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UNITED STATES OF AMERICA

before the

SECURITIES AND EXCHANGE COMMISSION

Precision Microwave Corporation
Main Street
Millis, Massachusetts

File No. 2-18720
File No. 1-4583

FILED

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SECURITIES & EXCHANGE COMMISSION

RECOMMENDED DECISION

Sidney Ullman
Hearing Examiner

Washington, D. C.
January 11, 1963

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BEFORE:

SIDNEY ULLMAN, HEARING EXAMINER

APPEARANCES:

John T. Hall, Jr., Esq., James E. Buck, Esq.,
and Paul B. Uhlenhop, Esq., for the
Division of Corporation Finance.

Joseph S. Mitchell, Esq., for Respondent.

John R. Ambrogne, Esq., for Joseph L. Travers.

THE PROCEEDINGS

These are consolidated proceedings under Section 8(d) of the Securities Act of 1933 ("Securities Act") and Section 19(a)(2) of the Securities Exchange Act of 1934 ("Exchange Act"). The proceeding under Section 8(d) was instituted to determine whether a registration statement filed by Precision Microwave Corp. ("Registrant") on August 21, 1961, contains inadequate and inaccurate financial disclosures and statements and, if so, whether a stop order should be issued to suspend its effectiveness. ^{1/} The proceeding under Section 19(a)(2) was instituted to determine whether a duplicate original Form 10 application ("Form 10") for registration of its common stock on the American Stock Exchange ("Exchange"), filed by Registrant with the Securities and Exchange Commission ("Commission") on December 21, 1961 contains inadequate and inaccurate financial disclosures and statements and, if so, whether it is necessary or appropriate for the protection of investors to suspend, for a period not exceeding 12 months, or to withdraw, the registration of

1/ Section 8(d) of the Securities Act provides:

"If it appears to the Commission at any time that the registration statement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, the Commission may, after notice . . . and after opportunity for hearing . . . issue a stop order suspending the effectiveness of the registration statement. When such statement has been amended in accordance with such stop order the Commission shall so declare and thereupon the stop order shall cease to be effective."

the common stock of Registrant on the Exchange.^{2/}

The allegedly false and inaccurate statements and financial information are in the Prospectus which is a part of the registration statement. Inasmuch as the Prospectus was incorporated by reference into the Form 10, both proceedings involve the same statements and financial information asserted to be false. Both also involve a challenge to the accuracy of the certificate of the certifying accountant and to his

2/ Section 19(a)(2) of the Exchange Act provides in pertinent part:

"The Commission is authorized, if in its opinion such action is necessary or appropriate for the protection of investors --

"(2) After appropriate notice and opportunity for hearing, by order . . . to suspend for a period not exceeding twelve months, or to withdraw, the registration of a security [on a national securities exchange] if the Commission finds that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder."

Trading in the stock of Registrant was suspended during these proceedings and until December 19, 1962, by a series of orders entered pursuant to Section 19(a)(4) of the Exchange Act, which provides in pertinent part:

"The Commission is authorized, if in its opinion such action is necessary or appropriate for the protection of investors - -

"(4) And if in its opinion the public interest so requires, summarily to suspend trading in any registered security on any national securities exchange for a period not exceeding ten days . . . "

The summary suspension was not continued beyond December 19, 1962, in view of the filing of amended financial statements by Registrant and dissemination of information to its shareholders and to the public, as stated in Securities Exchange Act Release No. 6973, December 17, 1962.

independence. A further charge is made in the 19(a)(2) Exchange Act proceeding, that a semi-annual report filed on Form 9-K and covering periods of time not involved in the 8(d) proceeding is also inadequate and inaccurate.

A hearing in these proceedings commenced on August 20, 1962 and continued until August 30, 1962. Under authorization by the Hearing Examiner for the filing of additional exhibits, an amended Form 9-K semi-annual report was filed by Registrant prior to the closing of the record on September 17, 1962. Registrant also filed as an exhibit its Form 10-K annual report which became due shortly after the close of the hearing.

Joseph L. Travers, President of Registrant as well as a director and its chief executive officer, was granted leave to participate in the hearing pursuant to Rule 9(c) of the Rules of Practice. Travers and Thomas F. Maher, Executive Vice-President and a director of Registrant, were selling stockholders under the registration.

In the Statement of Matters in the 8(d) proceeding and in the Order and Notice of Hearing in the 19(a)(2) proceeding the Division of Corporation Finance ("Division") challenged the certified public accountant's statement that he had followed generally accepted auditing procedures. During the course of the hearing, the Division was granted permission by the Hearing Examiner to amend and add a challenge to the independence of the accountant.

A recommended decision by the Hearing Examiner was requested, proposed findings of fact and conclusions of law were filed by counsel for the

Division and counsel for Respondent, and the Division filed a reply brief. On the basis of a careful examination of the evidentiary record developed at the hearing and of the documents filed by counsel, and on the Examiner's observation of the several witnesses who testified (all of whom were produced by the Division), he makes the following findings of fact and conclusions of law.

FINDINGS OF FACT

The Registrant

1. Registrant and its six wholly-owned subsidiaries,^{3/} are engaged in the business of manufacturing microwave components for radar detection and missile guidance systems and communication systems; manufacturing components for jet aircraft engines; and applying and processing coatings to components for jet aircraft engines and missiles. These activities are conducted under sub-contracts with prime contractors. In addition, the company has been engaged in the development of microwave sub-systems.

2. Registrant was incorporated in Massachusetts in 1959. In 1961, it acquired all of the outstanding stock of its six subsidiaries from Joseph L. Travers and Thomas F. Maher. The principal office of Registrant is at Millis, Massachusetts, and its plants are located at Millis and Saugus, Massachusetts. One subsidiary, Precise Metal Products ("Precise Metals") is by far its most important, and is the largest selling

^{3/} Precise Metals Products, Inc., Norfolk Precision Corp., Travers & Co., Inc., Research Corporation of Waltham, Metal Process, Inc., and Ceramic Specialties, Inc.

and distributing company of the group.

3. The registration statement covered a proposed public offering of 165,000 shares of \$1.00 par value common stock at a selling price of \$10.00 per share and 22,500 common stock purchase warrants. Of the shares, 115,000 were offered on behalf of Registrant, 40,000 on behalf of Joseph L. Travers, and 10,000 on behalf of Thomas F. Maher. The registration statement filed on August 21, 1961, became effective on November 8, 1961. All shares of common stock registered thereby were sold and thereafter Travers and his family owned 48.2% of the stock of Registrant, and Maher and his wife owned 12%.

4. The Form 10 for registration of the stock on the Exchange, which incorporated by reference the registration statement and its financial statements, exhibits and amendments, was filed on December 21, 1961. The registration on the Exchange became effective on January 15, 1962. Pursuant to Section 13 and to an undertaking required by Section 15(d) of the Exchange Act, Registrant was required to file with the Commission certain periodic reports, including the Form 9-K semi-annual report challenged by the Division as inadequate and inaccurate. This report was filed on January 12, 1962.

5. The Division contends that inadequate and inaccurate information was contained in a consolidated summary of earnings and in financial statements in the Prospectus, as a result, in part, of: (a) the improper

action of Travers in directing an arbitrary and unwarranted write-down or decrease by the sum of \$40,000.00 in the amount of commissions payable to two sales representatives of Precise Metals; (b) the over-statement of inventory of Precise Metals as of May 31, 1961 and of its earnings for the fiscal year ending on that date because of an improper method of evaluating its work-in-process inventory; (c) the distortion of consolidated sales figures for the four month periods ending September 30, 1960 and 1961, which were furnished in response to a deficiency letter from the Commission, in order to portray a relatively favorable picture of the financial condition of the corporation for the more recent period. The Division also asserts that the certificate in the Prospectus of the Certified Public Accountant, John F. Kenefick, is false and inaccurate with respect to a statement therein of the auditing procedures applied to determine the fairness of the financial statements, and that the statement to the effect that Kenefick is independent is also false. In addition, the Division charges that the Form 9-K report filed with the Commission for the six month periods ending November 30, 1960 and 1961 contains consolidated sales figures of Registrant and its subsidiaries which were distorted in order to develop a more favorable picture of the financial condition of the corporation for the latter period.

(a) Sales Commissions

6. Joseph E. Stieglitz and Edward J. McNeill were employed by Precise Metals prior to Travers' assumption of control of the company in

June 1960. Stieglitz was employed in March 1960 under an oral agreement providing for a weekly draw of \$230.00 a week, plus expenses, against commissions of 5% of his sales. McNeill was employed on March 31, 1959, under a written agreement providing for commissions at the rate of 5% of sales, and reciting that it would continue in effect "until terminated by either party, in writing, thirty days prior to the date desired by the terminating party". The agreement was not terminated prior to March 20, 1962, when McNeill sent Travers a letter ending his employment. Both Stieglitz and McNeill, accordingly, were engaged in selling activities for Precise Metals throughout its fiscal year ending May 31, 1961.

7. The sales made and the commissions earned by and paid to Stieglitz and McNeill were recorded on a monthly basis on work sheets and interim financial statements by James Smith and Agnes Hogan. James Smith, a 1956 graduate of the Bentley School of Accounting and Finance, Boston, Massachusetts, was hired by Travers for Precise Metals, and served as its office manager and accountant from October 1960 until May 1962. Agnes Hogan was the company's bookkeeper. Under company policy, the figures representing the unpaid commissions due the sales representatives were "booked" or entered once a year into the general ledger of Precise Metals from Smith's monthly work sheets.

8. Smith testified that as of May 31, 1961 Precise Metals was obligated to Stieglitz and McNeill for unpaid commissions in the amount of approximately \$43,000.00. His work sheets and the company records were computed on the basis

^{4/} Smith's testimony originally fixed the unpaid commissions as of May 31, 1961 as approximately \$48,000.00. He corrected this figure during cross-examination, explaining that the larger amount included \$5,000.00, temporarily recorded as due to Joseph Albizer, plant manager of Precise Metals, as a bonus or salary increase.

of 5% of sales, and reflected commissions payable to Stieglitz in the amount of \$8,318.43 and to McNeill in the amount of \$37,533.01, a total of \$45,851.44 as of that date.

9. John F. Kenefick, a certified public accountant since 1953, was engaged by Travers in June 1961 to audit the records of Registrant in connection with the registration statement proposed to be filed. He testified that Smith's work papers reflected total commissions due Stieglitz and McNeill in the amount of \$45,851.44 as of May 31, 1961. In his own work sheets for Precise Metals, prepared in connection with the registration statement, Kenefick recorded this liability for commissions in the amount of \$45,851.43 (sic). Thereafter, however, at one of the many conferences between Kenefick and Travers during the course of the work on the registration statement, Travers told Kenefick to "hold the matter of salesmen's commissions in abeyance for the time being, since he had reason to believe the sheets were inaccurate". Kenefick testified further:

"Sometime later in June, during the course of my audit, June 1 and up to August 15, Mr. Travers had a routine conference which we held in his office. He informed me that Smith had erred in reviewing salesmen's commissions, particularly as to the rate of commission for Mr. McNeill and Mr. Stieglitz during the year ended May 31, 1961.

"Smith used a flat rate of 5% on sales whereas these two men were on a sliding scale of commissions.

"Mr. Travers advised me of the correct liability of 5/31. He gave me the figures that were due at that time, which I in turn recorded as part of my journal entry 23. Mr. Travers stated that the figure he gave me represents the full liability of the corporation to these men at May 31, 1961. He further stated that both McNeill and Stieglitz deserved much of the credit for the success of Precise and he intended to [re]ward them personally."

10. Based upon this information from Travers, Kenefick changed his work sheets to reflect total commissions due the two men as of May 31, 1961 of \$5,851.43 after adjustments.

11. Smith's testimony was in substantial agreement with the above. Travers was dissatisfied with the figures after reviewing Smith's work sheets on the consolidated statement of earnings and the consolidated balance sheets as of May 31, 1961.^{5/} He advised Smith that he intended to improve the profit picture by making a personal agreement with Stieglitz and McNeill regarding their commissions. Following Kenefick's adjustment based upon information from Travers, Smith used the reduced figure of \$5,851.43 in preparing a balance sheet for Precise Metals, and this figure was entered in the books of the company as its liability for accrued commissions as of that date. This figure, then, rather than the liability originally computed by Smith and given to Kenefick, was included in Registrant's consolidated general^{and} administrative and selling expenses and charged to profit and loss for the year ending May 31, 1961. In the Prospectus, the audited combined statement of earnings and the consolidated balance sheet for Registrant and its subsidiaries reflect the liability for commissions in the amount of \$5,851.00 as of May 31, 1961.

12. Kenefick took steps to confirm or verify the information given him by Travers concerning the commission liability of Precise Metals. On July 8, 1961 he prepared letters addressed to himself for the signature of each of

5/ Travers also attended or was graduated from the Bentley School of Accounting and Finance and, as indicated infra, was regarded by Kenefick as the chief accounting officer of Registrant.

these two salesmen, confirming the respective amounts given by Travers, viz., \$2,318.43 for Stieglitz and \$3,533.00 for McNeill. The letters were typed by Travers' secretary and were then given by Kenefick to Travers, who suggested that he would see the two men and have the letters signed and returned to Kenefick promptly. Kenefick received the confirmation signed by Stieglitz about one week later, but received no reply from McNeill. Nor did he receive a second confirmation which he prepared and mailed directly to McNeill on July 14, 1961.

13. Stieglitz signed the confirmation in the amount of \$2,318.43 after he was approached either by Travers or by Joseph Albizer, plant manager of Precise Metals, and was asked to sign because the company had not come up with the profits they were looking for. He was told by Travers that the \$6,000.00 difference between the amount owed him and the amount he was acknowledging would be assumed by Travers as a personal responsibility and would be paid to him either in cash or stock.

14. McNeill received the confirmation dated July 8, 1961, which was prepared by Kenefick and sent by Travers, with a typewritten note attached, which read:

"Dear Ed:

"Please sign and return.

"T. Maher."

Thomas F. Maher, the Executive Vice-President of Precise Metals, was a close friend of McNeill. However, this note was neither signed nor initialled by Maher, and the record suggests no request made by Maher that McNeill

verify an indebtedness of \$3,533.00 in lieu of the larger amount reflected in Smith's records.

15. Nor did McNeill sign the second confirmation received from Kenefick directly. McNeill had never had conversations with Travers or other officers of Registrant or Precise Metals concerning a sliding scale of commissions in lieu of the 5% set forth in the written agreement. He did have conversations with Travers, however, prior to July 8, 1961, relative to his acceptance of common stock of Registrant in full or in part payment of commissions due from Precise Metals. These conversations and negotiations with Travers and Harold Karp, counsel for Registrant, continued after the filing of the registration statement and the sale of the stock thereunder. The record contains no evidence that an agreement was reached, except that on January 9, 1962 McNeill received 410 shares of the common stock of Registrant from Maher, 410 shares from Travers, and a check from Maher in the amount of \$6,000.00. He has instituted suit for additional commissions allegedly due.^{6/}

16. The records of Precise Metals and of Registrant were changed by the amount of \$40,000.00 without justification and at the direction of Travers, in order to reflect a more favorable consolidated financial situation than actually existed as of May 31, 1961.

6/ Even if an agreement for the assumption of all or part of a corporate obligation by company officers had been reached prior to May 31, 1961, generally accepted accounting practice would require disclosure of the facts. Cf. Accounting Series Release No. 62 (1947):

"In order that investors may make proper use of the summary earnings table and to prevent the possibility of misleading inferences, certain explanatory data are usually necessary."

(b) Precise Metals' Inventory as of May 31, 1961

17. The inventory of Precise Metals as of May 31, 1961 was taken on June 1, 1961 by several employees, including Smith. Also assisting was George Martin, an accountant who had done work for some of the companies in the group, and who was engaged by Kenefick to assist him in connection with the preparation of the registration statement. (Smith was similarly engaged by Kenefick under circumstances more fully disclosed infra.)

18. The physical aspects of taking the inventory were observed by Kenefick, who thereafter made the inventory audit. Precise Metals' inventory, as of May 31, 1961 amounted to \$331,747.57, or approximately 88% of the consolidated inventory of Registrant; its work-in-process inventory, including termination charges under contracts terminated by prime contractors prior to completion, amounted to \$195,480.00, constituting approximately 59% of its total inventory and approximately 52% of the total inventory of Registrant.

19. Smith testified that the work-in-process inventory of Precise Metals was priced by its plant manager, Joseph Albizer, by multiplying the contract or sale price of each item by its percentage of completion. He stated that this method was used because of the inadequate cost records of Precise Metals and the inability to determine actual costs of material, labor and overhead or burden going into the various items comprising the work-in-process inventory. On cross-examination, Smith testified that the inventory was computed twice: that on the first occasion it amounted to approximately \$284,000.00 or some \$47,000.00 less than the figure which was reached on the second count and used in the financial statements. Smith's testimony was

vague and imprecise regarding the work-in-process inventory as of May 31, 1961, and he had no detailed information as to Albizer's computations. However, he is correct in asserting that the work-in-process inventory was not evaluated by computing the cost of material, labor and overhead going into the items. This finding is supported by the report of Scovell, Wellington & Company (subsequently merged with Lybrand, Ross Bros. & Montgomery) dated May 23, 1962. Scovell, Wellington was engaged by Registrant in the spring of 1962, and under instructions from Registrant's counsel made extensive examination of Registrant's records in an effort to recast the financial statements then under challenge by the Division. In the first of its two reports, that of May 23, 1962, Scovell, Wellington stated:

"In regard to inventory pricing we are informed by Mr. Albizer that the cost of work-in-process items is determined by deducting 10% profit margin from the selling price of the item and then applying a percentage factor, representing its stage of completion, to the result."

20. Conversely, Kenefick testified that Albizer had informed him on June 1, 1961 that he maintained informal cost records for work-in-process. However, Kenefick did not see any of these records and Albizer told him he did not know where they were. (Nor did Scovell, Wellington see such records during their examinations.) Kenefick's work sheets recite that cost of work-in-process was established by the plant manager from informal job cost records and that Kenefick's review of the percentage of completion and of the costs used indicated to him that the company's method of

pricing the work-in-process inventory was sound. Kenefick testified that from his discussions with Albizer he concluded that Albizer was familiar with the costs which should be used in evaluating work-in-process inventory. Nevertheless, the Examiner finds that cost records for work-in-process inventory at Precise Metals were inadequate and that they were not used in computing such inventory as of May 31, 1961; that, on the contrary, the method used was that described by Albizer to Scovell, Wellington, as quoted above.

21. Counsel for the Division contend in their briefs that such method of computing the work-in-process inventory, i.e., selling price less 10%, multiplied by the percentage of completion, resulted in an over-statement of Registrant's inventory as of May 31, 1961, as well as an over-statement of its net income for the fiscal year ending on that date. They assert that the deduction of 10% (for profit) was inadequate especially in light of substantial selling and general and administrative expenses and therefore resulted in an over-statement of work-in-process inventory.^{7/}

22. The costs of work-in-process inventory of Precise Metals should have included cost of labor, materials and a reasonable allocation of manufacturing overhead. Montgomery's Auditing, (8th ed., 1957) p. 194.

23. Absent adequate cost records, the use of a formula based on selling price might in appropriate circumstances not result in material misstatements of inventory, provided adequate deduction from selling price is made for such charges as selling and general and administrative expenses, as well as certain

^{7/} In the event that Albizer deducted only 10% from the selling price because he intended it to represent the margin of profit remaining after allowance for selling and general and administrative costs, this would simply mean that cost of inventory necessarily included the elements of selling and general and administrative expense. Such inclusion, of course, would be violative of generally accepted principles of accounting.

other costs of doing business, in addition to a reasonable allowance for margin of profit.

24. Such reductions might have achieved the conservative evaluation of inventory required by good auditing procedures in the preparation of financial reports for a registration statement.

Absent such reductions, work-in-process was not properly evaluated inasmuch as the 10% figure used was significantly inadequate.

Cf. Scovell, Wellington's report of May 23, 1962, relative to the method used by Albizer:

"To the extent that this method results in the inventorying of selling, general and administrative expenses it cannot be considered a generally accepted method of computing inventory costs. We do not attempt to determine what the inventory cost would have been if only material, direct labor and manufacturing overhead had been included as cost."

25. This is one of several statements by Scovell, Wellington in its reports, indicating an inability to recast Registrant's financial statements with any assurance of accuracy, despite the expenditure of much time on the project. Although the report does not state the conclusion that selling and general and administrative expenses were in fact inventoried by the method followed, the Examiner reaches this conclusion. The evidence, including the figures in the Prospectus and in Scovell, Wellington's reports relating to expenses and inventory, indicates that the over-statement of Precise Metals' inventory as of May 31, 1961 was material.

26. The record contains no evidence of the manner of computing inventory of the other companies in the group. Since there is no indication of under-statement of such inventories as of May 31, 1961, it is concluded that the material over-statement of Precise Metals' inventory resulted in a material over-statement of Registrant's inventory as of that date.

27. Counsel for Registrant point out in their brief that there is no indication in the record that Precise Metals' work-in-process inventories were not priced by the same method in the prior fiscal years. They urge that an over-statement of inventory year after year, resulting from the deduction of an unrealistic or insufficient percentage of the selling price, would not result in an over-statement of earnings for the fiscal year ending May 31, 1961.

28. Actually, the second report of Scovell, Wellington, that of July 9, 1962, indicates that in computing net earnings for periods ending in 1961, they learned that:

"According to management personnel [inventories] were physically taken and priced in a manner consistent with previous periods."

Thus, this supports the view that the same method of pricing the work-in-process inventory was followed for the preceding fiscal year. If this method caused an over-statement of inventory at the start of the fiscal year, i.e., at June 1, 1960, then an under-statement of earnings for the fiscal year ending May 31, 1961 would be the result, except as the further over-statement at year-end would correct or "over-correct" it.

29. Total inventory of Registrant and of Precise Metals was greater at May 31, 1961 than it was on May 31, 1960 by a substantial amount, and, as indicated, approximately 52% of Registrant's inventory was that of Precise Metals. Note 3 to the consolidated financial statements in the Prospectus

reads, in part:

"The inventory amounts used in determining [Registrant's] cost of products and services sold for the respective periods are as follows:

May 31, 1958.	\$ 30,142
May 31, 1959.	73,034
May 31, 1960.	133,531
May 31, 1961.	375,877"

It is clear that a material over-statement of earnings for the fiscal year ended May 31, 1961 was produced by the use of a formula which over-stated the inventory as of that date by an amount in excess of the over-statement as of the end of the preceding fiscal year, May 31, 1960.

(c) Comparative Earnings for 4 Month Periods Ending September 30, 1960 and 1961

30. In October 1961, a work sheet of comparative sales and earnings of Registrant and its subsidiaries for the 4 month periods ending September 30, 1961 was prepared by Smith from the books and records of the several corporations at the request of Travers. Travers thereafter expressed dissatisfaction with the comparative figures, and in order to portray relatively favorable figures for the 1961 4 month period, instructed Smith to reduce the 1960 sales figure by \$100,000.00, i.e., from \$1,028,082.00 to \$928,082.00. Smith prepared a new comparative statement reflecting sales in the lower amount. Thereafter, on or about October 26, 1961 the sales figure of \$928,082.00 was further reduced by Kenefick by \$50,000.00 to \$878,082.00. This was done during the course of Kenefick's preparation of a statement of Registrant's sales and earnings on an unaudited basis in response to a deficiency letter from the Commission dated October 20, 1961, requesting a comparative statement for 1960 and 1961 in connection with the registration statement. The reduction of \$50,000.00 was made by Kenefick at the request of Travers and without Kenefick's knowledge that Smith had earlier

reduced the sales figure by \$100,000.00. It was done ostensibly to correct the sales figure so that it would reflect sales returns that had not been recorded in the records of Registrant and Precise Metals.

31. Both of the above changes in the sales figure, totalling \$150,000.00, were unjustified and arbitrary. The first was made without figures purporting to justify it. As to the second, there is no credible evidence of unrecorded sales returns approximating the figure of \$50,000.00. The Examiner concludes that these reductions were not in accordance with and were not an accurate representation of the experience of Registrant.

32. Respondent concedes that the changes in this unaudited sales figure were made, but urges that they corrected prior over-statements of sales for the 1960 period. Although the record indicates the probability that an over-statement of sales had been made at the direction of Travers in order to improve Registrant's credit, the record, including the two reports of Scovell, Wellington, does not indicate with any assurance of accuracy the extent of an over-statement or, therefore, of any "correction" that may have been achieved by the reductions of \$150,000.00.

33. At the same time that Kenefick made the reduction of \$50,000.00 in sales, he reduced by the amount of \$20,000.00, i.e., from \$153,781.00 to \$133,781.00, the profit or net earnings of Registrant for the 4 month period ending September 30, 1960, as shown on Smith's work-sheets. He also made other adjustments correcting errors by Smith, including an apparently proper deduction for Massachusetts excise tax, and he computed the per share earnings for the comparative periods in 1960 and 1961, as required by the deficiency letter.

34. The reduction of \$20,000.00 was made at the request of Travers, and purported to reflect decreased earnings resulting from the \$50,000.00 reduction in sales. The Examiner concludes that this reduction was unwarranted and that the resulting figures for net profit and for per share earnings did not accurately reflect the experience of the Registrant for the period.^{8/}

35. Just as the sales and net earnings figures for the 1960 period were decreased in order to reflect a more favorable comparative picture for the 1961 period, so were other arbitrary steps taken to improve the 1961 figures of Registrant for the 4 months ending September 30.

36. At the direction of Travers and originally in order to portray to the principal underwriter of Registrant a favorable sales picture, the sales book of Precise Metals was kept open for a period of ten days following September 30, 1961, or through October 10. As a result, October sales totalling approximately \$35,000.00 were included in the September figures and became a part of the Registrant's sales figures for the 4 month period.

37. It was customary to keep the sales book of Precise Metals open for a period of time following the end of the month in order that sales of products which were completed and awaiting shipment on the last day might

^{8/} Following are figures reported in the Prospectus for 4 months ending September 30, 1960:

Net Sales.	\$878,082.00
Net Earnings.	64,578.00
Net earnings per share of common stock...	.2153

Cf. Scovell, Wellington's first report, which computes per share earnings from books of account, after adjustments, at \$.4833; the second report computes them at \$.3138.

be included in the sales of that month, although shipped and billed in the following month. It was unusual, however, for the sales book to be kept open for a period of ten days following the end of the month, and there is no evidence that the products shipped through October 10, 1961 were completed and awaiting shipment on September 30, 1961. This was done in October 1961 at the direction of Travers in order to increase the sales which would be reflected on the statements of sales and earnings of Registrant for the month of September.

38. In addition, also at the direction of Travers, Smith included in the sales figures of Precise Metals for this 4 month period in 1961, inter-company sales of approximately \$23,000.00.^{9/} Thus, a total amount of approximately \$58,000.00 was improperly used to increase the sales figure of Registrant for the period.

39. The reports of Scovell, Wellington confirm an under-statement of sales and earnings for the 1960 period of 4 months and an over-statement of sales and earnings for the comparable 1961 period. However, they also indicate that it is impossible to recast with reasonable accuracy the extent of such under-statement or over-statement or, conversely, the extent to which under-statement may have adjusted or corrected over-statements made in prior statements in order to bolster the credit of Registrant. It is

^{9/} Under generally accepted accounting principles, inter-company transactions are eliminated in preparation of consolidated financial statements. Regulation S-X (17 CFR 240.4-08) requires elimination or a statement of reasons for non-elimination and of the methods of treatment. Cf. Montgomery's Auditing, supra, p. 484:

"Intercompany items should be eliminated from the various account classifications of the consolidated income statement so that results of operations may reflect only transactions with the public."

clear from the amounts discussed above and from the figures contained in the reports of Scovell, Wellington, however, that the inaccuracies in Registrant's sales and earnings figures for the periods were significant.^{10/}

(d) Comparative Sales and Net Earnings for the 6 Month Periods Ending November 30, 1960 and 1961.

40. In December 1961 Travers advised Kenefick of his plans to have the stock registered on the Exchange and requested that Kenefick assist in preparing the application. Kenefick concluded that most of the required financial information could be incorporated by reference to the Prospectus of Registrant. In addition, however, it would be necessary to prepare a consolidated balance sheet as of November 30, 1961, and a combined statement of earnings for the six months ending on that date, on an unaudited basis.

41. At the same time, Kenefick and Travers discussed the need for the filing by Registrant of a Form 9-K report reflecting financial information for the six month periods ending November 30, 1960 and 1961.^{11/} Kenefick advised that the 1961 figures to be prepared for the Exchange application

^{10/} Following are figures reported in the Prospectus for the 4 months ending September 30, 1961:

Net sales.	\$807,749.00
Net earnings.	75,531.00
Net earnings per share of common stock..	.2518

Cf. Scovell, Wellington's first report, which computes per share earnings at \$.2085; the second report computes them at \$.2199.

^{11/} Form 9-K, which is required to be filed pursuant to Section 13 and Section 15(d) of the Exchange Act, calls for financial information not required to be certified. The initial report also requires information for the corresponding six month period of the company's preceding fiscal year.

could be used, but that the six month figures for 1960 required by the 9-K report would present a problem because of the need for restating income for certain of the companies. He informed Travers that no audit was being made and that Travers must certify the figures. Travers asked Kenefick to assist Smith in the preparation of the unaudited figures for the six month periods.

42. The figures were compiled for the several corporations by Kenefick, Martin and Smith. Thereafter, a comparative statement was shown to Travers, who expressed disappointment in it. Travers advised Kenefick by telephone that the 1960 six month figures of Precise Metals were inaccurate; that because of serious money problems in that year the inventory of Precise Metals had been over-stated. Following the telephone conversation, Kenefick reduced the inventory figure for Precise Metals as of November 30, 1960 by \$100,000.00 in the preparation of the Form 9-K. In addition, Kenefick reflected sales returns of \$23,065.00 for the 1960 period, which he was advised by Travers had not been recorded in the books of Precise Metals and were, therefore, not reflected in the comparative statement.

43. Travers also had previously advised Kenefick by telephone that Smith had failed to take into consideration and to reflect in his work papers sales of Precise Metals in the amount of approximately \$34,000.00 made during the 1961 six month period. Kenefick added the \$34,000.00 for this period as sales of Precise Metals in preparing the Form 9-K for Registrant.

44. Kenefick made no attempt to verify the information given him by Travers with regard to the \$100,000.00 or the \$34,000.00 items. In preparing the Form 9-K, he reflected these changes and also accrued vacation pay, accrued Massachusetts excise taxes and Federal income taxes. The resultant figures were used in the Form 9-K filed with the Commission on January 9, 1962.

45. Respondent urges that the reduction of \$100,000.00 in inventory as of November 30, 1960 corrected an over-statement previously made in the inventory. There is no credible evidence, however, indicating the extent of over-statement of inventory which may have been made as of November 30, 1960. It is clear that the dominant purpose of Travers, in directing changes in the comparative figures, was to portray a favorable picture of Registrant's business during the 1961 six month period rather than to reflect a fair and accurate picture for each of the periods. It was only after reviewing a disappointing comparative consolidated statement that he advised Kenefick that inventory had been over-stated for credit purposes in the 1960 period. This is a matter which he would not have failed to mention at the outset of discussions with Kenefick if he were interested in reporting a fair and accurate picture.

46. This conclusion is supported by Smith's testimony to the effect that Travers requested him, on March 6, 1962, to make changes in the

books of Precise Metals for the 1961 period, in order that there would be conformity with the 9-K figures. Smith testified that Travers suggested three alternative methods by which this could be accomplished, one of which involved the rewriting of certain sales made in December 1961 so that they would be reflected as November 1961 sales.

47. The Examiner finds, absent credible evidence pertaining to the over-statement of inventory of Precise Metals as of November 30, 1960, that the reduction in the amount of \$100,000.00 was unjustified. He also finds that the increase in sales of Precise Metals for the six month period in 1961 by the amount of \$34,000.00 was unjustified and did not reflect the experience of that company.

(e) The Certificate and the Independence of the Certified Public Accountant

48. The Prospectus contains a letter from John F. Kenefick, Certified Public Accountant, addressed to the Board of Directors of Registrant and dated July 27, 1961, which is reprinted under the caption, "Report of Independent Certified Public Accountant." The letter states in pertinent part that the accountant has examined the consolidated balance sheet of Registrant and its subsidiaries as of May 31, 1961 and the related statements of consolidated earnings and consolidated retained earnings (deficit) for the three years ended May 31, 1961, and that these examinations were made in accordance with generally accepted auditing standards. The letter also states that, (subject to an explanation not here pertinent regarding inventories) the related statements of consolidated earnings present fairly the results of operations for the years ended May 31, 1959, 1960 and 1961, in conformity with generally accepted accounting principles applied on a consistent basis.

49. The Division contends that this certificate is inadequate and inaccurate in its statement of the auditing procedures applied to determine the fairness of the presentation of the financial statements in the Prospectus. More specifically, as indicated above, the Division challenges the certificate as it relates particularly to Kenefick's procedures regarding the commissions owed by Precise Metals to McNeill and Stieglitz, as well as to his procedures regarding the inventory of Precise Metals at May 31, 1961.

50. Inter-related with these issues is the added charge that the certified public accountant was not, in fact, independent, particularly because of a subservience to the Registrant in adopting Travers' figures on the liability of Precise Metals for commissions and in accepting the computation of work-in-process inventory as of May 31, 1961 without adequate verification. The Division also urges that the changes made by the accountant in the unaudited comparative statements for the four month periods and the six month periods on the basis of information from Travers not verified by Kenefick also demonstrate his lack of independence.

51. With respect to the unaudited statements, Kenefick testified that he was performing a mechanical function and was authorized to accept and collate information and figures from Travers, the chief accounting officer of Registrant, without the requirement of verification. The Division has cited no authority supporting the conclusion that an accountant is not authorized to accept and use, without confirmation, information from an ostensibly responsible official of a company, in connection with unaudited material

to be prepared by the accountant. There is no convincing evidence that Kenefick knew the information and figures given him were false, and the Examiner concludes that using it as Kenefick did was not so flagrant a departure from good accounting practice as to demonstrate a lack of independence.

52. Conversely, with respect to the audited statements a certificate of an independent accountant carries with it important responsibilities to third persons who may be expected to rely on the accuracy of its information. The burden of taking reasonable action to verify and support the veracity of these statements is a serious one. As stated in Accountant's Handbook (4th ed., 1961) at 28-6, regarding the significance of an auditor's report:

"As an independent expert he makes an intensive review and investigation of the financial statements of the client company, referring to the supporting records and documents and the actual assets where necessary. Throughout the examination his effort is to collect sufficient evidential matter to permit him to develop an informed opinion as to whether or not the financial statements under examination present fairly the financial position of the results of operation of the company examined. His report is the vehicle by means of which his opinion is expressed formally to his client and others."

Cf. In the Matter of Cornucopia Gold Mines, 1 S.E.C. 364, 367 (1936),

where the Commission stated:

"The insistence of the [Securities] Act on a certification by an 'independent' accountant signifies the real function which certification should perform. That function is the submission to an independent and impartial mind of the accounting practices and policies of registrants. The history of finance well illustrates the importance and need for submission to such impartial persons of the accounting practices and policies of the management to the end that present and prospective security holders will be protected against unsound accounting practices and procedure and will be afforded, as nearly as accounting conventions will permit, the truth about the financial condition of the enterprise which issues the securities. Accordingly, the certification gives a minimum of protection against untruths and half-truths which otherwise would more easily creep into financial statements."

53. The Examiner finds that the auditor did not exercise due professional care in accepting from Travers the information and figures on the liability of Precise Metals for selling commissions. Travers' statement that the basis for compensation had been changed from 5% to a sliding scale should have aroused Kenefick's suspicion, particularly because the figures Smith had furnished were decreased by the round amount of \$40,000.00. Under the circumstances, good accounting procedures would require careful and persistent efforts to verify this information. Although the error did not become productive because McNeill failed to confirm the amount due, Kenefick also erred in permitting Travers to transmit the prepared verifications to the salesmen.^{12/} The cumulative effect of this error becomes material in the evaluation of Kenefick's independence as an auditor.

54. Nor did Kenefick insist on reviewing the commission figures given him by Travers, purportedly computed under a sliding scale. Conversely, he

^{12/} See Accountant's Handbook, supra, 28-15, regarding the confirmation:

"In the application of this technique it is essential that the auditor exercise control over the preparation, mailing, and receipt of confirmation requests."

changed Smith's work-sheet figures by \$40,000.00 even though he had received no confirmation from McNeill. Additionally, his suspicion should have been provoked by Travers' statement that he intended to reward the salesmen personally. Under all the circumstances, he failed to follow generally accepted auditing standards in changing the sales commission figures. Without taking appropriate steps and achieving a satisfactory verification, no certification of the financial statement was proper. His failure is sufficiently gross to indicate a lack of independence, as charged.

55. Kenefick also failed to take reasonable precautions in regard to the work-in-process inventory of Precise Metals. Albizer's inability or refusal to show any cost records should have provoked the auditor's insistence either on a circumspect review of cost records, which, to the extent they existed, may have been found inadequate, or, in the alternative on at least a sufficiently thorough spot check of work-in-process inventory to assure the accuracy of the figures given him.^{13/} On the contrary, the auditor did not adopt reasonable methods to verify the evaluation of work-in-process inventory, and this failure further evidences his lack of independence. Cf. Accountant's Handbook, supra, 28-9, 10.

13/ Kenefick testified as follows:

"I asked to see them. At the time he said, 'I do not know where they are.' I intended to go back to see them. It was one in many hundreds of items. I wanted to see the cost(s). I said, 'Mr. Albizer, a cost system should be installed for the efficiency of this operation.'"

Cf. Montgomery's Auditing, supra, p. 228.

"[The auditor] should make sufficient tests to be satisfied that costs to be applied to inventory are fair and in accordance with generally accepted accounting principles."

56. Kenefick engaged Smith at the suggestion of Travers, and paid him \$700.00 out of his total fee of \$7,000.00.^{14/} Smith was to assist in the preparation of the registration statement after his regular working hours as office manager for Precise Metals and his work for the other companies of the group, but much of this work was done during regular hours. Nor was Smith's assistance confined to purely clerical functions, as testified by Kenefick. He assisted as an accountant, performing accounting functions in many areas, including the preparation of consolidated balances and net earnings statements.

57. It was impossible for Kenefick to know and evaluate the extent of review required over Smith's work, for he could not demarcate the work done by Smith as a company employee from that done as Kenefick's employee. It is not an answer that he reviewed all of Smith's work, for the critical and objective analysis with which an auditor should review information or figures furnished by a client would not obtain in his evaluation of work or information furnished by his own employee. Cf. In the Matter of Red Bank Oil Company, 21 S.E.C. 695 (1946). Kenefick's attitude toward this engagement was demonstrated at the outset by his hiring of Smith at the request of Travers.

58. The Examiner concludes that the auditor so unreasonably subordinated his judgment to the desires of his client in accepting the information given him by management and using this information in the audited statements, that he was not in fact an independent auditor.

^{14/} Kenefick also paid Martin \$1,500.00 for his assistance as an accountant.

CONCLUSIONS OF LAW

On the basis of the foregoing, the following conclusions are reached:

1. With respect to the registration statement filed under the Securities Act and the Form 10 filed under the Exchange Act, which incorporates by reference the registration statement, the consolidated balance sheet as of May 31, 1961 and the combined statement of earnings were false and misleading in that:

(a) Commissions due to salesmen in the amount of \$40,000.00 were excluded from selling ^{and} general and administrative expenses for the year ending May 31, 1961, resulting in a material over-statement of net earnings and stockholders' equity and a material under-statement of liabilities;

(b) The inventory as of May 31, 1961 was materially overstated, and as a result the net earnings for the fiscal year ended on that date were also materially overstated;

(c) The combined statement of earnings was false and misleading because the unaudited net sales, net earnings and net earnings per share of common stock for the 4 month periods ended September 30, 1960 and 1961 were materially misstated;

(d) The certificate of the certified public accountant was false and misleading in its statements and representations that the examination of Registrant's consolidated balance sheet and earnings statements was made in accordance with generally accepted auditing standards; that the balance sheet presents fairly the financial position of Registrant and its subsidiaries as of May 31, 1961, and that the related statements of consolidated earnings present fairly the result of operations for the year ended May 31, 1961 in conformity with generally accepted accounting principles applied on a consistent basis.

2. The unaudited financial information for the 6 month periods ended November 30, 1960 and 1961, set forth in the semi-annual report on Form 9-K was materially misstated.

RECOMMENDATIONS

The Securities Act, Section 8(d) Proceedings

Respondent urges that no stop order should issue, and cites the following cases to support its argument that the issuance of a stop order in this matter would not accord with the Commission's policy and practice in the past. Miami Window Corporation, Securities Act Release No. 4503 (June 21, 1962); Drayer-Hanson, Inc., 27 S.E.C. 838 (1949); In the Matter of Universal Camera Corporation, 19 S.E.C. 648 (1945); Automation Shares, Inc. 37 S.E.C. 771 (1958); and In the Matter of Central Specialty Company, 10 S.E.C. 1094 (1942).

In the three last-named cases, amendments were filed to the registration statements, correcting the deficiencies therein. In the Drayer-Hanson case no stop order proceeding was instituted by the Commission, the matter constituting, rather, a report of investigation pursuant to Section 8(e) of the Securities Act. And in the Miami Window case a new management had taken over the registrant, apparently had voluntarily disclosed to the Division the irregularities of its predecessors and had voluntarily informed the stockholders and the public regarding the fact that questions had arisen concerning the reliability of the financial statements.

More importantly, in each of the cases the Commission was satisfied that all or substantially all of the deficiencies in the respective registration statements were corrected to the extent that correction could reasonably be made, and that under the circumstances investors would be

adequately informed of the facts. In each case the Commission determined that issuance of a stop order was not necessary in the public interest or for the protection of investors, and in the exercise of its discretion considered the corrective amendments and found them adequate.

Here the Registrant has filed with the Commission an amended 9-K report, its Form 10-K annual report for the fiscal year ended May 31, 1962, including certification of the financial statements by Scovell, Wellington in its letter dated August 1, 1962, and on October 30, 1962 Registrant filed a copy of its annual report to stockholders, dated July 14, 1962.

It is impossible to reconstruct, with any assurance of accuracy, Registrant's financial statements as of May 31, 1961 or those for the interim periods included in the registration statement. The financial statements certified by Scovell, Wellington merit serious consideration in determining the extent to which corrections and disclosure of deficiencies are being made by Registrant, even though such correction and disclosure are not being made by amendment to the registration statement. However, it is not deemed expedient, practical, or within the province of the Examiner to attempt to evaluate the accuracy of the Form 10-K annual report or its financial statements, especially because they speak as of May 31, 1962.

It is deemed appropriate, however, to point out that in its reply brief the Division asserts that the amended 9-K and the Form 10-K filed by Registrant "contain inaccurate explanatory language concerning the figures challenged in this proceeding and omit entirely many relevant facts and circumstances developed in the hearing." With this statement, the Hearing

Examiner is in accord. The changes and explanations made in the amended 9-K are substantially inconsistent with the findings made above. By way of example, it is noted that the Form 10-K report explains the elimination of \$100,000.00 from the September 30, 1960 sales figures of Registrant as an error in copying figures from one work-sheet to another, a suggestion which the Examiner refused to adopt after hearing the witnesses and reviewing the documentary evidence relating to this discrepancy.

In The Matter of Hazel Bishop, Securities Act Release No. 4371 (June 7, 1961) the Commission held that ^{under} the circumstances of that case it would not exercise its discretion to consider assertedly curative amendments to a registration statement which were filed following the development of the record at a hearing in a Section 8(d) proceeding. A stop order, accordingly, was issued. The Commission stated:

"Our staff is in the process of examining the most recent amendments to determine whether the disclosures therein remedy the deficiencies which existed in the prior filings, and will now be in a position to consider it in the light of this opinion. We have directed that the staff's views with respect to the amendments now on file and any other amendment which registrant may wish to submit following publication of this opinion be communicated promptly to registrant. Thereafter, the matter is to be submitted to us promptly for appropriate action on the question of lifting the stop order and making the registration statement effective.

"Accordingly, a stop order will issue."

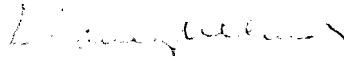
In view of obvious discrepancies between the Examiner's findings, on the one hand, and the explanations and asserted corrections in the filed material and stockholders' report, on the other, and the inability to evaluate the Form 10-K report and its statements as of May 31, 1962, under the circumstances in which the discrepancies were created by present management the Examiner does not recommend that the Commission exercise its discretion and determine that a stop order should not issue. It is recommended, rather, that a procedure similar to that adopted in Hazel Bishop be followed in this case.

The Exchange Act, Section 19(a)(2) Proceeding

In view of the distribution of Registrant's annual report for the fiscal year ended May 31, 1962 to stockholders, the filings with the Commission and the Exchange subsequent to the hearing, and other information made available to shareholders and to the public, the Commission determined not to continue the issuance of temporary suspension orders banning trading in Registrant's stock after December 19, 1962 and pending the conclusion of these proceedings. The Commission's Release of December 17, 1962, expressed that determination. Presumably, trading in the stock has been engaged in on the Exchange and in the over-the-counter market subsequent to December 19. In the event of the issuance of a stop order as recommended, still further publicity would be given this matter and presumably would be brought to the attention of stockholders. Under these circumstances it would not appear necessary or appropriate for the protection of investors to suspend or withdraw the registration

of the common stock of Registrant on the Exchange, and the Examiner recommends against such action.^{15/}

Respectfully submitted,



Sidney Ullman
Hearing Examiner

Washington, D. C.
January 11, 1963

^{15/} To the extent that the proposed findings and conclusions submitted to the Hearing Examiner are in accord with the views set forth herein they are sustained, and to the extent that they are inconsistent therewith, they are expressly rejected.