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In the matter of Harmon R. Stone: File no. 4-114: Rule 2(e), Rules of Practice: Findings and opinion of the Commission

United States. Securities and Exchange Commission

(Accounting Series Release No. 97)

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C.
May 21, 1963

In the Matter of HARMON R. STONE File No. 4-114 Rule 2(e), Rules of Practice	FINDINGS AND OPINION OF THE COMMISSION

ACCOUNTING - PRACTICE AND PROCEDURE

Denial of Privilege to Practice Before Commission

Inadequate Audit

Lack of Independence

Where accountant, who certified financial reports of registered broker-dealer filed with Commission, failed to perform various auditing procedures specified in Commission's Minimum Audit Requirements for such reports and failed to comply with generally accepted auditing standards in that he did not properly obtain confirmations of customers' accounts and closed accounts and did not properly balance securities positions or verify securities in transfer, and where he certified financial statement of a mutual fund for periods when company of which he was a principal stockholder and co-manager made loans collateralized by securities to salesmen and customers of broker-dealer which was principal underwriter and a broker for the fund and, through an affiliate, its investment adviser, held, accountant inadequately performed his professional duties and engaged in activities incompatible with required professional independence and his privilege of practicing before Commission will be suspended for period of sixty days.

APPEARANCES:

James E. Dowd, of the Boston Regional Office of the Commission, for the Office of the Chief Accountant of the Commission.

Jason M. Poster, of Poster, Wilinsky and Goldstein, for respondent.

By COHEN, Commissioner:

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These are proceedings under Rule 2(e) of our Rules of Practice 1/ to determine whether Harmon R. Stone, a certified public accountant

1/ 17 CFR 201.2(e). That Rule provides, in pertinent part, that this Commission may "deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is (Continued) with offices in Chestnut Hill, Massachusetts, should be denied, temporarily or permanently, the privilege of appearing or practicing before us.

The order for proceedings alleges that Stone inadequately performed his professional duties and engaged in improper professional conduct. It states that in connection with the preparation and certification of four financial reports of Keller Brothers Securities, Co., Inc. ("Keller"), a registered broker-dealer, 2/ during the period April 30, 1957 to June 30, 1960, Stone failed to comply with certain of the Minimum Audit Requirements set forth in the instructions to our Form X-17A-5 applicable to such reports and with generally accepted auditing standards. It also recites that between February and May 1961, Trinity Investment Company ("Trinity"), a finance company located in Stone's offices and of which Stone was one of three stockholders and an officer and co-manager, made loans to customers and employees of Keller collateralized by securities.

Stone filed an answer admitting the allegations in the order but stating that he prepared and certified the Keller statements in good faith in the belief he had complied with all applicable requirements. In lieu of a hearing he submitted various statements and affidavits as to his character and professional competence, and he waived post-hearing procedures. He further stipulated that we may also consider any relevant and material information reported to us by our staff and may, on the basis of such information, the allegations in the order, and his answer, conclude that he performed his professional duties in an inadequate manner and engaged in improper professional conduct within the meaning of Rule 2(e).

On the basis of Stone's admissions, prior testimony given by him to the staff in connection with an investigation of Keller, and the other material submitted to us, we make the following findings:

Stone has been a certified public accountant since 1950 and has been a sole practitioner at least since 1954. He had performed accounting services for Keller from its inception in 1956 and for a predecessor partnership which had commenced business in 1954. In addition to certifying to Keller's financial statements he was at all times available to Keller and its bookkeeper for accounting advice and also performed monthly audits which consisted primarily of reconciling the bank statements and preparing financial statements for management purposes. He was also the certifying accountant for Mutual Securities Fund of Boston, a registered investment company of which Keller was the distributor and for which Keller through an affiliate provided investment advice until around the middle of 1961.

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1 contd./

found by the Commission after notice of and opportunity for hearing in the matter (1) not to possess the requisite qualifications to represent others, or (2) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct."

2/ Keller and Herman J. Keller, its vice-president, were permanently enjoined from violating the anti-fraud and net capital provisions of the Securities Exchange Act of 1934, and receivers were appointed to administer their assets. S.E.C. v. Keller Brothers Securities Co., Inc., D. Mass., Cal. No. 61-367, May 5, 1961, October 6, 1961.

Inadequacy of Audits

Stone's certificates to the Keller financial statements which were filed with us on Form X-17A-5 recited that his examination of Keller's records was made in accordance with generally accepted auditing standards, and included tests of accounting records and other auditing procedures considered necessary in the circumstances and a review of the procedures followed for safeguarding the securities of customers. However, in all four audits - all of which were performed in the same manner - Stone omitted many of our specific audit requirements and failed to comply with generally accepted standards and procedures followed by independent accountants in audits of broker-dealers.

Stone did not properly obtain confirmations of customers' accounts or of closed accounts. Although he requested all customers whose accounts showed money balances at the audit date to report any discrepancies in such balances ("negative confirmation"), he did not request any confirmation as to the securities shown in these accounts. In addition, no requests for confirmation were sent to customers whose accounts showed a zero money balance, even though such accounts contained securities, or whose accounts had been closed since the previous audit. The Minimum Audit Requirements applicable to our Form X-17A-5 require that written acknowledgements ("positive confirmation") of the accuracy of the money balances, securities positions, and open contractual commitments other than uncleared regular way purchases and sales, be obtained with respect to all accounts with customers. Generally accepted auditing standards and procedures applicable to the audit of a broker-dealer require that ordinarily accounts closed out during the period since the last audit be confirmed by direct correspondence with the customer on a test basis. 3/ These positive confirmations not only serve the purpose of establishing the accuracy of the money balances receivable and payable but also of the amount of securities in customers' accounts.

The audit procedures followed by Stone in his examination of Keller's securities record 4/ were also inadequate in that he failed to properly balance the securities positions. He prepared a list of securities quantities from the short positions of the securities record showing items in physical possession, safekeeping and transfer, and purchased but not yet received from sellers. His verification consisted of physically counting securities in Keller's office and requesting positive written confirmation of the purchased but unreceived items. He did not prepare a comparable list of the long securities positions of the securities record or compare the short and long securities positions with the securities reflected in the customers' accounts. Our Minimum Audit Requirements call for balancing of positions in all securities and commodities as shown by the books and records. In verifying the securities positions it is essential to verify the accuracy of all classes and designations of both long and short positions.

3/ Audits of Brokers or Dealers in Securities. American Institute of Accountants (1956), pp. 30-31.

4/ The securities record, or position record, is maintained in securities quantities only and consists of a separate sheet for each security traded by the broker-dealer, showing separately the location of or responsibility for the security (short position) and the ownership or right to possession (long position).

In addition Stone failed adequately to verify securities in transfer in that he did not obtain written confirmation of securities in the hands of transfer agents at the audit date. He asserted that items in transfer had been verified by examination at a later date during the course of the audit after they had been received at Keller's office, but the circumstances do not indicate that the application of this procedure of verifying securities in transfer was an acceptable alternative to the written confirmations. 5/

Stone's audits with respect to the Keller financial statements thus omitted many specifically required and basic procedures. Generally accepted auditing standards require that the independent accountant first take physical control, preferably at an unannounced time, of all cash, securities and other transferable evidence of ownership, and maintain such control until those items are inspected, counted and compared with the records. The auditor must then perform additional verification procedures including the balancing of the securities record and obtaining positive confirmation of customers' accounts and of securities in the hands of others such as those in transfer. The latter steps are necessary for the adequate verification of accounting records which reflect location and ownership of the assets which are inspected and counted. Stone's failure to properly perform these latter audit procedures negated the effectiveness of his audits with respect to Keller. 6/ His audit fell far short of the objective review required for the purpose of safeguarding funds and securities of customers and failed to give the public the protection which an audit is designed to achieve. Stone's certificates stating that his examinations were made in accordance with generally accepted auditing standards were accordingly false and misleading.

Dealings with Keller's Salesmen and Customers

We have also given consideration to the effect on Stone's status as an independent accountant of the loan transactions executed by Stone on behalf of Trinity with Keller's salesmen and customers in the period between February and May 1961. The loans were collateralized by securities and arranged through one of Keller's salesmen, who was paid a commission of 20% of the interest charged the borrower. 7/

The financial report of June 30, 1960 certified by Stone was the last report filed with us by Keller because Keller was placed in receivership in May 1961. However, at the time of the Trinity loan transactions Stone was performing the same accounting services for Keller and Mutual that he had previously performed. In the case of Mutual, Stone's selection as an independent public accountant was made on a year-to-year basis, and was ratified annually by vote of the

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5/ See Audits of Brokers or Dealers in Securities, supra, pp. 25-26.

6/ In the case of Stone's audits of Mutual Securities Fund of Boston, he verified securities positions and other items by inquiries to the Fund's custodian bank, which supplied the information from its records, and we find no inadequacy in those audits.

7/ Trinity made loans to other debtors, but did not make loans collateralized by securities to customers or employees of any broker-dealer other than Keller.

shareholders pursuant to the requirements of Section 32(a) of the Investment Company Act. Stone certified Mutual's financial statements for periods when the loans were outstanding and has continued to do so up to the present time. 8/ As has been noted, Keller and its affiliate acted as Mutual's distributor and investment adviser, and Keller's president was a member of Mutual's board of trustees.

By virtue of the Trinity loans Stone, as a principal stockholder of Trinity, assumed a relationship with Keller which was inconsistent with his position as an independent accountant. Independence requires avoidance of any relationship which might impair objectivity as an auditor, including material financial relationships with officers or employees of the client. 9/ Stone acquired a personal financial stake in the repayment of the Trinity loans by the borrowing Keller salesmen and customers. He thus had an interest in Keller's continued operation and solvency, on which the repayment of the loans by those persons might have been dependent. He also had an interest in the securities collateral, which was being delivered from and to Keller in connection with the loans. Keller, in turn, had material transactions with, and interests in, Mutual by virtue of the underwriter's sales charges it received in connection with the sale of Mutual shares as well as brokerage commissions earned in connection with the purchase and sale of securities on behalf of Mutual. Keller's affiliate also received investment advisory fees from Mutual and Keller's president received trustee's fees, both of which were determined on the basis of the value of Mutual's net assets. 10/

Under the circumstances Stone's activities on behalf of Trinity were incompatible with his role as independent accountant. Although the receivership prevented Stone from certifying Keller's financial statements subsequent to the Trinity transactions, he admitted that he still considered himself the auditor of record for Keller. Stone's continuance of this relationship as a public accountant for Keller was not in accord with the ethics of the profession. 11/ Moreover, his

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8/ Mutual's prospectuses filed with us both before and after May 1961 contain financial statements certified by Stone under the caption "Report of Independent Certified Accountants."

9/ See C.P.A. Handbook (1952), Ch. 5, pp. 19-20 which states that a certified public accountant should "avoid any financial relationship with officers or employees of client corporations, in the form of borrowing or lending, or participation in the profits of investments, or in any similar manner." See also Codification of Statements on Auditing Procedure, American Institute of Accountants (1951), p. 8: "to be recognized as independent, /the auditor/ must be free from any obligation to or interest in management, owners, creditors - or others entitled to rely on his report - which might influence his judgment as to the fairness of the financial statements."

10/ The financial statements in Mutual's annual report to stockholders filed with us in May 1961, which were certified by Stone, include items of investment advisory and trustee's fees paid in the period ending April 28, 1961.

11/ Rule 4 of the Rules of Professional Conduct of the American Institute of Certified Public Accountants provides that "A member shall not engage in any business or occupation conjointly with that of a public accountant, which is incompatible or inconsistent therewith."

certification of Mutual's financial statements during the period of these loans deprived mutual's shareholders of the protections afforded by an independent examination of the fund's financial condition as contemplated by the Investment Company Act and our Regulation S-X. In our opinion it constituted improper professional conduct.

Conclusions

Stone has been a certified public accountant in Massachusetts since 1950. Apart from these proceedings there is no evidence that his professional conduct has ever been questioned, and he has submitted statements from a large number of persons who attest as to his character and competence in other accounting work. We do not believe that our findings in these proceedings raise a basic question as to his personal integrity. In this connection we note that Stone responded to our staff's examination into this matter with full cooperation and candor. However, we also cannot condone the serious discrepancies between proper auditing standards and the procedures Stone utilized in the audit of Keller's accounts. Accordingly, we conclude that he should be denied the privilege of practicing before us for a period of 60 days.

An appropriate order will issue.

Chairman CARY and Commissioners WOODSIDE, FREAR, and WHITNEY join in the above opinion.

Orval L. DuBois
Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION
May 21, 1963

In the Matter of HARMON R. STONE Rule 2(e), Rules of Practice (File 4-114)	ORDER DENYING PRIVILEGE OF PRACTICING BEFORE COMMISSION

Proceedings having been instituted pursuant to Rule 2(e) of the Commission's Rules of Practice to determine whether Harmon R. Stone, a certified public accountant, should be denied, temporarily or permanently, the privilege of practicing before the Commission;

Respondent having filed an answer admitting the allegations in the order for proceedings, submitted a stipulation and waived a hearing and other procedural steps;

The Commission having this day issued its Findings and Opinion, on the basis of said Findings and Opinion

IT IS ORDERED, pursuant to Rule 2(e) of the Rules of Practice, that Harmon R. Stone be, and he hereby is, denied the privilege of practicing before the Commission for a period of sixty days from the date hereof.

By the Commission.

(Entered on the date first noted above.)

Orval L. DuBois
Secretary