DIVISION OF CORPORATION FINANCE

TRAINING PROGRAM LECTURES

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Subject: Disclosure Problems Relating to Scientific, Engineering and Valuation Cases

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MR. COSTELLO. I want to try to give you a brief outline of the disclosure problems for which you will find the assistance of an engineer desirable or helpful, and try to help you recognize problems on which an engineer can be of special assistance. Due to the nature of the work and requirements of the forms and regulations, you will find no sharp dividing line between the duties of the analyst, engineer, accountant, attorney, or other experts. There are certain problems that may fall clearly in the domain of one particular expert. For example, when you see an appraisal, I think it is obvious that you would send it to an engineer. In between the clear cut cases you will find many problems that require the services and review of two or more of the experts. A simple example might be an analysis of the summary of earnings in a prospectus. You may find there that there has been a severe fluctuation, drop, or inconsistency of earnings. It is sometimes very hard to discern what causes that, and it might take a joint analysis by an accountant, economist, analyst and engineer. You may find that it is due to competition from new companies in the field; the expiration of a patent of the Registrant; a change in depreciation policy, which is the province of both the engineer and the accountant; a change in inventory valuation, or any number of things. I cite that as an example of the type of problem case you might run across.

Now to outline briefly and in general terms what should be referred for engineering review: Oil and gas and mining cases, of course, will go to Mr. White or Mr. Adelstein. They offer no particular problem of recognition. Then there are the cases involving scientific, engineering or appraisal problems which do not relate to mining or oil and gas. So I would suggest that you refer the following for engineering review: (1) All appraisals, whether in the financial statements or in the body of the statement. (2) Cases involving any new product or process, or device, or gadget, particularly by a promotional company, where they make claims for superiority or advantages over existing products or devices, or where other competitive advantages are claimed. You will find that cases like these often involve investigation of patents and patent applications, as to what patent coverage a company may have, or whether they are infringing the patents of others. (3) In addition, any questions involving fixed property, such as plant capacity and utilization, excess or inadequate capacity, should usually be referred for engineering review. (4) Any engineering

questions involving public utilities, such as electric and/or gas, pipelines and water companies, should be referred, of course, to the engineer, although most of the large utilities have been in here so often that many engineering questions have been pretty well answered. Cases such as these should not be referred to the engineer unless some new and/or particular question arises.

I would like to point out that it is quite helpful for the examiner to make his own analysis and, where possible, to indicate any engineering questions arising in his own mind. That would be helpful both to the engineer and the branch chief. In this connection I think you may all be aware of the fact that in Washington we have a tremendous amount of data available in other Government agencies and also most of the industry trade associations - many having their headquarters here. When information of that type is necessary or pertinent, there is no objection to the examiner contacting these sources, particularly when the question is well-defined or of a non-engineering nature. Examples would be statistics - for a particular industry on production, sales, consumption, etc. - to determine trends in production or competitive factors, or other things of that nature.

I think that is about all of the general guides I can furnish. I believe you will get a better appreciation of how these engineering services work if we go over some of the typical cases that we have had.

THOMASCOLOR INCORPORATED

The first one I should like to discuss with you is ThomasColor. That case was filed in Philadelphia during the War. It was the subject of an 8(a) hearing and involved a very substantial controversy in many scientific areas, including optics, photography (both still and motion-picture), and television. The registration statement as filed claimed that the company had developed and patented a new system of color photography, known as the additive system, which would have application in the motion-picture, commercial photography, and television fields. It was claimed that the company's system would be cheaper and better than existing systems for commercial and motion-picture use, and gave an estimate of the size of the potential market by stating the number of motion-picture theaters in the United States. Additional claims were made for the use of the company's color system for commercial photography and for color television. In very extended hearings experts testified for the Commission from the Army Signal Corps, the Department of Commerce, Bureau of Standards, and John Hopkins University. The outcome of that testimony showed that the new process of color photography that the company claimed was basically a very old process. It had been known for over 50 years. The patents which they had were very narrow. They didn't cover any broad principles of the additive system, but just certain little gimmicks or wrinkles--if you want to call them that. The important point that was brought out during the experts' testimonies was that the additive system was not suitable for commercial motion-pictures because of the very large light losses which were inherent in both the photography and projection end. About 75% of the available light was lost through the very complicated Thomas optical system. The additive system involved a special camera with a complicated system of prisms and mirrors which split the light into three beams, sent those beams through red, blue and green color filters resulting

in three images on one frame of motion-picture film--very small images. The picture was projected through the same system and put together, in one picture on the screen, and the light losses if you had a reasonable distance between the screen and projector were about three-fourths of the available light. So the picture looked a little dark, to say the least. The experts pointed out that due to making these small images on a standard frame of 35mm film that what they call definition was very poor and not up to commercial standards.

One of the big things established was that the special lens needed for projection, which was a rather bulky thing being really three lens systems in one, couldn't be adapted for standard motion-picture projectors without a complete rebuilding or re-engineering of the projector. We had estimates from the RCA people that that would run about $500 to $1000 at that time per projector, which, if multiplied by two to four projectors in a theater and then by some 18,000 theaters in this country would result in a fabulous figure.

We had some other interesting points in this case. We made some comparative tests, one of which was to measure the light loss. The company brought over a standard slide projector. They put their lens into it and projected a white light on the screen, which was measured with a light meter. They took off their lens, put on a standard lens and purported to measure the light loss. The difference was not as great as the experts thought it was, so we examined the standard lens they had and found that they had masked the aperture with tape to cut down the area about 25%.

We also had another test in this case in which we went out into the park in front of the Commission's office in Philadelphia and used the ThomasColor camera and a standard motion-picture camera we borrowed from the Army Signal Corps complete with a crew and took pictures of the same scene. As Thomas was taking his pictures, the Army cameraman came over to me and said that Thomas had a larger shutter opening than he had and that Thomas was running his film slower. That was designed to let more light onto his film. At any event, when those films were developed and shown in the hearing room one evening, Thomas' pictures were still a great deal darker. As a matter of fact, they were very difficult to see and his color was very bad. We had one expert from the University of Pennsylvania, and even he admitted that what they call the color quality on the Thomas film was somewhat inferior.

One of the original claims made in the Thomas prospectus was that his system could take color pictures under substantially the same conditions that black and white pictures could be obtained. We showed that was not so. As a result of the tests and testimony it became obvious that the Thomas-Color camera required at least three, and possibly five, stops more than is required for black and white photography. It was also through expert testimony that we established that his unit would not work in color television, again due to the light losses, and for the main reason that color television uses 16 millimeter film. The Thomas system put three

little images there which were each the size of an 8 millimeter film. When those small images were put together and projected the definition was so poor that it looked like the movies of the vintage of 1910.

Thomas' so-called commercial photography camera was not greatly different from the ones in standard use today or then, so he had no real advantages in that area.

This registration statement became effective after many amendments made during the course of the hearing. The Commission issued a stop-order opinion which is quite interesting though somewhat technical. The statement was later withdrawn because they only sold a very nominal amount of securities. The promoter of the company later went to prison for running "afoul" of state "blue sky" statutes and a II(e) proceeding against the certified accounts resulted in a ten-day suspension order for that nationally-known firm.

UTAH CHEMICAL & CARBON COMPANY

The next case I should like to mention is Utah Chemical and Carbon. It proposed to build in Salt Lake City a plant for what is known as low-temperature carbonization of bituminous coal. The products which would result from that process were what is known as char, a kind of semi-coke which can be used as a fuel, and certain creosote type oils, which were all proposed to be marketed in the Salt Lake area. This company was dressed up a little, it had certain members of the Chamber of Commerce on its board of directors, as well as people from certain civic groups, etc. The prospectus was keyed somewhat along that line. It claimed that it would effect civic betterment in Salt Lake City by eliminating a smoke nuisance in the City, which was very bad because of their use of bituminous coal, by replacing that fuel with these low-temperature chars, which are relatively smokeless.

The company had obtained a license under a German process called the Lurgi process, and they said it was unique and new, and there was some implication that it was the only known process for low-temperature carbonization. We made an investigation and found that low-temperature carbonization had been known for over 100 years. We found about 800 processes which had been tried at one time or another and generally discarded. The reason that they had never been successful was that high-temperature carbonization was much more practical from the technical standpoint of utilization of the by-products derived, and also for marketing the coke. We did find that this Lurgi process had been used in Germany for carbonizing German lignite, which is quite different from the bituminous coal they planned to carbonize in Salt Lake City. We also found that the process when tried on bituminous coal had given a lot of trouble because if the heat was too high the coals would choke up the retort and they would have to stop and scrape it out and start again. Then it would cake up again. They found that by reducing the temperature they could avoid that, but that slowed down the process so much that the total tonnage processed was about cut in half. This made the necessary capital investment disproportionate to what could be gotten out at the other end.

The prospectus also claimed that the by-products such as tars and creosote oil would be readily marketable. We looked into that and found that there was practically no market for what they call low-temperature tars in this country. The tars didn't meet the specifications of the American Wood Preservers Association or the American Railway Engineering Association--which applies to treating railway ties and bridge and switch timber. We found that about the only place it could be sold was in the road oil market which brought a price of about one-half of what was obtained in the wood preserving market.

The prospectus sought to minimize competition. It indicated that there were only two low-temperature carbonization plants in the country, which was true. There was one in North Dakota which had gone bankrupt. There was one in Pittsburgh which was doing well because they had an antismoke ordinance in the City of Pittsburgh, and they sold the chars at a good price. What they did not state was that the principal competition would come from the by-product coke industry using high-temperature processes and with plants all over the country.

Looking into their price structure and their cost of production, we found that they would have to sell both their fuels and their tars above prevailing prices to hit a break-even point, which had not been disclosed. We found that just in the normal course of events it would be very hard to sell their chars as fuel since it would have to bring a higher price than the coal which was being used in Salt Lake City unless they had an anti-smoke ordinance to enforce the purchase of their fuel, which they didn't have.

After many letters and repeated conferences, the registration statement was amended to disclose all the foregoing matters and became effective. It was in connection with this particular registration statement that the technique of the "Introductory Statement" which is currently in fairly wide use in the Division was introduced. I mention this because one of the examiners in the Division, when reading the Introductory Statement contained in the prospectus, commented that the statement read "like a comic strip." I would, therefore, like to read some of the principal paragraphs contained in the Introductory Statement to see if you agree with that examiner's estimate.

"REFERENCE TO SPECULATIVE FEATURES OF THESE SECURITIES

"In subsequent pages the securities offered hereby are described and the business of the Company is set forth in some detail. The following is a reference to certain aspects of the Company and its business which contribute to the speculative nature of the securities offered:

(1) The Company is in the development stage. This offering is being made for the purpose of providing capital with which to build a plant. Attainment of production is not possible until the completion of the plant which is expected within eight to ten months after the successful completion of the offering, but there is no assurance that the plant will be completed within this period. (See p.9.)

(2) The Company proposes to use the "Lurgi process" with Utah non-coking, bituminous and sub-bituminous coals to produce smokeless coal products, but the adaptation of this process to these Utah coals has not yet been demonstrated on a commercial basis and will not be determined until after the proposed plant has been in operation for some time. (See pp. 7-8.)

(3) The only Company in the United States using the "Lurgi Process" has operated at a net loss every year with a single exception since its inception and is an admitted financial failure. The only Canadian user of the "Lurgi Process" underwent reorganization before it attained success. These two companies used lignite type coals as distinguished from the bituminous and sub-bituminous coals to be used by the company. (See pp. 4, 5, 6, 7 and 8.)

(4) No representation is made that the Company is anything more than a non-exclusive licensee of six patents, four of which have expired. Any future competitor may acquire the "Lurgi Process" upon the same terms as the Company without hindrance. (See p. 10.)

(5) The Company will engage in the production of fuels in competition in a limited market, insofar as Salt Lake City is concerned, with established coal, gas and oil companies possessing greater financial resources. (The population of Salt Lake City proper at the present time is estimated at 180,000 and for Salt Lake City and vicinity at 234,000.) A possible future source of competition may arise in the development of a true, smokeless domestic stoker. (See pp. 10-11.)

(6) The Company will be dependent for its raw coal upon mines which will be in competition with it in the retail market. (See p.11.)

(7) The commercial success of the enterprise depends in part upon revenue derived from by-products if the Company's processed smokeless fuel is to be sold at competitive prices with raw coal. The Company's by-product creosote oil may not meet generally accepted standard specifications, therefore, the market for it may be limited. (See p.10.)

(8) The Company's smokeless coal products will be sold at higher prices per ton than unprocessed raw coal. (See p.11.)

(9) No representation is made that the Company is presently able to estimate accurately its production costs or the prices of its products to the consumer. (See p.11.)"

Another interesting sidelight in this case was that the debentures being offered were stated on the face of the prospectus to be "offered as a Speculation." The staff took the position that a debenture being a fixed amount security had little or no chance of appreciation and that any speculative factors present could only operate to reduce the value of the securities. As a result, the following interesting paragraph was also included in the Introductory Statement:

"(15) The securities hereunder are offered as a speculation, but although the Debentures may be so described on the basis of the adverse factors present, they offer a more remote opportunity for speculative appreciation in value since (1) they represent a fixed obligation of the Company payable at maturity at the face amount thereof and (2) although convertible into Common Stock, the initial conversion value is $6.25 per share whereas the Common Stock is being offered at $3.75 per share, thereby requiring a 66-2/3% increase over and above the offering price of the Common Stock before the conversion feature would have any appreciation value."

The registration statement was subsequently withdrawn presumably because of inability to market the securities.

REGULATION A

We also have had two or three of these low-temperature carbonization matters under Regulation A. Those were even worse in some respects than this. I should like to mention one aspect of one of those. It was filed in the Seattle office not too long ago. We raised the question as to whether they could market the tars, and they said they could. They brought a sample of it down to Denver. We arranged a conference with a Bureau of Mines engineer. The company said that their product met the specific gravity specifications of the American Wood Preservers Association. The Bureau of Mines said that it would not, so they had the thing analyzed and found that they had blended the sample with some tars bought from a high-temperature by-product coke plant. They finally admitted that their tars wouldn't meet the specifications.

GENERAL RADIANT HEATER CO. INC.

Another case which was rather interesting and involved certain engineering principles was one called the General Radiant Heater Company, Inc. That company proposed to exploit an electrical radiant heating system which was supposed to have been successfully used in England and to which the Company had acquired rights. This prospectus had a long list of claimed advantages for Electric Radiant Heating, including the elimination of boilers, furnaces, chimneys, flues, pipes, ducts and radiators. It was also claimed that the Company's device gave radiant heat which was better than any other kind. The prospectus stated that the heat is radiated from the heat source much as the sun's rays are radiated from the sun. That was quite true, but it is also true of any ordinary steam or hot-water radiator--to a degree.

The gist of this case was that we found that electrical heating in any form in most sections of the country is much more costly than coal, oil, or gas. Electricity is a highly refined form of energy, coal, oil, or gas being used to make electricity, it is obviously going to be more expensive. To demonstrate: 1 kilowatt of electricity contains 3,415 British therma units, and operating at 100% efficiency that is the maximum heat that can be obtained from 1 kilowatt of electricity. Electric rates do vary substantially but in most larger Eastern cities they run about 3 cents or more per kilowatt hour. Assuming that rate, the cost of 1 therm

(100,000 B.T.U.) of heat from an electric source, assuming 100% efficiency for the heater, would be 87.9 cents. Taking natural gas, which costs about 12 cents per therm here in Washington at this time, and assume a 70% efficiency for the gas heater (which is about average), the cost of a therm of heat would be 17 cents. So the cost discrepancy is about 5 to 1. That was not pointed out.

Claims were also made of greater comfort for radiant heat. The ordinary hot water radiator delivers roughly about one-half of its heat by radiation--that's where it gets its name--and about one-half by convection, which is transmitted by heating the air passing over the heat source. We found that these electric radiant heaters deliver around 55 to 60% of their heat by radiation and about 40% by convection, so there is not actually much difference. They had made some tests at the Bureau of Standards on the Company's electric panels and did find that these panels when placed near the floor produced slightly higher floor surface temperatures. That may be a little excuse for saying that a person sitting in the room would be a little more comfortable. We went along with them to that degree, we let them say that much.

We had several conferences on this case and the prospectus was finally substantially amended. The cost factors were pointed out, claims for increased comfort were reduced, but the amended prospectus clearly showed that electrical heating was uneconomic in areas where the cost of electric power exceeded the range of 1/2 cent per kilowatt hour. It also pointed out that the areas where such rates prevail were confined to sections where large amounts of hydro-electric power are available, such as the Pacific Northwest or the TVA area. That eliminated many big centers of population from the Company's potential market.

The prospectus also admitted that unless the house was insulated to almost the "nth" degree that the cost of electric heating would be uneconomic even where low electric rates prevail. This prospectus was just about ready for clearance when they suddenly decided to withdraw the registration statement since the Commission revoked the registration of the underwriter for certain fraudulent practices in connection with the sale of its own stock and also for some misrepresentations they had made by jumping the gun in this case. So their securities never got to the market.

OSBORN HY-TRANS, INC.

We had an interesting Regulation A filing in Denver recently. It was a company called Osborn Hy-Trans. This company had developed, proposed to produce, and market what they claimed to be a new type of hydraulic transmission. The offering circular stated that based on dynamometer tests the efficiency of their transmission unit was 83-1/2% and that the automotive transmission in present day use only had an efficiency of 25%. That last, of course, was a complete error, since modern automotive transmissions run about 80 to 85% efficiency. We asked the company about that, and they said that the 25% was in error, that it had been taken out of an article in Motor Trend Magazine which referred to the whole automobile, not just the

transmission. We also asked them for the results of their test data which gave them the 83-1/2% efficiency for their unit, and they sent it to us. What they had tested was 1/2 of a hydraulic transmission. In other words, a hydraulic transmission has to have two units operating in series with one in reverse to make a complete hydraulic transmission. So if you took two of the company's units and operated them in series, and each one had an efficiency of 83-1/2% as claimed, the resulting efficiency of the overall unit would be 83-1/2% of 83-1/2%, or about 70%, whereas the automotive transmissions in present use have efficiencies of 80 to 85%. We pointed that out to the company, the offering circular was revised to show that their efficiency was 70% and modern automotive transmissions were about 85% efficient. The offering circular as revised also stated that the company did not intend to enter the automotive field, but intended to confine their marketing efforts to industrial applications only.

KEMIC CORPORATION OF AMERICA

We had another Regulation A filing in San Francisco when Mr. Blackstone was Regional Administrator. He and I had some correspondence on a company known as Kemic Corporation. This company was going to produce and market a chemical compound to be used as a catalytic agent in the manufacture of concrete. Those are commonly referred to as "admixtures". They are added to concrete to produce certain qualities like fast setting, high initial strength, increased workability, and one is used for concrete to be placed under water. This company had a license under a patent application from its principal promoter. We wrote and asked them for their secret formula. They said they wouldn't tell us that because somebody else might get it. We took the position, in effect, that if they were going to claim all of these advantages, they would have to tell us what it was. In the course of the correspondence they hired an engineer to try to convince us that we didn't have to know. The engineer admitted in one of his letters that the company's proposed compound was of chemicals which "are currently recognized specifics in the concrete industry and their individual beneficial results have been well known over a long period of time."

The offering circular as filed certainly implied strongly that this particular product of the company was the first such product to be discovered or invented--that there never was anything like it before. The facts were that admixtures have been used for at least 50 years, their use has been growing, they are manufactured and sold in large quantities and their use is actively promoted by some very large companies, principally the Masters Builders Company of Cleveland, Ohio, and Sika Chemical Corporation of Passaic, N. J. We also found that there is no one universal admixture, that there are a large number and that you select the one to impart the particular quality you want in the concrete, which usually requires engineering services by the company selling the compound.

We finally got the offering circular revised to point out that there was a lot of competition from similar products being marketed by large concerns, that as far as they knew theirs was not particularly different from others, and that it was necessary if they were to successfully market these products to furnish engineering services to the customers to determine the proper mixture for the particular job.

AELUS WING COMPANY

There was a Regulation A filing in New York called Aelus Wing Company. This company has four spheres of activities, according to their offering circular. One, they are going to build "Sky-Clone" homes. They also have a "HydroDynamic" ship; a "Hydro-Thermal" heater; and a "pneumatic air and rarified gas" wing. They were certainly diversified.

The only legitimate thing that we could find in the enterprise was the "Sky-Clone" home. They had built a few houses utilizing a very large concrete block which they manufactured themselves. This block was 24 x 24, instead of the 8 x 15 standard cinder or concrete block. They described their system of laying their walls dry, and then injecting the mortar by pneumatic injection, the blocks were held together by steel rods and anchors--it was said to be the best construction you could have. Of course we know that the use of steel rods and anchors is standard practice in concrete block construction. The injection of mortar by pneumatic means has been tried and found wanting a number of times. So their claims in those respects were eliminated or reduced. We also made them show that these 24 x 24 blocks would weigh in the neighborhood of 200 pounds each, so they couldn't be thrown around and laid very rapidly. The standard block weighs about 35 or 40 pounds. So much for the "Sky-Clone" Home.

The other items were just about as fantastic as they sound. I should like to read to you their description of the "Hydro-Thermal" heater in their offering circular:

> "The Electro-Aqua-Jet compounder is the thermal generator which produces the rapid formation of aqueous vapors to establish high conductivity and thus promote convection and radiation throughout the system of the Hydro-Thermal heater. A summation of the various advantages derived from the Hydro-Thermal heater follows:***."

The investigation disclosed that the description was largely meaningless and any claims made for the device had no basis in fact.

The Hydro-Dynamic Ship was even more visionary, having a specially designed wet surface hull to minimize frictional flow, a "cradle structure which comprises the funnelling means and planing board mechanism which is the main factor employed in orienting the dynamics of the ship by means of creating water shafting and controlling yaw and pitch." Many other similar senseless statements were made for the ship and for the Rarified Gas Wing which was, as the name implies, a new type of wing for aircraft eliminating rigid structure, supplying ample flexibility, increasing buoyancy in flight, etc. An expert consulted at the National Advisory Committee for Aeronautics characterized the description of the wing as "gibberish." I think the same description could be applied to the heater and Hydro-Dynamic Ship.

The issuer was required to delete all reference to the visionary schemes described and to confine its circular strictly to the production of concrete blocks and the erection of the so-called "Sky-Clone" homes.

APPRAISALS

I would like to say just a word on appraisals before I finish. I won't attempt to make you appraisal engineers, or to discuss the Commission's policy on appraisals with you. If you get an appraisal, you had better send it along and I'll take a look at it. You might be interested in the various types of appraisals and appraisal techniques. Appraisal, in the sense I use it, is a method of estimating value. I am not too sure what is a proper definition of value. You can find many legal, accounting, or economic concepts of it. Professor Bonbright has a two volume work called "Valuation of Property". In that he devoted several chapters to a discussion of what value is, and I don't think that he arrived at any conclusion. It was a discussion of what the courts have held it to be. The willing buyer - willing seller concept is the one most used, especially by real estate appraisers and is usually accepted by the courts in condemnation cases, estate taxes and the like.

There are a great number of appraisal techniques. They may roughly be divided into three general classes: first, the reproduction or replacement cost less depreciation, the result of which is termed by most appraisal companies as "Sound Value". We don't agree with that nomenclature by any means.

A second usual technique is comparative sales of similar property when valid sales comparisons can be obtained.

The third technique often used is the capitalization of actual or estimated future earnings.

The first category, reproduction cost appraisals, is widely used for insurance purposes, which is quite proper since fire or other casualty losses are usually paid on the basis of replacement cost less depreciation. Most authorities agree that reproduction cost estimates are not necessarily related to market value or the worth of the property appraised, and, at best, they might represent only an upper limit of value. In other words, you wouldn't pay more for property than you could go out and replace it for, but you might pay a lot less. Bonbright commented on this in his work on valuation, and I quote:

> "The mere fact that the physical assets of a railroad company or of a steel company may actually have cost many millions of dollars to construct not only fails to determine the present value of the company, it has utterly no influence on its value, unless in some indirect way it may affect the net earnings. And precisely the same statement applies to estimated replacement costs of the physical assets, not less than to historical costs. It will benefit the owner of an enterprise nothing to possess a company with costly assets. What the owner wants if profitableness, not expensiveness."

I think that puts in a nutshell what we think of reproduction cost appraisals.

The second category, comparative sales, is most often used for the purpose of estimating the values of vacant land.

The third method, capitalization of earnings at certain arbitrary (if you will) rates, is considered by most authorities as the best approach to the value of any income producing property or group of properties for obtaining what may be called an enterprise valuation. It is often the only way to arrive at any estimate of the value of intangibles such as patents, leaseholds, contracts, good will. So much for appraisal techniques.

The use of appraisals in registration statements has plagued the Commission a great deal, particularly in its early days. In the early years of the Act is was common practice to use appraisals to inflate the value of assets and to sell securities on the basis of those values. The favorite device used was for a promoter to obtain title to a decrepit or obsolescent manufacturing plant, or brewery in many cases (that was when repeal came along in 1933 and 1934). The promoter would then form a corporation, have the assets appraised at four or five times what they cost him, and transfer them to the corporation at that value for a consideration of stock or cash or both. The Commission squashed that rather promptly. You will find in Volumes 1 and 2 several opinions on such uses of appraisals: Haddam Distillers, Continental Distillers, Brandywine Brewing and Breeze Corporation which was a patent valuation matter.

The current policies of the Commission have largely eliminated the use of appraised values or write-ups of property in financial statements. Accounting Release No. 8 sets forth the Commission's accounting policy in regard to the use of appraisals in financial statements.

However, as we all know, the use of appraisals or references to appraisals in the non-financial portions of the registration statement crop up from time to time. I think we have two now pending that involve appraisal questions. I would like to run briefly over one case involving an appraisal question which also has a number of other interesting aspects. That is the Colorado Milling and Elevator case. You will find the opinion of the Commission in Volume 15 of the Decisions on Page 20. That company owned several flour mills and a large number of grain elevators and related properties in Denver and throughout the whole Rocky Mountain region. The securities were closely held by the heirs of John K. Mullen. As often happens, there was a falling out among the heirs and they decided to sell the business. Union Securities Company became interested in purchasing it for reasons which you will see in a minute. Union purchased about 98% of the outstanding stock from the Mullen family for around $14,000,000 cash. Bank loans of the same amount were obtained to finance the purchase and were secured by a pledge of the purchased stock. The day after the purchase, Union caused a cash dividend of $7,000,000 to be declared, which was almost all the cash in the company's treasury.

Immediately after receiving the dividend, Union reduced its bank loan by half ($7,000,000). On the same day a debenture issue of $6,500,000 was created and immediately paid as an additional dividend to the common stockholders (Union). Union then made plans for a public offering of the debentures which was the subject of the registration statement. The proceeds from the sale of the debentures, accruing to Union, were to be used to liquidate the remainder of the bank loan which would leave Union owning practically all of the outstanding stock of the registrant which was obtained at no cost to them. A very nice trick.

There was furnished gratuitously in the prospectus an appraisal by Stone & Webster, which is a well regarded engineering firm. The appraisal was based on reproduction cost less depreciation and showed a so-called "Sound Value" for the property of $10,700,000, which was about $7,000,000 greater than the net book value, the amount being immediately close to the amount of the debentures being issued and registered. It appeared that the appraisal was inserted in the prospectus solely for the purpose of indicating that the debentures issued as a dividend had value behind them as represented by the excess of appraisal figures over books.

An analysis of the appraisal indicated that it was made by very rough and short-cut methods and did not follow accepted appraisal norms. Also, an estimate of non-physical depreciation by the field appraiser, resulting from obsolescence and excess capacity of grain elevators in the amount of nearly $4,000,000, was not given effect in the final appraisal as used in the prospectus. The Commission's opinion indicated that the use of such appraisal was materially misleading but did not comment further on it in view of the fact that it was deleted from the registration statement and prospectus after the institution of stop order proceedings.

Adjourned.