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# Independence of certifying accountants - Compilation of representative administrative rulings in cases involving the independence of accountants

United States. Securities and Exchange Commission

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For IMMEDIATE Release Thursday, December 11, 1958

SECURITIES AND EXCHANGE COMMISSION  
Washington 25, D. C.

SECURITIES ACT OF 1933

Release No. 4002

SECURITIES EXCHANGE ACT OF 1934

Release No. 5829

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

Release No. 13877

INVESTMENT COMPANY ACT OF 1940

Release No. 2801

ACCOUNTING SERIES

Release No. 81

INDEPENDENCE OF CERTIFYING ACCOUNTANTS - COMPILATION  
OF REPRESENTATIVE ADMINISTRATIVE RULINGS IN CASES  
INVOLVING THE INDEPENDENCE OF ACCOUNTANTS

The Securities and Exchange Commission today announced the publication of an additional release in its Accounting Series dealing with independence of accountants. This release, which summarizes cases in the Commission's experience under the independence rule 1/ since the publication of Accounting Series Release No. 47 on January 25, 1944, together with prior releases and Commission decisions reflects the development of policy regarding the practice of accountants before the Commission over a period of some twenty-five years. See Appendix.

The various laws administered by the Commission either require or give the Commission power to require that financial statements filed with it be certified by independent accountants, and with minor exceptions the Commission's rules require that such statements be so certified. The concept of independence was well developed and the value of a review by independent accountants who are in no way connected with the business was established before the passage of the first Act now administered by the Commission--the Securities Act of 1933.

The passage of the Securities Act, however, is an important landmark in the development of the concept of the responsibility of the independent accountant to the investor and the public. The original draft of the Securities Act did not require certification by independent accountants. A representative of the accounting profession appeared at the hearings on the bill before the Committee on Banking and Currency of the United States Senate to suggest revisions of the bill. 2/ He pointed out that the bill as drafted imposed "highly technical responsibilities upon the Commission as to accounting principles, their proper application and their clear expression in financial

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1/ Rule 2-01 of Regulation S-X.

2/ Statement of Col. A. H. Carter, President of the New York State Society of Certified Public Accountants, before the Committee on Banking and Currency, United States Senate, 73d Congress, 1st Sess., on S. 875, p. 55.

statements," and suggested the bill be revised to require that "the accounts pertaining to such balance sheet, statement of income and surplus shall have been examined by an independent accountant and his report shall present his certificate wherein he shall express his opinion as to the correctness of the assets, liabilities, reserves, capital and surplus as of the balance sheet date and also the income statement for the period indicated."

The committee considered at length the value to investors and to the public of an audit by accountants not connected with the company or management and whether the additional expense to industry of an audit by independent accountants was justified by the expected benefits to the public. The committee also considered the advisability and feasibility of requiring the audit to be made by accountants on the staff of the agency administering the Act.

In the report on the bill the Senate committee stated that it was intended that those responsible for the administration and enforcement of the law should have full and adequate authority to procure whatever information might be necessary in carrying out the provisions of the bill, but it was deemed essential to refrain from placing upon any Federal agency the duty of passing judgment upon the soundness of any security. 3/ The proposal to require certification by independent public accountants was incorporated in the bill as passed.

The requirement that industry furnish financial statements certified by independent accountants imposes upon the Commission the responsibility of ascertaining whether audits pursuant to its requirements are made by qualified independent accountants. Rule II (e) of the Commission's Rules of Practice and Rule 2-01 of Regulation S-X reflect this concern. Under Rule II (e) the Commission may disqualify, and deny, temporarily or permanently, the privilege of appearing or practicing before it to any accountant who is found by the Commission after hearing in the matter not to possess the requisite qualifications to represent others; or to be lacking in character or integrity; or to have engaged in unethical or improper professional conduct. These proceedings are conducted privately and may or may not result in a published opinion. They have been rare. Day-to-day problems arising under Rule 2-01 of Regulation S-X are largely concerned with determining whether particular relationships are of a nature which would prejudice the independent status of an accountant with respect to a particular client.

In administering Rule 2-01 the Commission has not attempted to set up objective standards for measuring the qualifications of accountants other than requiring that they be in good standing and entitled to practice as independent accountants in their place of residence or principal office. However, it is expected that they will have adequate technical training and proficiency and will conduct their audit in a workmanlike manner in accordance with generally accepted auditing standards. 4/ Rule II (e) of the Rules of Practice recognizes that ethical and professional responsibility is founded upon character and integrity.

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3/ Senate Report No. 47, 73d Congress, 1st Sess., p. 2.

4/ See Rule 2-02 of Regulation S-X.

As stated in Accounting Series Release No. 47, 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, but it has not been practicable to identify all of the circumstances which might prevent an accountant from being independent. However, in Rule 2-01 (b) of Regulation S-X, as recently revised 5/ to recognize the increasing complexities in the business world, the Commission has stated that ". . . an accountant will be considered not independent with respect to any person or any of its parents or subsidiaries in whom he has, or had during the period of report, any direct financial interest or any material indirect financial interest; or with whom he is, or was during such period, connected as a promoter, underwriter, voting trustee, director, officer, or employee." In connection with this revision practicing accountants indicated that an interpretive release similar to Accounting Series Release No. 47 would be a helpful guide to the profession. This release therefore summarizes previously unpublished rulings on independence which have arisen under the several Acts administered by the Commission. A finding in a particular case that an accountant is not independent under our rules does not necessarily reflect on his professional standing or qualification to serve other registrants with the Commission.

In Accounting Series Release No. 47 it was said that it was 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 growth of the accounting profession since 1944 and the number of inquiries received from public accountants unfamiliar with the rules suggest the need for publication of rulings in this category.

Administrative rulings in this area have been reviewed and there are stated briefly herein the relationships which existed in select cases where an accountant was not denied the right to certify the financial statements because under the circumstances it was concluded that the independence of the accountant was not prejudiced. It is emphasized that these rulings were made after taking into consideration all known relevant circumstances and under changed circumstances the relationships stated in some of these examples could be disqualifying. Appropriate procedure in all cases where any doubt exists is to discuss the facts with the staff.

The following examples have been selected as representative of administrative rulings in specific cases:

**NOT INDEPENDENT**

Representative situations in which accountants have been held to be not independent with respect to a particular client:

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5/ Accounting Series Release No. 79, April 8, 1958.

I. Relationships Specified in Rule 2-01 (b) of Regulation S-X

A. Financial Interest

1. An accountant took an option for shares of his client's common stock in settlement of his fee. The option subsequently appreciated in value. The question of independence arose in connection with a proposed merger and application for listing on a national securities exchange.
2. Chartered accountants for a proposed registrant, a foreign corporation, owned a stock interest in the company.
3. Company A proposed filing a registration statement for a securities issue, part of the proceeds of which were to be used to acquire the assets of Company B. The certificate of the accountants of Company B could not be accepted for inclusion in the registration statement because a partner of the firm owned stock of Company B.
4. Using their own funds, the wives of partners in an accounting firm purchased stock in a client of the firm immediately prior to registration.
5. Shares of stock in a proposed registrant held by an accountant's wife had originally been received by him in settlement of his audit fee.
6. Partners and staff members of a small accounting firm which had certified the financial statements included in a registration statement subsequently acquired shares of stock of the registrant. They were denied the privilege of certifying subsequent financial statements to be included in a post-effective amendment to the registration statement.
7. An interpretation was given that the S.E.C. does not recognize a difference between a corporation and a registered investment company which would permit the ownership of shares in the latter by the accountant certifying its financial statements filed with the Commission.
8. After the issuance of an offering circular, some partners of the accounting firm which had certified the financial statements acquired shares of the company. In connection with a subsequent listing application the registrant was advised that the accountants had lost their independent status.

B. Director, Officer, Employee

9. From the time of organization of a proposed registrant in November 1952 until July 1954, an accountant served as assistant treasurer, comptroller and director with the responsibility of keeping the

accounts of the company and also acted as co-signer of checks. He also owned shares of the registrant's common stock. In July 1954 arrangements were made for an issue of securities. Even though the accountant severed his affiliation with the company as officer and director and made a gift of his shares of stock to his daughter, his certificate was not acceptable.

10. A partner in the firm of certifying accountants was a director of a proposed registrant, a stockholder, and a trustee of a testamentary trust which controlled a substantial portion of the registrant's stock. Even though he were to resign as director and trustee and dispose of his stock interest, the accounting firm could not be considered independent in connection with the proposed registration. It was also held that another partner of the accounting firm acting individually and apart from the firm could not be considered independent.

11. A partner in an accounting firm acted as controller and exercised some supervisory powers with respect to the proposed registrant's accounting procedures.

12. Financial statements for the first two years of the three-year period required to be included in a registration statement had been certified by an individual practitioner who gave up his practice to become an executive of the registrant.

## II. Other Relationships and Conditions Resulting in Lack of Independence

13. An accountant who certified the financial statements of a registrant was the father of the secretary-treasurer of the registrant who was employed by the registrant on a half-time basis. Prior thereto, the secretary-treasurer had been employed by the registrant as its full-time principal accounting officer.

14. The wife of a partner of the accounting firm certifying the financial statements of an investment company was secretary-treasurer of the company.

15. A partner of an accounting firm was the brother of the holder of 50 per cent of the stock of proposed registrant. The accountant was also counsel for the company, and his wife held \$35,000 of its preferred stock. The audit of the registrant's accounts was to be made by a branch office of the accounting firm in which the partner had only a financial interest.

16. The wife of the accountant who had certified the financial statements of a proposed registrant was the sister of the widow of the founder of the company. The widow had inherited 60 per cent of the company's stock from her husband and her son 10 per cent.

17. An accounting firm which certified the financial statements of a registered investment company had exclusive custody of the key to the company's safe deposit box. Under these conditions the accountants were acting as custodian of the securities portfolio and were in the position of auditing their own work.

18. An accountant and five persons who were the sole stockholders of the proposed registrant acquired a parcel of real estate for the purpose of selling or leasing it to the company. The total purchase price was \$85,000, of which \$26,000 was paid in cash and the balance by a note secured by a mortgage. In addition to providing his portion of the cash payment, the accountant loaned the others \$21,000 on interest bearing notes to cover their share of the down payment. It was also provided that the accountant would receive 25 per cent of any profit arising from sale of the property to an outsider.

19. A certifying accountant, together with certain officers of the registrant, organized a corporation which purchased property from the registrant for \$100,000, giving the registrant \$25,000 cash and a purchase money mortgage for \$75,000.

20. Accountants were advised that they would lose their independent status if a trust created by partners and their wives purchased a building occupied by a client under a 21-year lease. The building was owned by an unrelated person and the transaction would have involved a substantial sum of money.

21. The partners of an accounting firm were considering investing in a finance company which operated a wholly-owned insurance agency to arrange insurance on the property financed. It was contemplated that a substantial part of such insurance would be placed with an insurance company client of the accounting firm. They were advised that if the insurance was so placed they would not be considered independent with respect to their client.

22. Two of the partners of the 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.

23. A certified public accountant who was also a lawyer practiced both professions as a partner in separate accounting and law firms. Both firms were approached by an investment company to accept engagements in their respective fields.

24. 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.

25. A partner of an accounting firm acted as one of three executors of the will of a principal officer of a registrant and as one of three trustees of a trust established under the will. The principal asset of the trust was a substantial proportion of the voting stock of the registrant.

26. A partner in an accounting firm which audited registrant's accounts was appointed agent in control of certain buildings by the trustee for 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 for the benefit of the wife and children of the controlling stockholder.

#### NO ACTION

Representative situations in which accountants have not been held to be not independent with respect to a particular client:

#### I. Relationships Specified in Rule 2-01 (b) of Regulation S-X

##### A. Financial Interest

27. A large national accounting firm had certified the financial statements covering the first eight years of a ten-year summary of earnings to be included in a registration statement. Another firm of accountants certified the last two years. At the time of their last certificate, two years earlier, there was no indication that the former firm was not in full compliance with the independence rule. It was deemed unnecessary for the firm to circularize the partners to determine whether any had subsequently acquired stock in the registrant.

28. Members of an accounting firm acquired shares of stock of a company controlled by one of their clients, an individual. The accounting firm had never done any work for the company. Upon being engaged to certify financial statements of the company in connection with a proposed registration, they immediately sold their holdings.

29. An accounting firm was held to be not independent because the wife of a partner owned stock in the registrant which had been acquired out of community earnings, and another accounting firm was engaged to audit the years in question. The wife disposed of the stock, and the firm was told that no objection would be raised to their certifying in subsequent years.

30. An accounting firm and the individual practitioner who preceded it had audited the accounts of proposed registrant since 1949. At



various times between 1954 and 1957 a partner and an employee on the audit each acquired small amounts of issues of debenture bonds and subordinated notes. The securities held by these persons were redeemed by the company in August 1957 prior to certification of financial statements to be used in a proposed registration statement.

31. The following interpretations of the independence rule were given to an accounting firm which submitted two hypothetical situations:

- (a) Company A proposed to file a registration statement and merge with or acquire Company X, which has been entirely independent of Company A. Financial statements of each company certified by different accounting firms were to be included in the registration statement.

In this situation if partners of the firm of accountants for Company X had a financial interest in Company A, that accounting firm could be considered independent for the purpose of certifying the statements of Company X to be included in a registration statement filed by Company A. This conclusion assumes that Company A's shares are widely held and the partners' interest is similar to any public investor's. A different conclusion would be indicated if the partners of the accounting firm were in a position to influence the action of Company A.

If Company X were to continue as a subsidiary of Company A, the accounting firm would not be considered independent for subsequent audits unless the partners of the firm promptly disposed of their financial interest in Company A.

- (b) In a situation similar to that described above, the accounting firm which had certified the statements of Company A generally would have no knowledge of the investments of its partners in non-client corporations such as Company X. In some large national accounting firms the determination of such holdings can be a time-consuming and burdensome task. Under these circumstances Item 24 of the requirements of a registration statement under the Securities Act of 1933 (disclosure of relationships between registrant and experts whose opinions are included in the registration statement) may be answered in the negative with a disclaimer of knowledge as to whether or not the certifying accountants of Company A had any interest in Company X.

**B. Director, Officer, Employee**

32. A partner of an accounting firm was a director and member of the executive committee of a company for six years. In the year following his resignation the firm was engaged to certify the company's financial statements, but the audit did not cover any of the time during which the accountant served as a director.

33. A partner of an accounting firm who held shares of a registrant's stock was elected a director. Eight days later he was notified of his firm's appointment as accountants for the current year. He never attended any meetings of the Board of Directors and did not participate in the selection of his firm. Upon being notified of the appointment of his firm as accountants he immediately resigned his directorship and sold his stock.

34. Company A acquired Company B in January 1955. Financial statements of Company A for years ended June 30, 1954 and prior and financial statements of Company B for the year ended July 31, 1952 had been certified by accounting firm X. Financial statements of both companies for subsequent years were certified by accounting firm Y. After completion of the last audits of the respective companies by accounting firm X, a partner of that firm became a director of each company. The statements certified by accounting firm X were accepted for inclusion in a registration statement of Company A because the accountants were independent at the time of their certification and more recent audits were made by accounting firm Y.

35. An accountant had certified the financial statements of a prospective registrant for twelve years prior to its consolidation with another company in February 1957. After completion of the 1956 audit his services were terminated. At the time of certification he was independent in all respects. In May 1957 the accountant was elected to the Board of Directors and thereafter purchased shares of the common stock of the company. Late in 1957 the company proposed filing a registration statement which would include certified financial statements of the last three years examined by the accountant and a subsequent period to be certified by another accountant.

36. An accounting firm took into its partnership an individual who had been vice president and comptroller of one of their clients. The individual's resignation from the registrant and affiliation with the accounting firm would occur subsequent to the filing of the registrant's annual report on Form 10-K but before the designation of auditors for the current fiscal year. Although he would be a general partner, sharing in income from all sources, he would have no part in any work done for the client-registrant and would not be located in the same city as the client's head office.

II. Other Relationships and Conditions Prompting Inquiries as to Independence

37. Registrants A and B each own 50% of the outstanding stock of Company C, but are otherwise not related. The accounting firm which audits Registrant A would not be disqualified because of ownership of a small number of shares of stock of Registrant B. However, the accounting firm which audits Company C would not be considered independent if any of its partners had an interest in either Registrant A or B.

38. Partners in an accounting firm owned stock in a company in which a substantial minority interest was owned by a client. Both companies were large and their securities were listed on a national securities exchange.

39. One of two partners of an accounting firm formed in February 1955 and dissolved in February 1956 became secretary-treasurer of a company in July 1955. He retained no interest in the partnership. The accounting practice was continued by the other partner who was engaged to make a first audit of the company in June 1956.

40. An accountant was co-executor of an estate which held approximately 15% of the outstanding shares of stock of a registrant. He had audited registrant's accounts for several years prior to the latest fiscal year. Another accountant had been engaged to certify the financial statements of the latest year for inclusion in a registration statement. The estate was being terminated and the registrant proposed engaging the accountant as auditor for subsequent years.

41. A staff member who had prepared financial statements for a mining company in the development stage and had participated in the audit was offered a position as an officer prior to the filing of a registration statement. Acceptance of the position by the staff member would not of itself destroy the independence of the accounting firm in connection with the proposed registration statement.

42. Accountants had installed an accounting system and prepared tax returns for a registrant prior to being engaged to certify financial statements to be included in a registration statement.

43. In addition to certifying the financial statements of a registrant, the accountant reviewed certain transactions of prior years, prepared fixed asset subsidiary ledgers, prepared the annual report to the state of incorporation, made recommendations for adjustments, and when consulted gave his professional opinion on the accounting treatment of particular transactions.

44. Due to the unexpected resignation of registrant's comptroller at the end of the year, the accountant was called upon to provide assistance in closing the books for the year. The work performed did not involve making decisions on a managerial level.

45. Following the death of the registrant's bookkeeper, an accounting firm posted the general ledger from the books of original entry and prepared periodic financial statements for the last eight months of the fiscal year. Registrant's bookkeeping staff had full charge of accounting journals and subsidiary ledgers and recorded all transactions. Financial statements certified by the accounting firm were accepted, but the accountants were advised to discontinue the bookkeeping services immediately.

46. A company operating hotels requested an accounting firm to assign to a 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 or 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.

#### BROKER-DEALER REPORTS

The revision of the broker-dealer reporting requirements effective November 15, 1957, 6/ requires that all but a limited number of these reports be certified by independent accountants. Certification is required primarily in the interest of safeguarding the funds and securities of customers and consequently a more detailed audit is required than that ordinarily made in a regular annual audit of a commercial or industrial company for preparation of the annual report to security holders.

The following are examples of representative situations in which an accountant has been held to be not independent with respect to a broker-dealer client:

47. A partner of the accounting firm which certified the financial statements of a registered broker-dealer was a partner in the registrant.

48. An accountant certified the financial statements of a brokerage firm in which his father and uncle were officers and owners of substantially all the outstanding stock.

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6/ Securities Exchange Act of 1934 Release No. 5560.

49. An accountant certified the financial statements of a small brokerage firm in which his brother was a partner.

50. An accounting firm which had certified the financial statements of a registered broker-dealer for several years took the son-in-law of an officer of the registrant into their partnership.

51. A partner of the accounting firm which had certified the financial statements of a registered broker-dealer loaned securities to a partner of the registrant. The latter was the brother-in-law of the accountant. The securities were put in the firm's capital account and were used as part of the collateral securing a bank loan.

52. An accountant certified financial statements filed with the Commission by securities dealers. While considering an offer to serve as salesman for one of the securities dealers he 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. He was advised that accepting such employment would place him in the position of engaging in a line of endeavor incompatible with that of an independent public accountant.

53. An accountant certifying the financial statements of a registered broker-dealer was a co-signer on the broker's indemnity bond.

54. An accounting firm was advised that the effecting of cash transactions in securities with a broker-dealer client ordinarily would not be cause for questioning its independence with respect to such client. However, if as a result of such transactions a partner becomes indebted to the broker-dealer or becomes a creditor of the broker-dealer by leaving funds or securities on deposit, then the independent status of the accounting firm becomes questionable.

## APPENDIX

Principal References Concerning the Practice of Accountants Before  
the Commission

## OPINIONS AND ORDERS OF THE COMMISSION

- Cornucopia Gold Mines, 1 SEC 364 (1936)
- American Terminals and Transit Company, 1 SEC 701 (1936)
- National Boston Montana Mines Corporation, 2 SEC 226 (1937)
- Rickard Ramore Gold Mines, Ltd., 2 SEC 377 (1937)
- Metropolitan Personal Loan Company, 2 SEC 803 (1937)
- Interstate Hosiery Mills, Inc., 4 SEC 706 (1939)
- A. Hollander & Son, Inc., 8 SEC 586 (1941)
- Abraham H. Puder and Puder and Puder, Securities Exchange Act of 1934  
Release No. 3073 (1941)
- Southeastern Industrial Loan Company, 10 SEC 617 (1941)
- Kenneth N. Logan, 10 SEC 982 (1942) (Accounting Series Release No. 28)
- Associated Gas and Electric Company, 11 SEC 975 (1942)
- C. Cecil Bryant, 15 SEC 400 (1944) (Accounting Series Release No. 48)
- Red Bank Oil Company, 21 SEC 695 (1946)
- Drayer-Hanson, Incorporated, 27 SEC 838 (1948)
- Cristina Copper Mines, Inc., 33 SEC 397 (1952)
- Coastal Finance Corporation, 37 SEC 699 (1957)

## ACCOUNTING SERIES RELEASES

- No. 2 (1937) Independence of accountants--Relationship to registrant.
- No. 19 (1940) McKesson & Robbins, Inc.
- No. 22 (1941) Independence of accountants--Indemnification by registrant.
- No. 28 (1942) Kenneth N. Logan (10 SEC 982)

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- No. 47 (1944) Independence of certifying accountants--Summary of past releases of the Commission and a compilation of hitherto unpublished cases or inquiries.
- No. 48 (1944) C. Cecil Bryant (15 SEC 400)
- No. 51 (1945) Disposition of Rule II (e) proceedings against certifying accountant.
- No. 59 (1947) Williams and Kingsolver
- No. 64 (1948) Drayer-Hanson, Incorporated (27 SEC 838)
- No. 67 (1949) Barrow, Wade, Guthrie & Co., Henry H. Dalton and Everett L. Mangam
- No. 68 (1949) F. G. Masquelette & Co., and J. E. Cassel
- No. 73 (1952) Haskins & Sells and Andrew Stewart
- No. 77 (1954) Disposition of Rule II (e) proceedings against certifying accountant.
- No. 78 (1957) Touche, Niven, Bailey & Smart, et al. (37 SEC 629)

#### CHANGES IN THE INDEPENDENCE RULE

Article 14, Rules and Regulations under the Securities Act of 1933, 1/  
Federal Trade Commission, July 6, 1933

Article 41, Rules, Regulations and Opinions under the Securities Act  
of 1933 as Amended, April 29, 1935

Rule 650, General Rules and Regulations under the Securities Act of  
1933, January 21, 1936

Rule 2-01, Regulation S-X, Adopted February 21, 1940, Accounting  
Series Release No. 12

#### Amendments of Rule 2-01

Accounting Series Release No. 37, November 7, 1942

Accounting Series Release No. 44, May 24, 1943

Accounting Series Release No. 70, December 20, 1950

Accounting Series Release No. 79, April 8, 1958

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1/ The Securities and Exchange Commission was established under provisions of the Securities Exchange Act of 1934 and was authorized to continue in effect until modified all rules and regulations issued by the Federal Trade Commission under the Securities Act of 1933.