkeeper. The certifying accountant devoted about one day a month to the clerical or bookkeeping tasks described above. *Held*, the accountant could not be considered independent for the purpose of certifying the financial statements of this registrant."