ADMINISTRATIVE PROCEEDING
FILE NO. 3-2233

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

FILE COPY

In the Matter of

ERNST & ERNST
CLARENCE T. ISENSEE
JOHN F. MAURER

Rule 2(e) of the Rules of Practice

INITIAL DECISION

(Private Proceeding)

Appearances: Theodore Sonde, Assistant General Counsel, Alan Blank and Michael J. Roach, Attorneys Office of General Counsel, for the Office of the Chief Accountant of the Commisssion.

Frank C. Heath, Patrick F. McCartan and Marc L. Swartzbaugh of Jones, Day, Cockley & Reavis, Cleveland, Ohio, for respondents.

Before: Ralph Hunter Tracy, Hearing Examiner

THE PROCEEDING

Introduction

This private proceeding was instituted by an Order of the Commission ("Order") dated November 20, 1969, pursuant to Rule 2(e) of the Commission's Rules of Practice to determine whether Ernst & Ernst, a firm of certified public accountants, and Clarence T. Isensee and John R. Maurer, partners and employees thereof, should be denied, temporarily or permanently, the privilege of appearing or practicing before the Commission.[1/]

The Commission's order initiating this proceeding was followed on February 2, 1970 by an order setting prehearing procedures which, among other things, directed that the Office of General Counsel ("OGC") file a Statement of Matters, that all parties file proposed stipulations of fact and that a prehearing conference then be held to resolve any differences. On March 2, 1970, the OGC filed a Statement of Matters and a proposed stipulation of facts. On March 5, 1970, respondents filed their proposed stipulation of facts. Thereafter prehearing conferences were held which resulted in a joint stipulation of facts being entered into on December 14, 1970.[2/]

On January 25, 1971, during the course of the evidentiary hearing, a motion by the OGC to amend the order for proceeding and the Statement of Matters was granted over the objection of respondents.

1/ Rule 2(e) provides for the temporary or permanent suspension from appearing or practicing before the Commission of "any person who is found by the Commission after notice of and opportunity for hearing in the matter (1) not to possess the requisite qualifications to represent others, or (2) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct."

2/ The stipulation, consisting of 113 pages and 78 appendices, was subsequently admitted into evidence during the course of the evidentiary hearing.

The Charges

The subject matter of this proceeding involves E&E's certification of financial statements of Western Equities, Inc. ("Westec") for the years ended December 31, 1964 and December 31, 1965, respectively.[3/] Westec's 1964 and 1965 financial statements were filed with this Commission pursuant to Section 13 of the Securities Exchange Act of 1934. Under the order and the Statement of Matters, as amended, the Office of the Chief Accountant ("OCA")[4/] alleges, in substance, that in connection with their audits and certifications of these statements, respondents willfully violated Regulation S-X which contains the Commission's accounting rules and regulations; that respondents failed to follow generally accepted accounting principles or to apply generally accepted auditing standards; that respondents knew that the certificates prepared and signed by them in connection with these financial statements were materially false and misleading; and that respondents were not "independent" public accountants with respect to their audits and certifications of Westec's 1964 and 1965 financial statements.

The evidentiary hearing was held at Washington, D.C. from January 18, 1971 to May 14, 1971, with all respondents being represented by counsel. Proposed findings of fact and conclusions of law and supporting briefs were filed by the parties.

3/ In addition, respondents are charged with aiding and abetting in the preparation and dissemination of materially false and misleading interim financial statements for Westec for the nine-month period ending September 30, 1965, which were not certified.

4/ The OCA is the charging party and is represented by the OGC.

The findings and conclusions herein are based upon the preponderance of the evidence as determined from the record and upon observation of the witnesses. 5/

Respondents

Ernst & Ernst ("E & E") is a nationally-known accounting firm founded in June 1903, which has been practicing before this Commission since its inception in 1934.

Clarence T. Isensee ("Isensee") received his B.B.A. degree in Accounting from the University of Texas in 1941. He joined E &E's Houston office in August, 1941 and, with the exception of some 4 years service in the United States Army from which he was discharged with the rank of Major in February, 1946, has been continously engaged in the practice of public accountancy with E&E's Houston office. He became a certified public accountant in the State of Texas in 1948 and was admitted to partnership in E&E in 1959. Isensee was the E&E partner in charge of the Westec engagement, and was and is the partner in charge of the audit staff of the E&E Houston office.

John F. Maurer ("Maurer") received his B.A. degree from Ouachita Baptist University in 1952. In 1952 he entered the United States Army, from which he was discharged in 1955 with the rank of First Lieutenant. Maurer attended the University of Texas from 1955 to 1957, completing all formal course requirements for a Master's degree in accounting. He has been employed on the audit staff of the E&E

5/ Respondents' contention that the quantum of proof required to establish the alleged violations is greater than a preponderance of the evidence is rejected. Norman Polliskey, Securities Exchange Act Release No. 838 at 9 (August 13, 1968); DeMammos v. S.E.C., C.A. 2, Docket No. 34169 (Oct. 13, 1967), affirming, James DeMammos, Securities Exchange Act Release No. 8090 (June 2, 1967); Underhill Securities Corporation, Securities Exchange Act Release No. 7668 at 6 (August 3, 1965)

Houston office since February 1957 and in 1959 became a certified public accountant in the State of Texas. He was promoted to audit manager in October 1963 and was named a partner of E&E on October 1, 1970 during the course of this proceeding. Maurer was the E&E Houston office audit manager on the Westec engagement.

Background

Western Gold Mines, Inc., was incorporated on January 25, 1944 in the State of Nevada. The Corporation's name was changed to Western Gold & Uranium, Inc. in 1953 and to Western Equities, Inc. in 1961. On September 2, 1964, Western Equities, Inc. merged with Geo Space Corporation ("Geo Space"), a company engaged in the design and manufacture of geophysical instruments and equipment used in the exploration of natural resources, such as oil, gas and minerals, and established its corporate headquarters and principal place of business in Houston, Texas. On May 20, 1966, the corporation's name was changed again, this time to Westec Corporation, and throughout this decision the corporation is referred to as "Westec" or "Westec Corporation."

Geo Space was the outgrowth of Hall-Sears, Inc. ("Hall-Sears"), a business founded in 1957 by Ernest M. Hall, Jr. ("Hall") and H.A. Sears ("Sears") to engage in the development and marketing of a line of geophones, a seismic measuring device. By 1961 Hall-Sears had sales of 1.2 million and embarked on an accelerated growth program. In 1962 Hall-Sears combined with Instrument Corporation of Florida ("ICF"), Hall becoming president and a director of the company. In 1963, with the acquisition of the assets of Geo Space Electronics Company, the name was changed to Geo Space Corporation ("Geo Space").

James W. Williams ("Williams") became a vice president of Business Funds, Inc. ("BFI") in 1961 and was elected a director of both BFI and Western Equities in 1963. BFI was a large SBIC (small business investment company) which provided financing for Hall-Sears when it began the growth program described above. In addition, at the time of the merger BFI received over ten percent of Westec's common stock and a Westec note for approximately three million dollars due on December 31, 1964. Western Equity became the surviving entity with its stock listed on the American Stock Exchange ("ASE"). It was through BFI that Williams became a dominant factor in the Geo Space-Western Equity consolidation, becoming Chairman of the Board of Directors while Hall became president and a director, positions both held until trading in Westec stock was suspended by the Commission on August 26, 1966. Hall, also, was treasurer of Westec from March or April 1965 until at least July 1966.

Following the merger, Herbert R. Belcher ("Belcher"), Secretary and Controller of Geo Space, became Assistant Secretary and Controller of Westec and served in these capacities for approximately one year, when he became Vice President of Westec, a position he occupied until the suspension of trading in 1966. With the exception of a period in 1957 and 1958, when he was employed elsewhere, Belcher was employed by E&E in its Management Services Division as an Industrial Engineer from 1952 until he joined Geo Space as its Secretary and Controller in February 1964. Belcher became a CPA in 1960.

Early in its history Geo Space ("Hall-Sears") had set up subsidiaries in England, Holland, Canada and France. In mid-1963 it acquired Seismic Supply ("Australia") Property, Ltd. so that upon completion of the merger with Geo Space, Western Equities became international in scope.

Westec's Engagement of E&E

E&E became auditors for Westec on September 24, 1964. Prior to that time the auditors for Geo Space were Peat, Marwick and Mitchell ("PMM"), and the auditors for Western Equities, Inc. were Olsen, Gardner and Squire.

E&E's interest in acquiring Westec as a client began in September 1963 when H.F. Reiss, Jr. ("Reiss"), a New York office partner of E&E alerted Erwin Heinen ("Heinen"), the partner in charge of the E&E Houston office, to the possibility. During the intervening period between September 1963 and September 1964 E&E personnel assiduously cultivated Westec officers and directors including Williams, Hall and Belcher. At one stage Belcher and Hall called Heinen to Geo Space's office and expressed their dissatisfaction with PMM which was then in the process of making the December 31, 1963 audit and asked whether it was possible for E&E to finish the audit that PMM had started and render a report. Belcher and Hall were informed that it would not be practicable and that they should continue with PMM until completion of the assignment.

Several months later, around the latter part of June, 1964 Williams and Hall again called Heinen to discuss whether E&E could take over from PMM who were then re-auditing some contracts-in-progress and amending a prospectus filed with the SEC. Heinen again stated that it would not be practicable but that E&E would be pleased to accept the assignment for the following year if it was offered. On August 21, 1964 Heinen was called to the Westec offices for further discussion. Belcher and Hall informed Heinen that Olsen, Gardner & Squire, Western's current auditors had told them that Haskins and Sells would be glad to accept their work on the mining and real estate operations of Western, presumably in return for doing the entire engagement. Heinen assured Hall and Belcher that E&E could work out a similar arrangement. On August 24, 1964 Heinen attended Western Equities stockholders meeting in New York where the merger with Geo Space was approved, with Williams and Hall becoming Chairman of the Board and President, respectively, of the surviving company, Westec. At this meeting Heinen met most of the directors of Westec. On September 24, 1964, following discussions between Hall, Williams, Belcher, Heinen, and Isensee, E&E was informed that the Westec Board of Directors had approved their being named auditors of Westec for the year ending December 31, 1964.

On September 25, 1964 Heinen wrote Reiss to thank him for his assistance in securing the Westec account and stated:

> Since the company has an American Stock Exchange listing and will have funds available from mine and real estate liquidations, they are going on an extensive expansion program. As a matter of fact, I had several meetings last week with Mr. Hall relative to an acquisition of a controlling interest in a substantial company which was acquired jointly by Western Equities, Inc. and Business Funds last week, and I know there are several others being contemplated.

FINDINGS OF FACT AND LAW

The 1964 Westec Financial Statements

The 1964 Westec financial statements included some 13 companies and divisions. Offices and operations were located in four states and five foreign countries. The company was then principally engaged in the design and manufacture of geophysical instruments and equipment used in the exploration of natural resources, the development and manufacture of precision timing equipment and other instruments, and in engineering and manufacturing microwave energy sources. In addition, the company was engaged in mining and the development of real estate.

In addition to Isensee and Maurer, the Ernst & Ernst Houston office assigned 7 employees to the 1964 Westec audit and utilized the services of the Ernst & Ernst Houston and Miami offices and the firm of Olsen, Gardner & Squire, certified public accountants with offices located in Provo, Utah. A total of 1,981 hours was expended by Ernst & Ernst in connection with the audit.

1964 Audit

Immediately upon accepting the engagement E&E began planning the audit for the year ending December 31, 1964. Heinen went to Phoenix, Arizona with Belcher on October 21, 1964 to inspect the former Western Equities properties and Maurer subsequently went to Florida with Belcher to inspect the former Geo Space properties. Maurer, who was named field manager for the audit, assisted in the preparation of a detailed audit program. E&E's Guide to Audit Procedure ("Guide") states that special problems arise in connection with a first examination, among them being the necessity of obtaining an adequate background of the client and its procedures and the extent to which the reports of predecessor accountants can be relied on. E&E did not contact PMM, the previous auditors with whom Westec had problems. B. Larry

Johnson ("Johnson") who had been the supervisor on the Geo Space audit performed by PMM became controller of Geo Space in September or October 1964, and apparently E&E felt that whatever information was required concerning PMM's experience with Westec could be furnished by Johnson.

As to the Guide's directive to know the client E&E was confronted at the outset with a situation which was indicative of management's attitude with regard to financial disclosure. This involved BFI of which Williams, Chairman of the Board of Westec, was vice president.

BFI Warrants

Geo Space had borrowed monies from BFI over a period of several years and in connection with such borrowings had issued warrants entitling BFI to purchase Geo Space shares at various stipulated prices. On June 24, 1964, Geo Space consolidated its indebtedness to BFI into one note of $3,083,750 due in installments of $200,000 payable on January 1, 1968 and $2,883,750 payable on January 1, 1969. This loan was restated and assumed by Western Equities upon merger of the companies and the warrants for 3,776,906 shares of Geo Space common stock previously issued to BFI were converted to warrants for 1,020,785 shares of Westec common stock.

On September 21, 1964, Westec's board of directors decided that the existence of the BFI warrants was having a depressant effect on the market for Westec's stock because of the dilution potential so the board authorized issuance of 459,663 shares of Westec's common stock for a cash consideration of 10¢ per share in extinguishment of the outstanding warrants.

The market value of the shares issued in settlement of the warrants ($3.00) represented an additional cost of the borrowing and it was necessary to determine the proper method of accounting for this additional cost.

On or about October 28, 1964, Belcher informed Isensee that Hall and Williams were interested in determining whether there were any methods by which this transaction could be accounted for so that it would not be disclosed in the current year's statement to stockholders.

Isensee took the position that costs incurred in the arranging of long-term financing are normally capitalized and amortized over the life of the loan. This was the accounting treatment eventually accorded to this transaction in Westec's 1964 earnings statement with $225,960 being charged to earnings for 1964 and $169,854 being charged to retained earnings. (See note I to the financial statements).

During discussions with management Williams had called attention to a similar loan by BFI to U.S. Brass of which he was a director, where the financing costs had not been charged to current earnings. In a letter to Isensee on October 21, 1964, written enroute to Phoenix with Heinen, Belcher referred to the U.S. Brass handling and asked Isensee to "check out this refinanced 'favorable treatment' for possible use in our case." However, upon examination of the U.S. Brass transaction with its auditors Isensee determined that the situation was not the same as Westec's and that the accounting treatment recommended by E&E was correct under the circumstances.

Management's concern over the disclosure of this transaction is evidenced, further, by a letter dated November 6, 1964, from Hall as President of Westec to Williams as vice president of BFI with a copy to

Isensee, discussing the transaction at length and stating: "It is a big item, perhaps to the point that investors will solicit an explanation or read the footnote."

In addition to the charge against earnings, which substantially reduced earnings for 1964, the 459,663 shares issued on October 1, 1964 further reduced per share earnings. However, these were pro-rated so that only 115,544 were considered as outstanding on December 31, 1964 for the purpose of calculating per share earnings. Westec's interest in per share earnings, as well as acquisitions, is indicated by management's letter to shareholders in the 1964 Annual Report which states: ". . . Your Board of Directors has approved the acquisition of five companies thus far in 1965 . . . . We confidently expect that they will contribute to achieving our general objective of increasing earnings per share by at least 75% in 1965 as compared to 1964."

The effect of this transaction on per share earnings continued to concern management and on March 29, 1965 Isensee wrote to Hall and Williams stating that in furtherance of prior discussions relating to the determination of net income per share he was enclosing Accounting Research Bulletin No. 49 entitled "Earnings Per Share."[6/] Isensee, also, disclosed that he had discussed the per share earnings question with an officer of the New York Stock Exchange ("NYSE") who had expressed the opinion that the BFI type transaction was a most unusual one and that argument could be made for either using shares outstanding at the end of the year or average outstanding shares and that his Exchange would approve either method, but would strongly urge that the method of determining the per share figure be disclosed.[7/]

6/ Accounting Research Bulletins ("ARB") are issued by the American Institute of Certified Public Accountants ("AICPA").

7/ Average outstanding shares method used in 1964 and 1965.

Sale of Arizona Property

About the third week in February 1965, Belcher visited with Isensee concerning the sale by Westec of its Lightning Warehouse property ("Lightning") in Arizona to an individual investor for a note receivable (no cash was paid on the sale).[8/] Belcher was interested in knowing whether it was possible to record the sale as having been made at December 31, 1964, rather than in February, 1965. Isensee told Belcher, in effect, that it would be exceedingly difficult to justify such treatment in view of the fact that no cash down payment had been received in 1964 and all of the documentation would reflect 1965 dating and consummation. Isensee agreed that the document could be dated in 1964, but pointed out that the notarization and the recording of the deed must necessarily reflect February, 1965 dating. Isensee also pointed out that Belcher had approached him in late December, 1964, to discuss the sale of some Florida property belonging to ICF, it being Westec's desire to realize as much income as possible in 1964. In this latter instance Isensee agreed that it would be proper to take up the income on the sale of the Florida property inasmuch as such sale was for cash and notes, to an unrelated individual investor[9/] who was agreeable

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8/ The individual investor referred to was actually the J.D. Corporation ("J.D.") owned by Donald McGregor ("McGregor"). McGregor testified that he and John F. Austin, Jr. ("Austin") president of the T.J. Fettes Company, a Houston real estate and mortgage firm of which McGregor had been executive vice-president until he retired in 1962, had been formed to engage in real estate transactions and that he bought out Austin in 1960. Austin was Chairman of the Board of BFI and a director of Westec in 1964 and 1965.

9/ Donald McGregor who appears in a number of Westec transactions in 1964 and 1965. In fact, Belcher inquired of Heinen before E&E was offered the engagement as to who McGregor was because he was a friend of Hall and Williams and his name had appeared "several times" concerning "loans and/or other financial transactions to Mr. McGregor" by Geo Space.

to leasing the building back to the company on a month-to-month basis rather than on a long-term lease (there being no sale and lease back situation because of the month-to-month arrangement).

On or about March 10, 1965, Hall called Isensee at home one night to discuss the rules governing pooling of interests and also the rules regarding inclusion in 1964 income of profit arising from the sale of the Arizona (Lightning) warehouse, considering the fact that the sale was not concluded until February, 1965. Isensee told Hall that it was the company's obligation to report the results of operations of a specific twelve-month period and it was not possible to include selected transactions from outside that period and still be able to say that only a twelve-month period was being reported on.

At about the same date, March 10, 1965, Belcher again approached Isensee and stated that the company was very desirous of including the profit ($128,000) from the Lightning sale in the year 1964 and what would E&E's reporting of the transaction be if it was so included. Heinen and another E&E partner, Henry Hogan ("Hogan") sat in on the discussion and it was the consensus that it would be necessary to have a footnote disclosure that the 1965 transaction was included in the 1964 operations and E&E's opinion would be qualified by reference to the footnote.

Isensee pointed out to Belcher that while the SEC could not force the company to have an unqualified opinion in its report to shareholders it would normally require one in the event a registration statement was filed later. Isensee also told Belcher that he felt sure the American Stock Exchange would not be happy about the company's financial statements containing a 1965 transaction of this nature or about E&E's opinion containing an exception. Isensee suggested to Belcher that management might want to consult Campbell Griffin ("Griffin") counsel for the company but it was Belcher's opinion that Griffin need not be consulted. He felt that it was probable that the company would want to include the transaction even though it resulted in a qualified opinion from E&E. When Isensee suggested that the matter again be reviewed with Hall and Williams, Belcher agreed but asked that it be held in abeyance for several days and that it not be referred to Griffin at this point. Although the final outcome was that the Arizona property sale was reported as a 1965 transaction, thus excluding approximately $128,000 from 1964 income, management did not agree to this without further resistance as will be discussed under Draft Financials for 1964, infra.

Sale of Florida Property

Included in the reported income of Westec for the period ended December 1964 under the heading "Gain on Sale of Assets" in the Westec financial statement is an amount of $89,984 representing gain on the sale by Westec's Instrument Corporation of Florida Division ("ICF") to Donald McGregor ("McGregor") of a plant and certain real estate located in West Melbourne, Florida. This is the Florida property previously referred to by Isensee under Sale of Arizona Property (supra). There was no written contract between the parties concerning this transaction and, according to respondents, it was handled by the exchange of a deed from Westec to McGregor and a mortgage deed and note from McGregor to Westec.

The only document establishing the sales price is a letter agreement dated December 31, 1964, signed by McGregor and addressed to Hall, which states that the total purchase price is $230,000, of which $30,000 has been paid as a down payment, the balance to be paid in 7 equal annual installments of $12,099.17. However, respondents claim that they never saw this letter agreement and that the transaction was actually consummated by a mortgage note of McGregor dated December 31, 1964, in the principal amount of $114,694.19 providing for a down payment of $30,000 on or before January 31, 1965, and the assumption by McGregor of two Geo-Space mortgage notes for the balance. A warranty deed dated December 31, 1964, conveying the ICF plant and real estate to McGregor was executed but not recorded in Florida until April 27, 1966. This deed recited that the grantee, McGregor, was assuming the two prior first mortgages on the property being conveyed. A mortgage deed dated December 31, 1964, from McGregor to Westec was also executed but not recorded in Florida until April 27, 1966. The ICF transaction was closed on or about March 22, 1965 and the settlement sheet relating to the transaction indicates that after certain adjustments McGregor owed a down payment of $26,435.51. The settlement sheet, prepared by Belcher, also reflected the rent as $2700 a month while Westec continued to make payments on the notes of $1400 per month.

On March 22 a check of $256,389.43 was received from McGregor representing the ICF down payment and an amount of $229,953.92 which was due on the sale of the Lightning Warehouse property also to McGregor.

The order and statement of matters alleges that respondents failed to conduct an adequate audit in connection with the ICF transaction which resulted in the filing of a false financial statement in that it failed to disclose among other things, that the transaction should not have been reflected in the 1964 financial statement, without an explanation similar to that recommended for the Arizona property sale; that McGregor was a record holder of more than 10% of the outstanding shares of Westec; and that there is no indication that McGregor ever in fact assumed the mortgage notes outstanding at the time of purchase.

Respondents argue that while E&E did not receive written confirmation from McGregor of the assumption of the notes it did receive a letter from Geo-Space dated February 16, 1965, representing that such assumption had taken place and that Belcher advised Maurer that such assumption by McGregor had taken place. Respondents argue that while the chief accountant claims that on December 31, 1964 McGregor was a record holder of more than 10% of Westec's stock the evidence shows only McGregor's ownership as of March 30, 1965, and even as to that McGregor testified that the records were in error. In any event respondents state E&E was not aware that McGregor was at any time a 10% shareholder of Westec. However, respondents did discuss with Westec management the obtaining of information necessary to complete schedules to Form 10-K and were advised by Westec management that Schedule II was not applicable.10/

Respondents, while asserting that they had no obligation to do more than they did, admit that technically they should not have relied solely upon representations of the corporation and Belcher concerning McGregor's assumption of the outstanding mortgages and that they should have checked the receipt of the down payment prior to release of the audit. They also urge that their failure to take such steps in no way affected this transaction since McGregor did assume the outstanding mortgages, and the down payment called for on January 31, 1965, was in fact paid in March of 1965, and that there is no evidence that these oversights occurred as a result of intentional wrongdoing on the part of respondents.

Respondents argue as part of their overall defense to the charges herein that Hall and Williams agreed early in 1965, while respondents

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10/ The instructions to Form 10-K under Part II, item 11 calls for the disclosure of any person known to own beneficially more than 10% of the stock.

examination of the Westec financial statements for the period ending December 31, 1964, was still in progress, that they would conceal and withhold from respondents any information which would arouse suspicions on the part of the auditors. However, in the present transaction, there is no allegation made that anything was withheld from respondents with the possible exception of the letter agreement signed by McGregor which respondents state they did not have access to without offering any further explanation. Respondents argue, further, that Isensee did not know who McGregor was so he asked Heinen about McGregor's reputation and was advised by Heinen that McGregor was a well-known real estate investor of considerable wealth and good reputation. McGregor and his part in a number of transactions engaged in by Westec will be discussed at some length further on in this decision.

The record shows that E&E first learned of the ICF transaction from Belcher sometime prior to December 28, 1964, and a conference was arranged between Isensee, Maurer and Belcher on December 28, 1964, at which time Isensee and Maurer inquired as to specific terms of the transaction referred to earlier by Belcher.

Maurer made notes at this conference concerning everything discussed and his entire comment concerning the Florida property transaction is "ICF-Bldg. to be sold 'arms-length' 'transaction' and rented on a month-to-month basis." However, Isensee and Maurer were informed by Belcher that the West Melbourne, Florida plant and real estate were being sold by the ICF Division to Donald McGregor for a consideration of

$230,000,[11/] consisting of a mortgage note from McGregor individually and the assumption by McGregor of outstanding mortgage notes of Geo-Space, a wholly-owned Westec subsidiary. When he had his notes of this conference typed up, Maurer did not refer to this transaction as "arms-length," he merely stated that the facts concerning the transaction should be confirmed by E&E from the buyer.

Isensee inquired of Belcher whether this transaction involved a simultaneous sale and lease-back for a long term of the property being conveyed by Westec, and was told by Belcher that there was no agreement or understanding to this effect; that Westec expected to combine the IFC operations with those of Metric Systems Corporation, a Florida company which Westec was then in the process of acquiring, and that until such time as this could be accomplished the ICF Division would be leasing the West Melbourne property from the purchaser on a month-to-month basis.

In connection with his review of the ICF transaction Maurer went to Florida and reviewed working papers. He found the property sale recorded on the ICF Division books but no supporting documentation. He did not see an appraisal as to the value of the property but testified that "the working papers in Florida which I was down there reviewing indicate a sales price of $230,000." Maurer had made the trip on the understanding that the necessary documentation would be in Florida but

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11/ McGregor testified that he was shown an appraisal previously made which appraised the property at $230,000 and that since then he checked and "that one was a bona fide transaction." McGregor did not get an appraisal of his own nor did he see the property prior to purchasing it.

found that it was back in Houston with Belcher. When he returned to Houston he inquired of Belcher concerning this matter and examined the copy of the McGregor note. He did not examine any other documents, but he did discuss them with Belcher.

E&E's Guide to Audit Procedure discusses auditing standards and quotes from Generally Accepted Auditing Standards, a special report by the Institute Committee on Auditing Procedures (1954), as follows:

> "Auditing standards may be said to be differentiated from auditing procedures in that the latter relate to acts to be performed, whereas the former deal with measures of the quality of the performance of those acts, and the objectives to be attained in the employment of the procedures undertaken."

E&E's Guide goes on to say under the heading "Standards of Field Work" "that sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination."

Viewed in the context of E&E's own standards, Isensee and Maurer cannot be said to have performed an adequate audit of the Florida property sale. Isensee and Maurer were already familiar with some of McGregor's transactions. In connection with the 1964 examination Maurer had discovered a note of Harris County Land Corporation ("Harris"), which was an uncollateralized ten-day note for $50,000 dated July 10, 1964, upon which, as of December 31, 1964, no payments of principal or interest had been paid, as Maurer noted in his work papers. As Maurer also noted this note was replaced by a new six-month note dated January 1, 1965, also uncollateralized. There is no indication of the business purpose for the loan and Maurer could not recall asking about the purpose of the loan. The note was payable to Geo Space and was signed by McGregor as vice president of Harris Land. McGregor testified that Harris was a "shell corporation" which he "used to assist in financing a loan" to Westec's president Hall, in the amount of $500,000.

McGregor was also the owner of the J.D. Corporation which was the purchaser of the Lightning Warehouse property. (Footnote 8, supra). In addition, McGregor was a 10% shareholder of the common stock of Westec. As indicated herein the closing for the Florida transaction and the Lightning Warehouse transaction took place at the same time and the payment for both properties was made by a single check from McGregor.

In view of the number and nature of the appearances of McGregor up to this time some inquiries should have been made concerning his activities. It is not deemed sufficient that Isensee went back to the E&E office and inquired of Heinen as to McGregor and when told he had a reputation for honesty and integrity let it go at that. McGregor's honesty should not have been the sole concern. Respondents should have been alerted as to whether the appearance of the same individual, who was a 10% shareholder of Westec, on the other side of material transactions contributing to Westec's 1964 income warranted further investigation in order to determine whether these transactions were arms-length, whether they were bona fide and whether any aspects of them required disclosure. Also, whether E&E should have examined the shareholders record in preparation of Form 10 K rather than depend on managements' assurance that such inquiry was not necessary.

Isensee was already aware of the company's announced acquisition policy so that in the face of his insistence on the amortization charge and the refusal to record the Lightning Warehouse sale in 1964 he should have been particularly on the alert when Belcher held the meeting on December 28, 1964, and discussed the Florida property transaction. It should be noted that Isensee was the one who reminded Beccher of this transaction sometime in early 1965 and went along with carrying it out as a 1964 transaction after having declined to approve the Lightning sale as a 1964 transaction. The apparent substitution of the ICF sale for the Arizona sale should have served as a warning to respondents that both transactions required further scrutiny.

DRAFT FINANCIALS

On or about March 12, 1965 Isensee and Belcher met with Hall and Williams to discuss a proposed final draft of the Westec financial statements for the year ended December 31, 1964. The pencilled income statement did not include the Lightning Warehouse transaction but did give effect to the amortization charge arising out of the BFI transaction discussed above. The net earnings per draft financials were $1,062,970.

At the meeting Hall and Williams disclosed that Westec was in the process of acquiring two additional companies. Apparently, too, they were still intent on including the Lightning transaction in 1964, even though, as Isensee had indicated, it would necessitate a footnote and an exception. This is indicated by the fact that Maurer drew up a draft footnote for the Lightning transaction, dated March 15, 1965, to explain its inclusion in 1964. Just when the final determination was made not to include Lightning in 1964 is not clear, but it was eventually recorded as a 1965 transaction and reported as such. Meanwhile, between March 12th and 31st another acquisition was made, bringing to three the acquisitions of which E&E was not aware until on or after March 12, 1965.

1964 Pooling of Interests Transactions

The three acquisitions which management presented to E&E on or after March 12, 1965, were Doliver Corporation ("Doliver") acquired on or about March 25, 1965, Beco Inc. ("Beco") acquired by a contract purportedly relied on by respondents dated March 29, 1965, and Trak-Microwave Corporation ("Trak") acquired on or about March 31, 1965, pursuant to an agreement dated March 26, 1965, and approved by the Westec directors on March 17, 1965. Each of these acquisitions was accounted for in the Westec financial statements for the period ending December 31, 1964, as a pooling of interests transaction as disclosed in note A to the 1964 financial statements. 12/ These three acquisitions added net earnings of $308,528 for the year ended December 31, 1964.

The Acquisition of Doliver Corporation

Doliver was created by McGregor and Mr. C.A. Bullen in 1962 or 1963 specifically for the purpose of acquiring a piece of property in Austin, Texas. Doliver was owned 50% by the Manhattan Construction Company and 50% by Texas Business Investment Company which in turn was owned by McGregor. Bullen was president of the company and McGregor was vice president and treasurer. Doliver never did acquire title to the Austin property but did acquire a contract option to buy the property.

12/ The 1964 E&E Westec audit report, as contained in the 1964 Westec annual report, is dated March 26, 1965, and was authorized for printing in final form by E&E late on Friday, April 2 or early on Saturday, April 3, 1965.

On or about March 26, 1965 Westec acquired all of the outstanding shares of common stock (4,000 shares) of Doliver from Manhattan Construction and Texas Business Investment Corporation, in exchange for 13,000 shares of Westec common stock. The terms and conditions of this acquisition were never embodied in any written contract. This acquisition was accounted for as a pooling of interests transaction in the consolidated financial statements of Westec for the period ended December 31, 1964, as disclosed in note A to those statements. The Doliver acquisition contributed $115,364.00 to Westec's net earnings for the fiscal year ended December 31, 1964, and resulted in increasing Westec's per share earnings for the year by 3.5¢ which amounted to 8.1% of Westec's 1964 earnings per share.

Except for the receipt of small amounts of rental and interest and payment of incidental expenses the only transaction of Doliver during the fiscal year ending December 31, 1964, was the sale of an option on certain real estate located in Austin County, Texas. The minutes of the board of directors for Westec do not disclose approval of the acquisition of Doliver prior to the issuance of the 1964 audit report. Just how the Doliver transaction was consumated is not clear but it was accomplished after Williams inquired of McGregor whether he had a corporation to sell.

Shortly before Maurer left for the Trak offices in Tampa, Florida on March 23, 1965, he was advised of the pending Doliver acquisition. When he returned to Houston on March 26, 1965, Belcher gave him a set of unaudited financial statements of Doliver to use in respondents' consolidation.On the 24th or 25th of March 1965, McGregor had engaged Haskins & Sells to audit Doliver, this being the first time Doliver had been audited. On April 2, 1965, Maurer and Belcher met with representatives of Haskins & Sells Houston office to review certain aspects of Doliver's audited financial statements and were given Haskins & Sells office typing copy which Maurer then compared with the unaudited statements received from Belcher previously.

As of December 31, 1964, Doliver's assets consisted of cash $96,462, trade accounts receivable $33,500 12a/ and two "non-current receivables", a note receivable $23,637 (the "Blakeway" note) and accrued interest $255. Doliver's income statement for the year ended December 31, 1965, shows interest income of $1,508.25 and net earnings $561.75. Its assets primarily were cash $1,233.81 and receivables of approximately $25,000 including the "non-current" Blakeway note of $23,637. There were no real estate transactions during 1965. McGregor testified that he insisted on the Blakeway note being assumed by Westec although he admitted it might be necessary to bring suit to collect it but in that event he stood ready to assist.

Isensee approved of accounting for the acquisition of Doliver as a pooling-of-interests transaction. Its approval according to his testimony, was based solely on representations of Belcher. Isensee did not see any financial statements for Doliver before the Westec annual report was issued, he did not see a draft agreement for the acquisition and never requested or saw a contract for the acquisition although he assumed there was one. According to Isensee it was Maurer's function to ascertain whether a contract existed. Maurer testified that he could not recall requesting a contract for

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12a/ Included was a $30,000 receivable from J.D. Corp. See p. 12, note 8, *supra*. In addition on 4-23-65 J.D. Corp. borrowed $300,000 from Westec.

the Doliver acquisition, he did not examine the minutes of Westec to determine whether the board of directors had approved the acquisition and he did not check the receipt of Westec shares by McGregor or the receipt of Doliver shares by Westec. Also, while the BFI loan agreement with Westec prohibited Westec from making other acquisitions without BFI's prior approval Maurer made no inquiry concerning a waiver of such restriction.

The order and statement of matters charges that the Doliver transaction should not have been treated as a pooling-of-interests because, inter alia, it involved the acquisition of a non-operating corporation. Also, that respondents failed to conduct an adequate audit which would have disclosed that McGregor controlled Doliver and was at the time the record holder of more than 10% of the Westec shares.

Respondents contend that Doliver was properly pooled in accordance with the requirements laid down in ARB-48 even though it was a "non-operating" company. Respondents argue that McGregor did not control Doliver and in fact was not even a shareholder of Doliver. They state, also, that they had no obligation to do more than they did to discover that McGregor was a 10% shareholder of Westec. Respondents state that Isensee inquired of Belcher concerning the future of Doliver corporation in view of the fact that it was a non-operating company and was told that it would engage in the making of investments in real estate. Respondents argue that Westec's intention for the purported use of Doliver as related by Belcher was important in determining that the transaction be accounted for as a pooling of interests.

It becomes apparent on a review of this transaction that it was simply a straight one time real estate deal which was structured as a matter of form over substance into a pooling transaction so that a material amount of income could be realized for inclusion in the 1964 earnings statement. Also, it should be noted that the acquisition of Doliver without a written agreement is comparable to the sale of the ICF property to this same McGregor, also, without a written agreement. The evidence strongly indicates that these were not arms-length transactions and were contrived for the purpose of substantially increasing Westec's income for the year 1964.

Accounting Research Bulletin No. 48

As referred to previously Accounting Research Bulletins are published by the AICPA and their purpose is described by the AICPA as follows:

> Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached . . . . It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment.

ARB No. 48 entitled Business Combinations was published in 1957 and concerned itself with the accounting treatment to be accorded the combination of two or more corporations which are combined for the purpose of carrying on the previously conducted businesses. The bulletin states that the accounting will vary depending largely upon whether an important part of the former ownership is eliminated or whether substantially all of it is continued. The bulletin differentiates between two types of combinations, the first of which is designated as a purchase and the second as a pooling of interests, and indicates the nature of the accounting treatment appropriate to each type. The bulletin states that for accounting purposes, the distinction between a purchase and a pooling of interests is to be found in the attendant circumstances rather than in the designation of the transaction according to its legal form. The bulletin then goes on to lay down a number of guide lines which are to be taken into consideration in determining whether the particular combination should be treated as a purchase or pooling of interests. While no attempt will be made here to reproduce or summarize the entire bulletin, it will be referred to throughout this decision wherever it is applicable to a particular transaction.[13/]

Acquisition of Trak-Microwave Corporation

On March 31, 1965, Westec acquired 250,000 shares (90.9%) of the 275,000 outstanding shares of common stock of Trak-Microwave Corporation ("Trak") in exchange for 1600 shares of Westec's 5% cummulative convertible preferred stock series C. This transaction was approved by the Westec directors on March 17, 1965, and the agreement was dated March 26, 1965. On March 26 Westec also entered

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13/ Newman T. Halvorson ("Halvorson"), E&E's Chief Technical partner was a member of the 21-man committee on accounting procedures which unanimously adopted ARB No. 48.

into an "earn-out" agreement described in the Listing Application of April 16, 1965 filed with the American Stock Exchange. The Trak acquisition contributed $113,804.00 net earnings for the fiscal year ended December 31, 1964, and resulted in increasing Westec's per share earnings for the year by 3.4¢ which amounted to 7.9% of Westec's 1964 earnings per share. In connection with its review of Westec's proxy material for the 1965 annual meeting of shareholders the Commission's staff questioned the pooling treatment of the Trak acquisition on the basis of the substantially different consideration (the "earn-out" agreement) accorded the five member officer group, one of whom held the 9% minority interest, as contrasted with the consideration accorded to the ninety-one percent majority interest, and took the position that the pooling of the Trak acquisition in the 1964 financial statements was inappropriate. On March 31, 1965, E&E delivered the 1964 Westec financial statements, including footnotes, to the Commission. The financial statements and the accountant's report thereon presented to the Commission in draft form were identical in form and content to the printed 1964 financial statements issued by Westec a few days later. At a conference held at the SEC in Washington on April 12, 1965, at which Belcher and Isensee were present, the Commission's staff accountants disagreed in principle with the pooling treatment that had been accorded to the Trak transaction by E&E. However, following considerable discussion the staff accountants consented to the pooling of the Trak acquisition although they still had reservations. The agreed upon accounting treatment accorded the Trak acquisition was that for

1964, 91% of Trak's outstanding capital stock would be treated as a pooling and the remaining 9% of such stock and a corresponding portion of Trak's 1964 operations would be accounted for as a minority interest.

The order and statement of matters alleges with respect to the Trak transaction that when taken together with the other two transactions treated as poolings of interests in 1964 it contributed to a material increase in Westec's consolidated earnings for the year. Therefore, it is alleged, the financial statements were materially false and misleading because there was no disclosure of the material impact of such transactions on the financial statements, particularly in light of the fact that each of the aforesaid transactions involved a business combination which occured after the close of the fiscal year. It is alleged, also, that respondents lacked independence and that one of the factors indicating such lack of independence was that respondents delayed their report of the 1964 financial statements in order to permit the aforementioned poolings to be retroactively included in the 1964 financial statements. The allegation concerning respondents' lack of independence will be considered later.

Acquisition of Beco

On March 29, 1965, Westec acquired all of the outstanding shares of common stock (225 shares) of Beco from J.C. Williams, president of Beco, (not related to James W. Williams) in exchange for 8,000 shares of Westec common stock. E&E received from Westec an executed copy of an agreement dated March 29, 1965, between Westec, Beco, and J.C. Williams providing for the unconditional exchange of all outstanding shares of Beco common stock for 8,000 shares of Westec common stock. This acquisition was accounted for as a pooling of interests in the consolidated financial statements of Westec for the period ended December 31, 1964, as disclosed in note A to those statements, increasing net earnings $79,360 or 2.5¢ per share.

The antecedents of the Beco acquisition are to be found in Westec's proposed acquisition of Metric Systems, Inc. ("Metric"). Up until the time Beco merged with Westec it had been an 80% owned subsidiary of Metric. Metric in turn was owned 52% by Business Funds (BFI) while BFI owned over 10% of Westec and was its single largest shareholder. Williams, who was chairman of Westec and the vice president of Business Funds, at this time was, also, a member of the board of directors of Metric. In December 1964, Metric and Westec began merger discussions. According to Wendell Gamel ("Gamel"), then president of Metric, it was understood at the time of the discussions between Metric and Westec that Beco would be included in the proposed merger. In these merger discussions Williams represented Business Funds, Hall represented Westec, and Gamel represented Metric. An agreement for the acquisition of Metric was negotiated and an application under Section 17(b) of the Investment Company Act of 1940 was filed with the SEC by BFI in February 1965 for the acquisition of Metric by Westec. Metric's earnings for the period ending February 28, 1965 were approximately $62,841. Under this agreement Westec was to acquire all of the Metric common stock in exchange for 86,460 shares of Westec common stock and 5,870 shares of Westec's 5% cumulative convertible preferred series B. However, the Metric acquisition was not consumated in March 1965. Since the acquisition of Metric was among affiliates of an investment company, and Commission approval could not be obtained in time for inclusion of Metric in Westec's 1964 report, the acquisition languished until the fall of 1965 when negotiations with BFI began again.

When it became apparent that the Metric acquisition could not be accomplished, Westec decided to acquire Beco because it needed earnings. Gamel testified that Williams told him that he needed earnings because things hadn't gone as well as he had hoped in the ICF operations, a subsidiary of Westec. Gamel testified that the acquisition of Beco by Westec was accepted by Metric merely for the convenience of Westec. Under the terms of this arrangement J.C. Williams, president of Beco and the owner of a 20% interest in Beco was to acquire Metric's 80% interest in Beco for an amount equal to Metric's cost and then exchange all of the capital stock of Beco with Westec in return for 8,000 shares of Westec common stock. On March 15, 1965, the agreement for the acquisition of Beco was negotiated. Hall representing Westec, Gamel and Marvin Johnson representing Metric and J.C. Williams representing his interest in Beco, met in New Orleans on that date. The agreement was embodied in a letter from Hall to Gamel dated March 25, 1965 and signed by Gamel for Metric and by J.C. Williams for Beco on March 29, 1965. The essential terms of this agreement were that J.C. Williams would borrow $25,000 and pay it to Metric for Metric's 80% interest in Beco.

Williams then sells all of the Beco stock to Westec taking 8,000 shares of Westec common in payment. At a later date Williams pays off his $25,000 loan with 3,000 shares of Westec thus leaving Williams with 5,000 shares of Westec common. Also, it was provided that the Beco transaction would be conditioned upon Westec's acquisition of Metric and in the event Westec did not acquire Metric the Beco transaction would be reversed.

Respondents state that they never saw this agreement but that a separate agreement dated March 29, 1965, was entered into between Westec and J.C. Williams providing for the unconditional exchange of all 225 outstanding shares of Beco by Williams with Westec for 8,000 shares of Westec. Respondents assert that Westec management withheld the conditional contract from them while making available the unconditional contract. Hall testified that the conditional contract was put in the file and was not shown to the E&E auditors although copies were mailed to Gamel at Metric and J.C. Williams at Beco. Hall's understanding was that he would not show the conditional provision to E&E but would simply put in in the file. Hall said that if the auditors found the contract in the file he would just cross that bridge when he got to it. Hall testified, further, that Isensee called it to his attention and said he (Isensee) wasn't aware of it. According to Hall "I believe it was shortly after this publication of the 1964 annual report."

The order and statement of matters alleges that the transaction with respect to Beco should not have been treated as a pooling of interests because, <u>inter alia</u>, it involved the elimination of an 80%

ownership interest in Beco through the payment of cash and was contingent upon another transaction which did not occur.

On March 23, 1965, Maurer and Belcher flew to Tampa, Florida, to visit the Trak offices. On the 24th they visited with the accountants for Trak and on March 25th they flew to Fort Walton Beach, Florida, where they visited the Metric offices for what Maurer described as "a social contact as far as I was concerned." The same day they drove by car to Brewton, Alabama and there visited the Beco plant. Beco was being audited by Price Waterhouse and Company ("PW") and Maurer discussed the progress of the Beco audit with a representative of PW. Maurer stated that he wanted to obtain financial information relating to Beco, that he reviewed what had been done and obtained copies of PW working papers in draft form. He obtained copies of certain "lead schedules" which he used in preparing a consolidated Westec report (dated that same day March 26, 1965). However, he did not receive any drafts of the financial statements or drafts of the footnotes which PW may have been considering using in their financial statements. He did not receive a draft opinion from PW. Maurer returned to Houston and following a further telephone conversation with PW over the fact that their opinion on the Beco financial statements would be qualified as to inventory, respondents included Beco in the Westec 1964 financial statements without waiting for receipt of the PW report.

Shortly after his return to Houston from Beco, Maurer received a contract dated March 29, 1965, which reflected that J.C. Williams had exchanged 100% of the stock of Beco for 8,000 shares of Westec. Although Maurer was aware that Beco had been a subsidiary of Metric he did not make any inquiry as to how J.C. Williams had become 100% owner of Beco nor did he make any inquiry concerning any possible relationship between the Beco acquisition and the contemplated acquisition of Metric. Although the contract of March 29, 1965 ("the unconditional contract") states that Westec's board of directors had approved the acquisition of Beco on March 17, 1965, Maurer never checked the minutes and in fact the minutes of Westec do not reflect that the acquisition of Beco was ever approved by the Westec board of directors. Isensee testified that it was Maurer's responsibility to examine the acquisition agreement or a draft if the agreement had not been completed. Isensee did not review Maurer's working papers to see if this had been done. Respondents did not check with BFI concerning whether or not a waiver was required from BFI before Westec could acquire Beco. (See Doliver, supra). Also, as in the case of Metric, the acquisition of Beco would have required an exemption from 17(b) of the Investment Company Act of 1940, and Griffin so advised Belcher but this seems to have been ignored. Isensee testified that he included the Beco transaction as a pooling of interests on the basis of his conversations with Westec management.

During the first few days of April 1965, Westec's 1964 financial statements, together with respondents certificate, were mailed to shareholders. Belcher testified that shortly thereafter he came upon the March 25 contingent contract in the files of Westec while he was assisting counsel in the preparation of Westec's form 8K report for the month of March 1965. Belcher testified that he discussed this contingent contract with Isensee and Griffin, company counsel, during a trip to Washington for a conference with the Commission concerning the Trak acquisition. This conference took place on April 12, 1965.

On April 14, 1965, PW mailed to E&E its audited financial statement of Beco for the fiscal year ended February 28, 1965. PW's report was dated April 9, 1965 and revealed that Beco formerly had been a subsidiary of Metric and that Metric had owned 80% of Beco prior to the time it was acquired by Westec. The PW opinion letter which accompanied these financial statements is addressed as follows:

> To the board of Directors of
> Beco, Inc.
> (formerly a subsidiary of Metric
> Systems Corporation - Note 1)

Also, at the top of each page of the income statement and balance sheet is the heading:

BECO, INC.

(a subsidiary of Metric Systems Corporation - Note 1)

Note 1 of the financial statements reveals that Westec's agreement to acquire Beco "will be rescinded in the event that certain other acquisition transactions, contemplated by Western Equities and currently under negotiation, are not consumated" and that Metric Systems sold for cash its 80% interest in Beco to J.C. Williams who then exchanged all the capital stock of Beco for shares in Westec.

The cover letter enclosing the financial statements was addressed to Isensee initialled by him and sent on to Maurer. Isensee testified, however, he did not read the PW report. Maurer also initialled the PW report but testified that he did not read it either.

Respondents argue that in preparing the consolidated financial statements for Westec for the period ended December 31, 1964, they relied upon and used the draft financial statements given to Maurer by a representative of PW in Brewton, Alabama. These draft statements did not contain any footnotes and there was no reference in the statements to the conditional nature of the acquisition. Respondents state that general accepted auditing standards do not require disclosure of reliance on other auditors performing part of an auditing examination unless the principal auditor wishes to disclaim responsibility for that part of the examination; that reference to the other auditors examination is recognized by the profession as something within the judgment of the principal auditors and respondents point out it is not unusual, particularly where time is a factor, for the auditors responsible for the engagement to utilize in their consolidation drafts of financial statements prepared by other auditors. They urge that the measures taken here were more than sufficient to permit reliance upon the draft financial statements prepared by PW for Beco. However, Maurer did not obtain draft financial statements only copies he made of working papers. Respondents argue, further, that the conditional agreement was not signed by Gamel until March 29, 1965, four days after Maurer met Gamel at the Metric plant in Fort Walton Beach, Florida. They also point out that respondents were provided by Westec's management with an executed copy of the agreement dated March 29, 1965, providing for the unconditional acquisition of Beco and that this was done in accordance with the understanding testified to by Hall that they would not disclose to the auditors any information concerning transactions in which Westec was engaged "that would arouse suspicion or hold things up." Respondents argue that they followed generally accepted auditing standards in their examination of this transaction. They cite AICPA, Statements on Auditing Procedure, No. 33 p. 12 (1963) as having particular significance to respondents examination of tne Beco acquisition.

> "The subsequent discovery that fraud existed during the period covered by the independent auditors examination does not of itself indicate negligence on his part. He is not an insurer or guarantor. If his examination is made with due professional skill and care in accordance with generally accepted auditing standards, he has fulfilled all the obligations implicit in the undertaking."

Respondents state that the reputation of management is recognized as a factor of importance to an auditor. Inasmuch as the Westec management enjoyed an excellent reputation in the Houston business community respondents state that they had no reason to suspect fraud or collusion on the part of management in connection with this transaction and that having obtained sufficient evidential support for the transaction, as presented by management, generally accepted auditing standards did not require respondents to question the integrity of Westec management or to examine any other possibilities.

It is not seriously disputed that in fact the acquisition of Beco by Westec in March 1965 was conditional or subject to reversal if Westec did not thereafter acquire Metric. Nor is it disputed that the Beco acquisition was material. What is disputed by respondents is whether they knew or should have known of that condition. Respondents concede that where an acquisition is subject to reversal by reason of a future contingency, not only is that transaction not eligible for pooling treatment, but it is not eligible for reporting as a completed transaction of any kind.

There is much confusion as to when Isensee first learned of the contingent nature of the Beco transaction. He testified before the U.S. Attorney at Houston in December 1967 that he may have known at one time of the conditional nature of the transaction but that the condition was eliminated prior to Westec's acquisition of Beco. He testified in this proceeding however that his testimony before the U.S. Attorney was incorrect and that he had, through his counsel, attempted to correct it shortly after such testimony was given. There is also Belcher's testimony that he discussed this condition with Isensee on a trip to Washington on or about April 12, 1965. Isensee's version, as testified to in this proceeding, is that he did not learn of the conditional nature of the Beco acquisition until October 1965, when he was informed of it by counsel in the course of preparing the exemption request for Metric for filing with the Commission so that Westec could acquire Metric.

Isensee testified that upon hearing of the condition he immediately contacted Belcher who assured him, according to Isensee, that he had not known of the conditional nature of the acquisition at the time the 1964 Westec financial statements were released to shareholders. Isensee then discussed the matter with Hall. As a result of his discussion with Hall, Isensee concluded that Hall genuinely regretted the situation and that his failure to call this matter to Isensee's attention was not something deliberate, but rather a matter of Hall's not appreciating the significance of the conditional agreement to the accounting treatment accorded the acquisition in the 1964 Westec financial statements. Isensee testified that Hall thought it was a private arrangement between Westec and Metric.

Isensee and Hall discussed issuing a supplemental report but concluded that it would be more confusing than helpful and that the transaction was of "borderline materiality." In any event nothing was done by respondents by way of correcting the 1964 financial statements after discovering the conditional nature of the transaction, whenever such discovery was made. Isensee decided that it would not be necessary to issue a revised or supplemental financial statement inasmuch as management now assured him (October 1965) that the acquisition of Metric would take place shortly and that would cure any condition existing in the Beco transaction. The Metric acquisition was completed in February 1966 and reported in Westec's financial statements for the year ended December 31, 1965.

Respondents relied on management to cure the conditional nature of the Beco agreement rather than making an attempt to correct it. An undated handwritten memo to Isensee reads as follows:

> "Clarence
>
> Perhaps we can talk Western into the complete elimination of the reversible element of the Beco transaction; this will be hard to sell to Metric but should be the best solution insofar as Western is concerned.
>
> Bob"

Bob is Robert Stillwell, one of Westec's attorneys. On the bottom of the above memo, in Isensee's handwriting, is the following.

> "Stillwell to attempt to get Hall to eliminate the reversable (sic) feature, since this would cure both the pooling (1964) and the current (1965) earnings problem.
>
> I
> 10-28-65"

A number of prominent CPA's testified as expert witnesses in support of respondents' determination not to reissue the 1964 financial statements. The consensus of their testimony was that given the assumed belief that the Metric transaction would be consummated they would not have recommended reissuing the report.

It is inconceivable that Isensee or Maurer would not have read the PW report when they received it in April 1965. Every page of the report clearly stated at the top of the page that Beco had been a subsidiary of Metric and attention was called to note 1. At the very least, it would appear to be routine practice for Isensee and Maurer to have read the PW opinion in order to ascertain whether the condition which PW had previously stated it would put in the opinion was there in accordance with such statement. If the opinion was read then it would be unavoidable not to see the reference to the footnote. As to the importance of footnotes Isensee previously testified in this connection ". . . and they leave out the footnotes, I can say to you they are not reading the financial statement."

It is doubly difficult to credit their testimony as to not having read any part of the PW report in view of their initials on it. In common business practice such acknowledgement fixes responsibility which cannot be avoided by saying "I initialled it but did not read it."

As to Isensee's testimony that respondents had no knowledge of the conditional nature of the Beco acquisition until October 1965 there is evidence to the contrary. A letter from E&E to Western Equities, Inc., dated August 9, 1965, wherein a number of problems are discussed, contains the following paragraphs:

> The information set forth herein relates to the problems attendant to Western Equities satisfying the requirement for three years' financial statements for inclusion in a registration statement on Form S-8, and is submitted at the request of Western Equities as a summarization of information known or made available to us in these matters. (Underscoring supplied)
>
> * * * *
>
> Beco, Inc. financial statements for its most recent fiscal year (ended February 28, 1965) have been audited, but the auditors opinion is qualified as to inventories due to inadequacy of inventory records. The former auditors of Beco, Inc., Price, Waterhouse & Company, have advised that, except as to the February 28, 1964 date, they are unable to audit and express an opinion on prior year financial statements because of non-observance of inventory taking and the lack of records to which acceptable alternative procedures could be applied. Sufficient inventory work was done at February 28, 1964 to permit an unqualified opinion on the balance sheet only.

If Isensee's testimony is to be believed then E&E is reporting to a client concerning audited financial statements by another accountant which have not been read by E&E.

Of course the obvious question which arises is if PW could discover the conditional nature of the BECO transaction why not E&E? Especially since copies of the March 25, 1965 contract were at Metric and Beco as well as in the Westec files.

It is concluded that in view of all the circumstances respondents did not follow generally accepted auditing standards in their examination of the Beco acquisition; that they knew or should have known of the conditional nature of the transaction; and that they should have acted affirmatively to disclose it.

Westec's Form 10-K for the year ending 12-31-64, dated 5-17-65 and filed with the Commission on 5-24-65, incorporated by reference the consolidated financial statements contained in its 1964 Annual Report. Therefore, it was materially false and misleading and should have been corrected, particularly in light of the fact that the PW report was received on or about April 18, 1965.

Summary and Conclusions Concerning 1964 Audit

A brief restatement, in summary fashion, of the foregoing transactions illuminates the many warning signals which should have alerted respondents to a more careful and diligent expansion of audit procedures but which, instead, they chose to ignore.

At the very outset management went on record as not wanting to disclose the amortization charge resulting from the conversion of the BFI warrants. Then it vigorously resisted excluding from 1964 income the sale of the Arizona property. These two adjustments reduced 1964 income by $353,961.

In an obvious attempt to offset the unfavorable impact of these adjustments, and the failure to consummate the Metric acquisition, all of which diminished its 1964 income by $416,802, Westec entered into four last minute transactions which added $398,512 to 1964 income, as follows:

Sale of Florida Property	$ 89,984
Acquisition of Trak	113,804
Acquisition of Doliver	115,364
Acquisition of Beco	79,360

The substitution of the Florida property sale for the Arizona property sale, both practically identical transactions, including the purchasers, presented a situation demanding thorough examination. A normal audit and analysis of the facts developed would have disclosed its non-arms-length nature. McGregor, as Maurer noted, already had an uncollateralized loan of $50,000 from Geo Space and, in addition, as Maurer, also, was aware, Westec continued, through the leasing arrangement, to make the monthly mortgage payments. Therefore, it is readily apparent, as a matter of economic reality, that McGregor was risking nothing and that Westec was using its own funds to consummate a transaction which materially increased its 1964 income.

When the Metric acquisition failed to materialize, largely due to the late filing of its 17(b) exemption request with the Commission (2-5-65), the Beco acquisition was quickly set up. This, too, was an identical situation, paralleling in every respect, including the necessity for a 17(b) exemption, the Metric situation. Moreover, respondents knew or should have known of the conditional nature of the Beco acquisition, particularly when PW informed them of it.

Concerning his discussion of the Beco contingency with Hall, Isensee testified:

> "Q. Now, you testified earlier as to the impression that you formed of Mr. Hall at an earlier point in the engagement, Mr. Isensee, did this matter in any way change your opinion or impression of Mr. Hall?
>
> A. No, because the explanation, the discussion that I had with him was not one that I was dealing with someone who was intentionally out to deceive me, but rather someone who simply had not appreciated the accounting significance of the matters that we were discussing, which was the conditional."

This explanation is simply unacceptable in view of the fact that by this time Isensee knew, or certainly should have known, that Hall had participated in the New Orleans meeting, had written the conditional letter agreement of 3-25-65 and then had furnished respondents with another unconditional agreement. The very fact that management had taken the trouble to execute two contracts should have dispelled any notion Isensee might have had as to Hall's naivete. From this point on, regardless of any other warnings, respondents were on notice that management's representations could not be relied on.

As to the Trak and Doliver acquisitions the former was criticized by the staff and the latter was not a bona fide transaction in any respect. The very coincidence of three quickly concocted poolings, Beco, Trak and Doliver should have alerted respondents to further investigation. Add to this the appearance of McGregor as the other party in the ICF, Arizona and Doliver transactions, regardless of his standing as a ten percent shareholder of Westec, and respondents contention that they had no obligation to do more than they did is unsupportable.

Respondents present a further argument that it was proper to accept information from PW without waiting for the report as time was a factor and it was necessary to close the audit for 1964. The Commission stated its position on this in ASR No. 105, 14/ where it said:

> "It is obviously improper for a certifying accountant to permit himself to be stampeded into an inadequate audit or an untrue certification."

The review of the entire audit for 1964 makes it abundantly clear that respondents did not follow generally accepted auditing standards. They relied to a great extent on management for supporting evidence of transactions and, when documentation was not supplied, they accepted management's word. Belcher was the one most often

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14/ In the Matter of Homer E. Kerlin, pursuant to Rule 2(e), Rules of Practice (July 29, 1966).

relied on in spite of Isensee's not very high regard for Belcher's ability, as illustrated by his testimony before the U.S. Attorney in Houston:

> Question: When did this feeling or knowledge or understanding of Mr. Belcher's deficiencies first become apparent to you for a company who (sic) had ambitions to be another Teledyne?
>
> Isensee: Mr. Susman, it would have been the logical conclusion the day he was hired.

Despite this unflattering opinion of Belcher, respondents did, as stated in their brief, "accept as factual certain representations made to them by Belcher who was of course more than a representative of management. He had been an associate of respondents for most of the preceding 12 years. His word on matters of fact quite naturally was accepted since he was considered by respondents to be an individual of integrity."

Respondents have argued at length that they were entitled to rely on representations of management because the individuals concerned had good reputations in the Houston business community. They also rely on this "good reputation" theory as excusing their failure to examine the transactions involving McGregor. This position is contrary to the Commission's holding in Accounting Series Release No. 78 [15/] wherein it stated ". . . an independent certifying accountant cannot, consistent with proper professional standards, rely on management's unverified representations. . . ."

Based on the foregoing description and discussion of the 1964 audit the conclusion is inescapable that:

> "In carrying out the work they failed to employ that degree of vigilance, inquisitiveness, and

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15/ Also cited as Touche, Niven, Bailey & Smart, 37 SEC 629, 647 (1957).

analysis of the evidence available that is necessary in a professional undertaking and is recommended in all well known and authoritative works on auditing." 16/

16/ In the Matter of McKesson & Robbins, Inc., Securities Exchange Act Release No. 2707 (12-5-40).

The 1965 Westec Financial Statements

The 1965 Westec financial statements included five divisions and forty-five subsidiary companies. Offices and operations were located in 5 states and eight foreign countries. At the time of the release of the 1965 financial statements, Westec and its subsidiaries, a conglomerate of companies, were engaged in the business of developing, manufacturing and supplying equipment in the geophysical and aerospace fields, providing well logging services to the oil and gas industries, and acquiring and developing oil and mineral interests and real estate.

In addition to Isensee and Maurer the E&E Houston office assigned 15 partners and employees to the examination of the Westec financial statements for the period ended December 31, 1965 and utilized the services of six other offices of E&E and nine other firms of independent public accountants. E&E expended in excess of 4900 hours in the performance of this audit examination.

1965 Audit

On March 22 and 23, 1966 meetings were held between various E&E Houston office personnel and Newman T. Halvorson, Chief Technical Partner of E&E for the specific purpose of discussing the Westec report for the year 1965. For this meeting Belcher had prepared, at Maurer's request, an analysis of earnings decline for the year ended December 31, 1965. On the agenda for this meeting, prepared by Maurer, was the question of whether Westec could report the sale of the Camerina Petroleum Corp. (Camerina), carved out production payments as current income. Other questions on the agenda concerned how

Westec should report its earnings, that is whether to use "one step income statements to shareholders and conventional to SEC"; and how the sale of oil properties of Weco, a subsidiary of Westec, should be reported. A set of draft financial statements were prepared by Maurer for this meeting but they did not reflect Westec's acquisition of two other companies which were treated as pooling of interests. One of these acquisitions was Seacat-Zapata Off-Shore Company, S.A. ("Seacat"), which was acquired a few weeks later on April 18, 1966. The other was Engineers and Fabricators Inc. ("EFCO") which was acquired on or about April 27, 1966. These latter two acquisitions contributed approximately $1,570,000 to Westec's reported earnings for 1965. E&E's certificate on the financial statements for the year end December 31, 1965 is dated April 28, 1966. Westec's reported net earnings for 1965 were $4,868,913. The contribution made by each of the aforementioned transactions is shown in the following summary.

	Amount	Percent
Seacat (pooling)	$684,805	14%
EFCO (pooling)	896,178	18
Camerina (carved-out production payment sale)	1,291,391	27
Weco (sale of oil properties)	2,042,840	42
All other income (loss)	(46,301)	(1%)
	$4,868,913	100%

In their message to shareholders in the 1964 annual report Hall & Williams had stated that their general objective for 1965 was to increase earnings per share by at least 75% as compared to 1964. Under date of February 24, 1966 a New York Stock Exchange member firm had published a report on Westec in which earnings per share for the year ended December 31, 1965 were predicted as being $1.10 per share.

On or about March 8, 1966, Heinen, in a memorandum to Isensee, said that the First City National Bank of Houston had inquired as to when the audit would be finished and Heinen had told him about April 1. The officer of the bank said that the figures that Westec had shown him indicated earnings of about $1.10 a share. Also, that the bank was anxious to see a consolidating statement.

As can be seen the items set forth in the above summary were material to Westec's achieving sufficient net earnings for 1965 to enable it to meet its projected per share earning of $1.10, which was the figure finally reported in its annual report.

In their April 28, 1966, letter to shareholders Hall & Williams stated: "Your management is particularly pleased that earnings per share during 1965 exceeded the forecast made at last year's annual meeting." The letter goes on to say, ". . . your management is again forecasting a per share earnings increase of at least 75 per cent."

<u>1965 Pooling of Interests Transactions</u>

The Westec consolidated financial statements for the period ended December 31, 1965, included the financial statements of three subsidiaries, Carey Machine and Supply, Inc. ("Carey"), Seacat-Zapata Off-Shore Company, S.A. ("Seacat") and Engineers and Fabricators Inc. ("EFCO"), acquired by Westec after the close of the fiscal year ended December 31, 1965 but before April 28, 1966, the date of the Westec 1965 financial statements. Each of these companies was acquired by Westec for the consideration hereinafter described with respect to each such acquisition. Each of these acquisitions was accounted for in the Westec financial statements for the period ended December 31, 1965 as a pooling of interests transaction, as disclosed in note 1 to the 1965 financial statement.

The Acquisition of Carey Machine and Supply, Inc.

Pursuant to an agreement dated March 23, 1966, approved by the Westec board of directors as of March 15, 1966, Westec agreed to exchange up to 25,000 shares of its common stock for the business properties and assets of Carey. The transaction was closed on April 6, 1966 and 16,786 common shares of Westec were issued in exchange for the business and assets of Carey.

The Carey acquisition was accounted for as a pooling of interests transaction in the Westec financial statements for the period ended December 31, 1965 as disclosed in note 1 to those statements. The Carey transaction contributed $109,868 to Westec's net earnings for the fiscal year ended December 31, 1965 and resulted in increasing Westec's per share earnings for the year by 2.3 cents which amounted to 2% of Westec 1965 earnings per share.

The order and statement of matters does not allege that the Carey transaction should not have been treated as a pooling of interest but does allege that the Carey transaction having occurred in 1966, when taken together with the EFCO and Seacat poolings, resulted in a material increase in Westec consolidated earnings for the year.

Therefore, the order alleges, the financial statements were materially false and misleading because there was no disclosure of the material impact of such transactions on the financial statements, particularly in light of the fact that each of the aforesaid transactions involved a business combination which occurred after the close of the fiscal year in which it was reported. The result of these three transactions being pooled retroactively was an increase in net earnings as reported for the year ended December 31, 1965, of $1,690,851.

Respondents contend that the Carey transaction was properly reported in that it was included in note 1 to the consolidated financial statements for the year ended December 31, 1965 and that there was no accounting requirement to do otherwise. It should be noted however, that all of the pooling of interest transactions from the beginning of 1965 through April 1966 are set forth in note 1 with the date of acquisition of each transaction. There is no indication either in the earnings statement or in the notes to show the financial impact of the three pooling transactions which took place after December 31, 1965 and contributed over 34% of the reported net earnings for the year. However, the impact question will be dealt with hereafter in the context of all of the transactions which contributed to Westec's reported net earnings for 1965. Each transaction which is the subject of an allegation in the order will be treated separately.

The Acquisition of Seacat

Shortly after the meeting on March 22 and 23, where the decline in Westec's earnings was discussed, negotiations were begun for the acquisition of Seacat. This was on or about March 26, 1966. Prior to being acquired by Westec Seacat was owned 50% by Zapata and 50% by Southeastern Drilling, Inc. ("Southeastern"). In his testimony Isensee described this acquisition as "probably the most complicated, unusual type of transaction that I had run into in some time."

The transaction went through a number of stages. In a memorandum dated March 30, 1966, Hall stated:

> "The first agreement between Western and Zapata was going to call for Western to lease the Seacat assets of Zapata at a price of $908,000 annually plus depreciation. However, E&E said this would destroy the pooling since there would not be 'the continuity of business enterprise.' In other words, Seacat would have changed from an operating company into a leasing company and this would destroy the pooling. Obviously, this concept had to be thrown out. Instead, E&E suggested that we draw up a work contract for Zapata whereby Zapata would manage Seacat for us. In looking over the numbers which Zapata believes Seacat can earn, it looked like a 50% split of the profits would give us the same amount of money as the lease plan."

Hall's memorandum continues "however E&E was not agreeable to this either because it does not appear that Zapata is operating a business for us. Instead, it looks like we are in partnership and this would destroy the 100% pooling." Thereupon, Hall stated that he had given the job to Isensee "to come up with a final set of numbers for the agreement, since the structuring of such numbers must be such that we protect the 100% pooling."

Isensee testified that at one time the transaction was so structured that E&E concluded that the substance of the transaction would not be really the acquisition of the assets of Seacat-Zapata--that it amounted in effect to a lease. Isensee maintains that he had no part in the discussions relating to the lease arrangements and that

Hogan gave Westec this advice before he (Isensee) entered the discussion. Hogan, on the other hand, maintains he did not give this advice and that it was given after Isensee entered the discussions. However, it appears clear that at one time Westec considered a deal where it would purchase the assets of Seacat and lease them back to Zapata and that E&E advised Westec that if the transaction were completed in this manner, it could not be treated as a pooling since there would be no continuity of the business enterprise. Also, E&E advised Westec that a direct profit sharing arrangement with Zapata might likewise prevent a pooling.

There were other complexities involved in Westec's acquisition of Seacat before an agreement was finally reached. Isensee testified that it was his understanding that the first proposal was for Southeastern and Zapata to both take Westec stock, but Southeastern concluded it did not want Westec stock. Thereafter, through a series of steps, all effected simultaneously with Westec's acquisition of Seacat, Zapata and Westec arranged for an effective elimination of Southeastern's 50% interest in Seacat for cash and debt securities, followed by an exchange of Zapata's interest in Seacat for stock of Westec. To finance the buy-out of Southeastern's interest, it was also agreed that Westec could pledge as collateral for Zapata's note the stock of Seacat which Westec received. Further, it was agreed Seacat would not pay any dividends on the stock for the next six years.

Pursuant to an agreement dated April 8, 1966 Westec agreed to acquire from Zapata 823 shares of the capital stock of Seacat in exchange for shares of Westec common stock. Until the time of the closing Seacat had outstanding 1,000 shares of capital stock, 500 of which were owned by Zapata and 500 owned by Southeastern. This exchange agreement between Westec and Zapata was conditioned upon occurrence, inter alia, of the following events:

(a) Seacat's redemption of 177 of the 500 shares of Seacat held by Southeastern Drilling in consideration of $1,300,000 cash and a noninterest bearing note in the amount of $350,000 payable on July 15, 1967.

(b) Zapata's purchase of the remaining 323 Seacat shares held by Southeastern in exchange for a 6-year 6% promisory note of Zapata in the principal amount of $3,000,000, and Westec's pledge of the Seacat shares acquired from Zapata to secure Zapata's note to Southeastern.

(c) Seacat's declaration of cash dividends to Zapata in the amount of $1,350,000, payable $1,000,000 at the closing and $350,000 on April 14, 1967.

A "collateral pledge and assignment" agreement among Westec, First City National Bank of Houston (as trustee), Zapata and Southeastern, was also entered into on April 8, 1966. It provides that during the term of the agreement, Westec "will vote the pledged stock and otherwise use its best efforts to the end that <u>no dividend</u> or other distribution (whether in cash, securities or other proprety) be paid or made on or with respect to the Seacat stock pledged by Westec as collateral for Zapata's $3,000,000 note to Southeastern (payable in twelve equal semiannual installments beginning on January 15, 1967 and ending on July 15, 1972).

The exchange agreement was further conditioned upon Zapata and Westec entering into a management contract under which Zapata would operate the business and properties of Seacat and cause to be performed the business operations of Seacat. Prior to the acquisition by Westec, Seacat's operations had been managed by Southeastern. The six-year management agreement between Zapata and Seacat (Westec), provides that Zapata will operate the business and properties of Seacat in exchange for an annual management fee as follows:

(a) All of the first $240,000 of Stipulated Profits, as defined in the Operating Agreement, plus

(b) 30% of Stipulated Profits in excess of $240,000 but not in excess of $740,000, plus

(c) 40% of Stipulated Profits in excess of $740,000 but not in excess of $1,240,000, plus

(d) 50% of Stipulated Profits in excess of $1,240,000. Seacat also agreed to pay directly, or to reimburse Zapata, for all direct costs incurred by Seacat or Zapata in the conduct of the business and operations of Seacat.

By action of the Westec directors on April 2, 1966, the principal officers of Westec were authorized to negotiate and consummate the Seacat acquisition, including the pledge agreement and the management contract, on such terms as they, in their discretion, deemed advisable.

The Westec-Seacat transaction is described in a listing application to the American Stock Exchange, dated March 29, 1966, as amended April 8, 1966. The transaction was closed on April 8, 1966, and pursuant to the agreed upon formula, 98,765 shares of Westec common stock were issued in exchange for all of the outstanding common stock of Seacat. No management fee became payable under the agreement described above from the effective date of the contract April 8, 1966, through August 31, 1966, by reason of the fact that Seacat did not earn any profit during that period. The acquisition was accounted for as a pooling of interests transaction in the Westec consolidated financial statements for the period ended December 31, 1965, as disclosed in note 1 to those statements. The purchase by Zapata of the 323 Seacat shares from Southeastern immediately prior to Westec's acquisition of Seacat and the arrangements made by Westec to secure payment of the obligation incurred by Zapata in connection with the transaction were discussed in note 12 to Westec'c 1965 financial statements. Westec's accounting for the acqusistion as a pooling of interests transaction was approved by E&E after consultation between Isensee and Hogan of the E&E Houston office and Halvorson in the E&E Cleveland Office. The Seacat acquisition contributed $684,805 to Westec's net earnings for the fiscal year ended December 31, 1965 and resulted in increasing Westec's per share earnings for the year by 14.1¢ which amounted to 14% of Westec's 1965 net earnings.

The order and statement of matters alleges that the transaction with respect to Seacat should not have been treated as a pooling of interests because, <u>inter alia</u>, it involved the elimination of a 50% ownership interest in Seacat through the payment of cash, the structuring of the transaction by respondents in such a manner that Westec was obligated under the terms of a management contract to pay out approximately 50% of the future profits of Seacat in the form of management fees and there was no continuity of the management of the acquired company. Also, the financial statements did not adequately disclose Westec's obligations under the management contract.

In support of these allegations the chief accountant of the Commission testified that in his opinion the acquisition did not meet the standards for pooling of interests accounting treatment. A mong the reasons cited for this opinion were (1) the elimination of half ownership (Southeastern's 50%), (2) the failure to have continuity of management, (3) the imposition upon the former operations of a management contract which changes the character of the business so that there is not really a continuity of the same type of operation that there was before, and (4) the financing agreement which had a restriction upon the declaration of dividends.

Respondents argue that there was no 50% elimination of ownership interest as that term has been used in this proceeding.[16A/] Respondents concede that there was a 17.7% elimination by virtue of the redemption of 177 Seacat shares held by Southeastern, one of the former 50% owners, and there was a 32.3% rearrangement of shareholder interest by virtue of the purchase by Zapata of the 323 Seacat shares still held by Southeastern after the redemption mentioned above. However, respondents argue that neither of these steps in the transaction inhibited the pooling.

16A/ As defined in ARB 48.

They argue that all of the standards laid down in ARB 48 had been eroded except the exchange of voting stock for voting stock or assets. This argument concerning the erosion of pooling standards is continually relied upon by respondents and will be discussed at the end of this section.

Respondents argue further that continuity of management, another standard laid down in ARB 48, was also no longer viable by the mid-60's.

Respondents argue that there was no change in the character of the business which Seacat was engaged in as a result of the management contract although they concede that the management contract did change the manner of payment for management services but that such change would not bar a pooling of interests treatment.

As to the charge that the financial statements did not adequately disclose Westec's obligation under the management contract, respondents argue that note 15 to the 1965 financial statements disclosed that Westec contracted out the management of the properties at a fee contingent upon earnings and that the terms of this contract were set forth in detail in the listing application filed with the American Stock Exchange in connection with the Seacat acquisition.

The record discloses at the time of the meeting in Houston on March 22 and 23, attended by Halvorson, the E&E technical partner from the home office in Cleveland, the agreement for the acquisition of Seacat had not been entered into. Therefore, the record discloses, that because of the complexities of the Seacat acquisition Isensee called Halvorson in Cleveland to discuss the propriety of treating the

Seacat acquisition as a pooling of interests. Halvorson testified that, on the facts given to him over the telephone by Isensee, he concluded that "this rather modest change in ownership by--or elimination of ownership by virtue of a redemption and subsequent transfer of shares between the shareholders ought not to be a bar to a pooling of interests." However, the record indicates that Isensee did not tell Halvorson of the Zapata management contract nor did Halvorson in his testimony recall Isensee's mentioning to him the cash dividend of some $1,350,000 that was to be paid to Zapata.

Halvorson's opinion concerning the propriety of the accounting for this acquisition was based upon the facts as given to him by Isensee sometime in the spring of 1966. Halvorson could not recall being told of the dividend pay out and Isensee testified that Halvorson was not told of the management contract. The management contract and the dividend payout were essential to an understanding of the transaction. As respondents have conceded a direct profit sharing arrangement might prevent pooling.

As stated before respondents placed considerable emphasis on the fact that ARB No. 48 had eroded since its publication in 1957. As applicable to the present transaction paragraph 6 of ARB 48 provides:

> "Since the assumption underlying the pooling of interests concept is one of continuity of all the constituents in one business enterprise, abandonment or sale of a large part of the business of one or more of the constituents militates against considering the combination as a pooling of interest."

In this transaction there was a complete change of management from Southeastern to Zapata and Zapata entered into a management contract with Seacat (wholly owned by Westec) which in effect gave Zapata 50% of the profits.

In response to respondents argument that the standards for pooling laid down in ARB 48 had been eroded attention is called to Accounting Research and Terminology Bulletin, published September 1961, which states under the heading Business Combinations: "The Committee on Accounting Procedures and the Committee on Terminology of the AICPA were superseded on September 1, 1959, by the Accounting Principles Board. None of the ARB's in force - No. 43, a revision of previous Bulletins, and 44 to 51, has been revised or revoked by any action of the APB to date of this publication."

In view of the Zapata management contract it would appear that Seacat earnings of $684,805, which Westec included in its 1965 earnings, would have been approximately $340,000 if the proper pro forma effect of this arrangement had been shown in the 1965 financial statements. The Chief accountant of the Commission testified:

> "The assumption is that this is a proper pooling which means a combining of the operations of the pooled companies. Here we have such a change in the earning capacity of the acquired company, that to combine the full earnings of the acquired company with the acquiring company, without giving a pro forma effect to the contract, leads to a misleading impression of the earning power of the combined enterprise."

Based on all of the relevant circumstances surrounding this transaction it is concluded that it was structured so that, as a matter of form over substance, it would appear as a pooling when in reality it did not meet the criteria.[17/] The important thing for an accountant to con-

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17/ ARB No. 48.

sider in reviewing a given situation is whether the bona fides of the situation justify, as a matter of economic reality, the application of pooling principles or concepts. Pooling lends itself to the generating of income and profits which would not otherwise be available, so that the manner of generating such income must be closely scrutinized in order to justify reporting it as such. The purpose of the Federal securities acts is to insure complete disclosure to a potential investor. The duty of an independent accountant is to see that such disclosure is made as to financial matters. The accounting profession has insisted on assuming this role from the date of enactment of the Securities Act of 1933.[18/] When a transaction is structured, as here, without regard to the facts and without disclosing that such structuring is a device to cloak substance in form, then the accountant is not fulfilling the role which the profession has coveted.

18/ House Report No. 152 (5-20-33).

The Acquisition of EFCO

On April 27, 1966 Westec acquired Engineers and Fabricators, Inc. (EFCO) in exchange for 85,545 shares of Westec stock. EFCO was valued at $5,400,000 and contributed $896,178 to Westec earnings for 1965 or 18¢ a share. This represented 18.41% of Westec's total net earnings for 1965.

E&E first learned of this acquisition early in April when Belcher advised Isensee that Westec was considering it and it would be effected through an exchange of Westec stock for either the stock or assets of EFCO. Isensee told Belcher that it could be included in the Westec consolidated financial statements for the period ended December 31, 1965, if the transaction was closed prior to E&E's completion of the 1965 audit. Isensee was familiar with EFCO because E&E were also the independent public accountants for EFCO and on April 26, 1966 completed their examination of the EFCO financial statements for the period ended March 31, 1966.

On April 13, 1966, Westec's proposed acquisition of EFCO was approved by the Westec board of directors. On April 13, 1966 Westec issued a letter of intent to acquire EFCO subject to a satisfactory audit by E&E showing net earnings in excess of $850,000 after taxes. On or about April 16, 1966, a draft agreement between Westec and EFCO was prepared providing for the acquisition by Westec of all the assets of EFCO in exchange for Westec common stock having a market value of $5,400,000.

On April 22, 1966 Hall of Westec called R. M. Hermance of the E&E Houston office and inquired whether E&E would approve pooling of an acquisition which was described by Hall and reported by Hermance in an E&E memo to Isensee dated April 22, 1966 as follows:

> "The company to be acquired presently has approximately 15 stockholders, some of whom are also officers and employees. A new nonrelated stockholder would acquire all of the outstanding stock of these 15 independent individuals and would shortly thereafter enter into agreement with Western Equities to exchange his newly acquired stock in the company for Western Equities stock. The company would continue in business as it is presently constituted with no significant change in management, company name, or operations, etc. The company's sales would be approximately 20 % of the sales of Western Equities."

After reviewing this memorandum and prior to the closing on April 27, Isensee learned from Belcher that another company, Tupper Lake Corporation ("Tupper"), was the third party who would purchase the EFCO stock from the EFCO shareholders for cash and then enter into an agreement with Westec providing for Westec's acquisition of EFCO through an exchange of all of the outstanding stock of EFCO for Westec common stock. Prior to the closing, the facts contained in the Hermance memorandum were submitted to Halvorson in Cleveland who approved the accounting treatment as a pooling of interests.

At the time of its acquisition by Westec EFCO was a closely held corporation with a total of 40,000 shares of stock issued and outstanding, 36,930 shares being held by nine persons. Three of these nine persons, E. E. Dillman ("Dillman"), president and director, Cyril S. Birch, executive vice president and director, and J. D. Pritchard, owned or controlled 34,620 of said shares. Dillman, who conducted the negotiations for EFCO, testified that he and the other principals in EFCO had been attempting to find a buyer for EFCO for over one year. EFCO had entered into an agreement with Rauscher-Pierce, a brokerage concern, to act as a finder for a buyer of EFCO. However, Dillman and his associates, because of their age and estate problems, were only interested in liquidating their holdings for cash and wanted either cash or a gilt-edged stock which they could immediately sell. When Westec approached EFCO with an offer the agreement with Raucher-Pierce to find a buyer had expired but was extended for one week in order to cover the negotiations with Westec. Dillman testified that he was told that Westec stock would be freely tradeable but when he found out that this was not so, and that the stock that EFCO would be given would in fact be restricted, he called the deal off. This was on April 18, 1966. Dillman testified that although the letter of intent said the stock would be unrestricted, he had talked to Dickey of the E&E office, who had previously advised him on tax matters, and was told that the stock was restricted.

On Tuesday, April 19, after Dillman had called the deal off, efforts were renewed by Westec to put the acquisition through. Dickey testified that various "sweeteners" were proposed to EFCO shareholders during that week. On April 22, Dillman was called to a meeting at which Hall & Williams offered the EFCO shareholders an interest-free loan without liability beyond putting up the Westec stock they were to receive as collateral for the loan. Dillman declined the offer and Williams & Hall told him to talk to his tax man so he met with Dickey on Friday, April 22. Dickey told Dillman that it was a sale, "it is just a device that is all." Dillman said he would have no part of it. Later that same afternoon, after Dillman had rejected the loan "device," Hall called Dillman and asked whether the EFCO shareholders would accept cash for their stock. Dillman after conferring with other EFCO shareholders, indicated they would.

On the next day, Saturday, April 23 Belcher called Isensee who was out of the city and told him that the EFCO deal had changed and that now a third party "was to come in and buy out the EFCO shareholders' stock and then effect the exchange of EFCO for Westec common stock." Belcher indicated to Iseneee that he had previously called Halvorson about this change in circumstances and Halvorson indicated that under these circumstances it would still be appropriate for Westec to record the acquisition of EFCO as a pooling of interests transaction.

Tupper Lake Corporation ("Tupper Lake") was incorporated by McGregor under the name of Roadway Inns of the Middle South in Texas in 1962, one-half owned by McGregor and one-half by his son. In late 1963 or early 1964 McGregor purchased his son's interest for $250 and changed the name to Tupper Lake. Although Tupper Lake had borrowed certain monies from Business Funds in 1964, McGregor testified that Tupper Lake did not have any financial resources to borrow money and that he had to endorse its note.

On April 23, 1966, Hall went to Chicago for a conference with Commercial Discount Corporation and secured a commitment for a $4,000,000 loan to McGregor or one of his companies. On April 25, 1966, Williams informed McGregor that financing, which included a $1,500,000 loan commitment from the First National Bank of Dallas, had been arranged. On April 27, 1966, Commercial Discount Corporation lent $4,000,000 and the First National Bank of Dallas lent $1,500,000 to Tupper Lake Corporation in exchange for notes of Tupper Lake. Tupper Lake used the proceeds of these loans to acquire all of the outstanding stock of EFCO from the EFCO shareholders. The 85,545 shares of Westec common stock acquired by Tupper Lake in exchange for the EFCO stock, plus an additional 67,950 Westec shares in the name of Tupper Lake were pledged by Tupper Lake as collateral for the $4,000,000 Commercial Discount Corporation loan. Documents reflecting these transactions were exchanged on April 27, 1966 between representatives of Tupper Lake, Commercial Discount Corporation and First National Bank of Dallas.

On April 27, 1966, Hall signed a security agreement granting Commercial Discount a security interest in 70,000 shares of Westec stock registered in Hall's name in connection with the $4,000,000 loan from Commercial Discount to Tupper Lake. These shares were already pledged to Commercial Discount to secure Hall's $1,000,000 personal guarantee of loans made to Continental Mining and Milling Co. and/or Contemporary Metals Corporation, including a $2,500,000 line of credit to Continental Mining and Milling Co. On April 27, 1966, Hall also signed a personal guarantee of the loan from Commercial Discount Corporation to Tupper Lake.

Maurer had spent part of Sunday, April 24, doing special work on the EFCO closing, including a review of financials included in the listing application. The listing application filed with the American Stock Exchange in connection with the EFCO acquisition, as amended on April 25, 1966, states that Donald McGregor is the sole stockholder and principal officer of Tupper Lake and that all of the 85,545 Westec shares which were to be given to Tupper Lake in exchange for the EFCO shares were unregistered. Tupper Lake, in substance, was to purchase 85,545 unregistered shares for $5,400,000, or approximately $63 a share. On April 25, 1966, Westec closed at 63 5/8. The listing application reveals that Tupper Lake was to receive a sum not to exceed $250,000 in connection with its role in the EFCO acquisition. Also, the last paragraph of note 12 to Westec's 1965 financial statements says:

> "In connection with an acquisition of a pooled business during April 1966, the company may be obligated to pay a fee in an amount yet to be determined."

McGregor and the representatives of Commercial Discount Corporation agreed at some point that the $4,000,000 loan from Commercial Discount would be paid off through the sale of the additional 67,950 Westec shares mentioned above at the rate of 5,000 shares per week or the rate of $300,000 per week, which ever was greater.

On May 5, 1966, an additional 10,000 Westec shares in the name of Tupper Lake were pledged as collateral to further secure the Commercial Discount loan to Tupper Lake, making a total of 77,950 shares pledged as collateral on this loan in addition to the 85,545 shares acquired by Tupper Lake in exchange for the EFCO stock, and in addition to the 70,000 shares registered in the name of Hall, which were also pledged in connection with the Continental Mining and Milling loan referred to above.

By August 16, 1966, 55,600 of the foregoing 77,950 shares had been sold by A. G. Becker & Co. and Moroney Beissner Company, Inc., on orders from McGregor with the proceeds being remitted to Commercial Discount. In addition, 5,000 shares of Westec stock had been sold by Tupper Lake on May 5, 1966 and the proceeds remitted to Commercial Discount, making a total of 60,600 shares sold, thereby reducing the balance due by Tupper Lake on the note to $990,076, (which balance included an additional $500,000 advanced by Commercial Discount Corporation to Tupper Lake on August 12, 1966). The loan made by the First National Bank of Dallas to Tupper Lake was paid off on or before May 9, 1966 out of the proceeds of the sale of 25,000 Westec shares in the name of Tupper Lake, 20,000 shares of which had been sold by G. C. Haas & Co. on April 25, 1966, and 5,000 shares by Moroney Beissner Company on April 26, 1966.

On May 20, 1966 Westec paid a negotiated fee of $135,000 for services in connection with the EFCO transaction to Tupper Lake (McGregor).

Based on the foregoing facts, most of which have been stipulated to between the parties, it is clear that Tupper Lake was used merely as a conduit by Westec in its acquisition of EFCO and that this was a non-arms length transaction engineered for the purpose of converting substance into form so that it could be recognized by respondents as a pooling of interests transaction.

Aside from the non-arms length nature of this transaction the chief accountant of the Commission testified that it did not meet the standards of a pooling of interests as there was a clear disregard of the principal of continuity of ownership of the combining corporation in that there was a 100% change in ownership in this case.

Moreover, there was a complete change in the power to control management, if not management itself, which also violated the pooling standards.[19]

Respondents argue that there was such erosion in and confusion concerning standards for pooling criteria that sales of shares by existing shareholders prior to a merger would not prevent pooling accounting where as here, voting stock is exchanged for voting stock. In support of this respondents cite a case involving Tamar Electronics Industries, Inc. ("Tamar") represented by Halvorson of E&E in which the Commission staff accepted as a pooling of interests a transaction involving a 100% change in ownership of shares of the acquired company. However, it appears on examination that the staff did not "approve" the Tamar pooling but rather accepted it as it had occurred in 1961 and the chief accountant felt that it would be better to let it stand rather than to recast on a retroactive basis for three years. As a matter of fact, the comment letter from the staff stated that the transaction could not be considered as a pooling of interests but should be reflected as a purchase. It would appear that this experience should have alerted E&E and Halvorson to the fact that the Com-

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19/ ARB No. 48 provides as follows in paragraph 6:

> "6. Other attendent circumstances should also be taken into consideration in determining whether a purchase or a pooling of interests is involved. Since the assumption underlying the pooling of interests concept is one of continuity of all of the constituents in one business enterprise, abandonment or sale of a large part of the business of one or more of the constituents militates against considering the combination as a pooling of interests. Similarly, the continuity of management or the power to control management is involved. Thus, if the management of one of the constituents is eliminated or its influence upon the over-all management of the enterprise is very small, a purchase may be indicated."

mission's staff, rather than accepting such change of ownership, would challenge the transaction on the grounds that it did not meet the standards for pooling of interests.

Respondents also argue that the presence of McGregor on the other side of this transaction should not have aroused any suspicions on the part of E&E or caused them to ask any questions concerning the use of Tupper Lake as a conduit but point out that respondents had made inquiries into McGregor's reputation and found it to be that of a man of integrity with good standing in the community. Respondents say, consequently, as in the Florida property sale, the presence of McGregor was not suggestive of the presence of fraud in the transaction.

As stated previously, the question is not whether McGregor had a good reputation or whether his presence was suggestive of fraud, the question is whether or not when McGregor appeared in five transactions that were consummated after the close of the respective reporting periods for 1964 and 1965, such appearances should have alerted E&E to make inquiry which would have shown that these transactions were not arms length and were designed to generate income. This is particularly true in this case where the respondents not only knew that McGregor had signed the contract and was the sole owner of Tupper Lake, but that he was also the unnamed recipient of the bonus mentioned in footnote 12 to the financial statement.

This transaction demonstrates that respondents, despite their knowledge of the facts surrounding the acquisition of EFCO, participated in structuring the transaction so that it would meet the requirements of a pooling of interest as a matter of form over substance, but did not see fit to make the disclosures in the financial statements which an investor would have the right to expect. E&E's footnote merely treats this as a stock acquisition without disclosing, among other things, that 5.4 million dollars was borrowed in order to finance the transaction through a shell corporation acting as a conduit, that unregistered stock was issued and pledged to guarantee the loans, and that apparently much of this unregistered stock was sold in order to liquidate the loans. E&E's participation in the structuring of the EFCO transaction so that the sellers could be paid in cash and Westec, as a matter of form, could utilize pooling of interests accounting treatment provided E&E with knowledge of the substantive facts concerning the transaction which respondents were under a duty to disclose.[20/]

20/ U. S. v. Simon, 425 F. 2d 796, 806 (C.A. 2, 1969) cert. den., 398 U. S. 904 (1970)

<u>Sale of Carved Out Oil Production Payment</u>

In September, 1965 Westec began acquiring shares of Camerina Petroleum Corporation ("Camerina") from various sources and before December 31, 1965, owned 97% of the outstanding Camerina shares. The acquisition of Camerina shares by Westec is described in Note 1 to the 1965 Westec consolidated financial statements.

On December 22, 1965, Camerina, pursuant to an agreement dated December 15, 1965 and approved by its Board of Directors, sold to New York Life Insurance Company (a) its note in the principal amount of $4,000,000, (b) a production payment, as carved out of United States properties, in the amount of $1,200,000 and (c) another production payment, as carved out of Canadian properties, in the amount of $1,950,000 (Canadian currency). For these two production payments Camerina received in 1965 a cash consideration of $2,954,628. These production payments were sold with no liability on the part of Camerina in the event the production should not be sufficient to equal the amount of the production payments, but Camerina was required to pay all lifting costs associated with the production. These production payments and their sale are described in Note 7 captioned "Sale of Carved-Out Production Payments" and the note payable is described in Note 10 captioned "Notes Payable and Long-Term Indebtedness" to the 1965 Westec financial statements.

The United States production payment was estimated to require approximately four years, based on normal operations, to produce the oil and gas applicable to the carved out interest and the Canadian production payment was estimated to require seven years of normal operations to pay out, all as described in Note 7 to the 1965 Westec financial statements. The United States and Canadian properties involved in these sales were seasoned oil properties.

After deducting from the gross proceeds of $2,954,628 the costs applicable to the sale, including depletion, depreciation, amortization and estimated future lifting costs based upon data provided in the September 30, 1965 engineering study of Robert W. Harrison & Co., Inc., independent consulting petroleum engineers and geologists, net income from the sale of the two production payments amounted to $1,291,391,[21/] or 27% of Westec's net earnings for 1965. This net income, with the approval of respondents, was taken into 1965 Westec income under the current-income method of accounting for the proceeds from the sale of oil production payments with disclosure in Note 7 to the 1965 financial statements of the following:

> "Under an alternative generally accepted method of accounting for sales of carved-out production payments, proceeds from such sales are accounted for as deferred income to be included in sales as the oil or gas (or other minerals) required to liquidate such payments is produced. If, in connection with the cash received from the sale of carved-out production payments during December, 1965, the subsidiaries had adopted this alternative method, the consolidated net earnings for the year 1965 would have been stated at approximately $3,520,000."

The order and the statement of matters alleges that respondents improperly certified Westec's 1965 financial statements, treating the sale of the two carved-out production payments as current income in the year of transfer 1965, less an estimated reserve for related future

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21/ This is the figure stipulated to by the parties in this proceeding although Note 7 shows $1,349,483. The difference of $58,092 represents income on production runs for November and December 1965 which subsequent adjustments credited to New York Life.

cost. It is alleged that such presentation was materially false and misleading and that respondents knew or should have known these facts.

The method to be used in reporting the income from the carved-out production payments was one of the items on the agenda of the conference held in Houston on March 22 and 23, 1966, and attended by Halvorson. (p. 49, supra). It was concluded that the income from the sales could be reported on the current income method as opposed to the deferred income method. Respondents produced several expert witnesses who testified that the income method used by Westec was a generally accepted alternative method of reporting income from a carved-out oil-production payment.

Much of the expert testimony was to the effect that in order to be generally accepted, an accounting principle does not have to be in majority use, it does not have to be prevalent and it does not have to be the best principle that could be used in the circumstances. The experts testified that in many areas of accounting there are alternative principles which are considered by the profession to be generally accepted.

The OGC, on the other hand, insists that the only method recognized by the Commission and in fact in generally accepted usage in the accounting profession at the time was the deferred income method.

The OGC argues that beginning in 1963 the Chief Accountant of the Commission had taken the position that the deferred income method of reporting for this type of transaction would be the only one acceptable in reports filed with this Commission. This position is supported by a memorandum of May 7, 1963 to the Commission from the Chief Accountant on the subject of accounting for carved-out production payments. This memorandum concerned a registration statement of Occidental Petroleum Corporation ("Occidental") and recommended that the Commission require that proceeds from the "sales" of carved-out production payments be deferred and credited to income as the gas and oil and other commodities are actually produced rather that being reflected as income at the time the proceeds are received as reported by Occidental in its reports for the years 1961 and 1962. The OGC states that since that time all reporting of carved-out production payments have been on the deferred income basis.

Respondents point to the fact, as stipulated to between the parties in this proceeding, that at the time of the release and distribution of the 1965 Westec financial statements, the Commission had not published any rules, regulations or other official releases or opinions on the matter of accounting for the proceeds from the sales of carved-out oil production payments, nor had the AICPA issued any such rules. Therefore, respondents contend, it was acceptable accounting practice to follow an alternative generally accepted accounting principle.

The OGC argues that although no publications had been issued by the Commission or the OCA the entire accounting profession was on notice that the current income method was not acceptable to the Commission and therefore E&E was violating S.E.C. requirements in acquiescing in its use, particularly in view of the fact that both Isensee and Halvorson were aware that three years earlier the Commission staff had objected when another E&E client attempted to report a sale of carved-out oil and gas payments on the current income method.

In connection with a review in 1963 of the financial statements of McCulloch Oil Corporation of California ("McCulloch Oil") for the year ending December 31, 1962, representatives of E&E learned that members of the staff of the Commission took the position that the recorded profit on sales of carved-out oil and gas payments should be deferred over the period of production. Thereafter McCulloch Oil, before distribution of its 1962 financial statements, changed the accounting treatment of the sale of carved-out production payments shown therein from the current income method to the deferred income method. Hogan of E&E advised Westec management that use of the current income method might be challenged by Commission staff members and recommended that Westec adopt the deferred income method in reporting the 1965 sale of carved-out production payments. In response, Westec management advised Hogan that it was Westec's intention to use the current income method if that was an acceptable alternative method of accounting. Hogan, Halvorson and Isensee of E&E concluded that Westec had the right to use the current income method for reporting gains from the sale by Camerina of carved-out production payments and approved the use of that method.[22/]

It is fairly obvious that by adopting the current income method in the face of the acknowledged fact that it was no longer acceptable to the Commission, E&E was taking a calculated risk that such treatment

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22/ Halvorson testified, "If Westec was determined to use it we would not object."

would not be observed or cited as a deficiency. However, when preliminary proxy material was filed in July 1966 in connection with Westec's proposed acquisition of Independent Coal & Coke Company the staff's letter of comment stated that "the proceeds from sale of carved-out production payments should be accounted for as deferred income. . ."

Isensee testified that in advising Westec management that the current income method was an "appropriate method of accounting" respondents were relying on ASR No. 4 which states, in pertinent part:

> "In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant."

Of course if respondents had, as they claim, an honest difference of opinion as to the Commission's position it could easily have been resolved. As Halvorson testified,"it is quite common for companies and their accountants to come down and discuss with the Chief Accountant (of the Commission) problems that they foresee in a filing or to discuss issues as to which they are unsure."

The Commission's Chief Accountant testified that by the time E&E certified Westec's 1965 financial statements the current income method of reporting the income from the sale of carved-out production payments was no longer a generally accepted accounting principle. The Commission, through its Chief Accountant, had begun, in the early 1960's, to recommend to various oil companies that they change to the deferred method of accounting. One of these companies was the E&E client, McCulloch Oil, previously referred to.

In a memorandum dated April 26, 1963, entitled Accounting for "Sales" of Carved-out Production Payments, the Commission's staff reported on a survey which showed that thirty-eight oil companies were using the deferred method while only four were using the current method. Among these four was Occidental, which after some dispute, agreed to use the deferred method in the future. The other three companies proceeded to change to the deferred method. Under these circumstances it is apparent that the accounting profession had ceased to consider the current income method as an acceptable one.

The foregoing facts and circumstances concerning this transaction lead inexorably to the conclusion that respondents, in their willingness to acquiesce in the client's wishes, knowingly ignored the Commission's policy concerning acceptable accounting principles. ASR No. 4, invoked by respondents, offers little solace in that it is addressed to a difference of opinion as to proper accounting principles and in the present situation it cannot be said, in all honesty, that a difference of opinion existed. Halvorson testified that he could not recall any similar case relating to a company's reported income in which E&E had a difference of opinion with the OCA and found it necessary to resolve it unilaterally by relying on footnote disclosure pursuant to ASR No. 4.

Nor can respondents rely on the fact that the Commission did not publish a release or other pronouncement as an excuse for not following Commission policy inasmuch as the evidence fully supports their awareness of such policy.23/

Sale of Oil Properties

Included in the reported income of Westec for the period ended December 31, 1965 is an amount of $2,250,000, representing the gross sale price from the December 29, 1965 sale by Weco Petroleum Co., Inc. ("Weco"), a wholly-owned subsidiary, of its interest in substantially all of the oil and gas properties of Weco, including its interest in 16 producing wells, to Irving Petroleum Investment, Inc. ("Irving"). Westec realized a gain on this sale of $2,042,840 or 42% of its reported net income for 1965.

Weco was incorporated under the laws of the State of Texas on January 21, 1965. In February 1965, James F. Patterson of Houston, Texas was engaged by Weco on a full-time basis as a consulting geolo-

23/ Moses v. Burgin, 445 F. 2d 369, 383 (C.A. 2, 1971); In the Matter of Haskins & Sells and Andrew Stewart, ASR No. 73 (10-30-52).

gist, and in July 1965 Weco employed Wallace H. Brown of Lafayette, Louisiana on a full time basis as a consulting engineer. The daily operations of Weco were supervised by James B. Roedel, President, and by Patterson and Brown, all of whom occupied office space in the Weco offices at Southwest Towers, Houston. At the time of the 1965 audit, the accounting records of Weco were maintained at the Westec offices under the direct supervision of Belcher with detail work being performed by Ray Thompson, Chief Accountant for Westec, and the Weco records pertaining to properties and general administration were kept in the company's offices at Southwest Towers. From the time of its organization through December 1965, Weco participated through investment in the drilling of approximately 90 wells, of which 16 (including 9 wildcat wells) were completed as producers, all as disclosed in the 1965 Westec annual report. Westec's interest in the 16 producing wells amounted to 2.51 net wells. During 1965 Weco incurred expenditures in connection with its drilling activities in excess of $500,000, including dry hole costs of $304,217 which were written off. Apart from the $2.25 million December, 1965 sale to Irving, Weco had gross income during 1965 of approximately $34,000.

In December 1965, Hall and Williams agreed to sell the Weco oil and gas properties to Hall's brother, implementing the sale through a corporation in order to avoid arousing any suspicion. Hall instructed his brother, Fred Hall, that the property should be sold to a corporation, and that he (Fred Hall) should set up a corporation to handle this if he didn't have a corporation available to make the purchase.

Hall further instructed his brother not to sign the conveyances or any legal instruments relating to the transaction, so that his name would not be prominent on any of the documents involved. It was further agreed by Hall and Williams that they "wouldn't disclose to the auditors or lawyers any information that would arouse suspicion or hold things up unless they had to."

Irving Petroleum Investment, Inc. was organized by Fred Hall, Ernest Hall's brother, as a corporation under the Texas Business Corporation Act in December, 1965. At the first meeting of the Irving Board of Directors in December of 1965, Fred Hall was elected President, Mortimer L. Hall was elected Vice President and Lois Hall was elected Secretary-Treasurer of the Corporation. Mortimer Hall is also a brother of Ernest M. Hall, Jr., former President of Westec, and Lois Hall is the wife of Fred Hall.

Of the total purchase price of $2,250,000 paid by Irving to Weco, $1,125,000 was received by Weco in cash on or before December 31, 1965. Weco accepted a note from Irving Petroleum Investment, Inc., for the remaining balance of $1,125,000. This note was paid in full on January 10, 1966.

The funds used to make these payments were obtained as follows:

> On December 21, 1965, 20,000 shares of Westec stock held in the name of Donald McGregor were transferred to Irving. On December 30, 1965, another 10,000 shares of Westec stock held in the name of Donald McGregor were transferred to Irving.
>
> On December 17, 1965, the Irving Board of Directors authorized Fred Hall, as President of the Corporation, to sell all or

any portion of the Westec stock owned by Irving, and between December 17, 1965 and December 31, 1965, 30,000 shares of Westec stock were sold by Irving pursuant to this authorization by its Board of Directors, Moroney, Beissner & Co., a brokerage firm, paying Irving $1,219,466.37 as the proceeds from the sale of this stock.

Between December 30, 1965 and January 10, 1966, Irving obtained loans of $753,862.85 from Wilcrof, Inc. and $375,000 from IEH Petroleum Co. None of these companies were Westec subsidiaries. According to the testimony of Hall, (given at Williams' criminal trial), these companies were owned or controlled by his brothers, Fred L. Hall and Mortimer Hall.

Sometime prior to year-end 1965, while performing a survey of major Westec transactions preliminary to the 1965 audit, Maurer was informed by Belcher that Weco had sold some oil properties during the year. Before Maurer returned to commence his field work in January of 1966, he had received copies of the conveyance documents relating to the December 29, 1965 Weco sale. In January, 1966, Maurer inquired of Belcher concerning the sales Belcher had mentioned during Maurer's preliminary survey and was informed by Belcher that those sales had not gone through, but that Weco had been able to dispose of those and other properties in the conveyance to Irving on December 29, 1965.

Sometime after June 30, 1965, Belcher prepared a document dated June 30, 1965 providing for the sale of carved-out production payments by Weco on certain properties known as the Fenris Properties to Donald McGregor for a consideration of $500,000. This document, which was prepared for execution by Roedel, President of Weco, and McGregor, was given by Belcher to Hall for the purpose of obtaining the signatures of the parties to the transaction. The document was never signed by either Roedel or McGregor.

The gain recorded on the books of Weco for this transaction ($489,171.11) was included by Belcher (as $490,000) under the one-line heading "Sales", in the unaudited consolidated statement of earnings of Westec for the six-month period ended June 30, 1965, which statement is included in the Westec interim report for the second quarter of 1965, in the Westec Form 9-K for the six-month period ending June 30, 1965, which was filed by Westec with the Commission on August 16, 1965, and (as $489,171.11) in the unaudited consolidated financial statements of Westec for the nine-month period ended September 30, 1965.

Sometime in September 1965, Hall reported to Belcher that Weco had made another sale of Weco Oil properties for $650,000. No document of conveyance concerning this transaction was ever prepared. The gain recorded on the books of Weco for this transaction ($626,000) was included by Belcher in the unaudited consolidated financial statements of Westec; $650,000 was included under the one-line heading "Sales", and $24,000 was included under the subheading "Cost of Goods Sold", for the three-month and nine-month periods ended September 30, 1965.

James Roedel, President of Weco, claims that he was not aware, until sometime after August 24, 1966, that either of these transactions were entered on the books of Weco.

In reviewing the Ernst & Ernst Weco work papers in early April, 1966, Isensee noted that there was no schedule analyzing the accounting for this year end transaction by Weco, as required by the E&E audit program, and requested that this be done. Garland Shelton ("Shelton")[24] examined the Weco accounting entries relating to the sale of these oil properties, and prepared a schedule, dated April 14, 1966, outlining the transactions recorded on the books and records of Westec. This schedule reflects:

(1) A journal voucher recording the sale as of June 30, 1965 of "Fenris Properties" to D. M. McGregor for notes receivable of $500,000 and resulting in a gain of $489,171.

(2) A journal voucher recording the sale of property for notes receivable of $650,000 and resulting in a gain of $626,000.

(3) A journal voucher recording the sale of property for notes receivable of $1,100,000 with related cost of goods sold of $164,668, and reclassifying the two earlier sales and reflecting aggregate sales of $2,250,000 and cost of goods sold of $207,159.

In preparing the above schedule Shelton noted that the $2,250,000 sale was actually recorded three times during the year. The first "sale" as of June 30 was booked as of August 31, 1965, by a journal voucher prepared on October 23, 1965, and reflected a sale to Donald McGregor for notes receivable for the full price. The second "sale" was booked as of October 30, 1965, by a journal voucher prepared on December 30, 1965, which would have been one day after the sale to Irving. This was also for notes receivable for the entire $650,000.

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[24] Shelton was an E&E accountant who worked under Maurer's supervision on the Westec audit.

The notes receivable were still unpaid on December 29, 1965. The third journal voucher booked the year-end sale by simply entering the difference between the accounts previously booked and the sales price and related costs as reflected in the December 29, 1965 sale.

Shelton testified that after he had prepared this workpaper schedule he asked Belcher for an explanation of the relationship between the earlier sales and the year-end sale. Belcher testified he told Shelton that both prior sales were supposed to be to Donald McGregor, but that he (Belcher) "had no further information relating to the identity or whether McGregor was, in fact, part of the corporation to which the [year-end] sale was made."[25/] Shelton testified that he accepted Belcher's statement that "we bundled [the properties] all up and sold the entire group" after the two earlier sales had fallen through as a "reasonable explanation for the question that arose in my own mind," filed his schedule in the workpapers, and went on with other work. At the time of Isensee's review the purchase price for the year-end sale had been paid. $1,125,000 was received in cash by Weco on or before December 31, 1965. The balance ($1,125,000) was represented by a note of Irving Petroleum, Inc., signed by Mortimer L. Hall, Ernest Hall's brother and was paid on January 10, 1966.

25/ On cross examination Belcher affirmed the accuracy of this account of his conversation with Shelton, even after he was confronted with his prior testimony to the effect that he was never told of any oil sales to McGregor.

The OGC argues that respondents should have discovered the non-arms-length nature of this transaction by the fact that Westec had booked two earlier sales to Irving, a situation which it is claimed should have caused respondents to investigate further not only the sale of these properties to Irving (and, incidentally, McGregor), but also interim earnings reports prepared by Westec and previously released to shareholders. (See p. 96 infra)

Respondents argue that the sale of the Weco properties presents another instance of collusive fraud on the part of Westec's management and that their examination produced "sufficient competent evidential matter" to demonstrate that the sale was properly authorized, documented and consummated. They state that they did not deviate from generally accepted auditing procedures in their examination of this transaction and all that was involved was a good-faith exercise of judgment.

The facts, as detailed above, demonstrate once again respondents disregard of signs which should have alerted them to a more careful examination. In the first place Isensee ordered a schedule prepared and then appears to have ignored it. Shelton's conversations with Belcher concerning McGregor's participation in the two small sales as well as his possible participation in the final year end sale were, also, disregarded. Besides McGregors' appearance the signature of Mortimer L. Hall on the note for $1,125,000 was overlooked. In view of all the available information the attempt of management to conceal the true nature of this transaction was susceptible of disclosure and a competent audit would have revealed the falsity of the transaction.

By this stage of the engagement respondents should have been on the alert for possible misrepresentations of management. As one of the experts called by respondents, testified on cross examination:

> "Given the knowledge about withheld information as in the manner of the Beco situation, one must as an auditor go on guard, as it were, in relation to other representations of the company rather generally."

However, instead of going on guard and evaluating Westec's "rather quick success" as Isensee characterized it, respondents simply expressed surprise at such good fortune. Isensee testified that he told Belcher:

> "Fine the question is going to be whether you have really got a bona fide sale, if you are going to be selling this property for receivable then there is going to be a question of whether the purchaser's credit is good on this thing, and he said, 'well, we expect to sell this thing for cash,' or at least suggested that, and I said certainly, there is no consideration that is more conclusive than cold hard cash in hand."

Respondents checked the receipt of cash but ignored all the other warning signals. While it is recognized that the ordinary examination of an independent auditor is not primarily or specifically designed to discover fraud, an awareness of such possibility should be present. As set forth in Statements of Auditing Procedure No. 33, (AICPA, 1963):

"In making the ordinary examination, the independent auditor is aware of the possibility that fraud may exist." However, as respondents point out in citing the same Statements No. 33, auditors can be held responsible for failing to detect fraud "only when such failure clearly results from failure to comply with generally accepted auditing standards."

The evidence is compelling that respondents did not comply with generally accepted auditing standards in their examination of the Weco transaction.

Purchase of Westec Stock by Weco

During the E&E audit of Weco the month of August 1965 was selected as the test month. Certain procedures were to be followed in connection with the testing of cash transactions, among them being the examination of "supporting documents for all transactions" including "Vendors' invoice with current date addressed to Weco" and the "correctness of accounting distribution." Also, the intercompany account balances between Weco and Westec were to be checked. The Weco audit was performed by John McCaskill, an E&E accountant.

In his examination of the August checks to Moroney, Beissner & Co., Houston brokerage firm previously mentioned, McCaskill found two checks, one dated August 4, 1965, in the amount of $10,909.25, bearing the typed notation "Dallas R. Davis account" and the other dated August 17, 1965, in the amount of $251.48. The check request form for the August 4 check indicated that the check was requested by Hall and approved by Belcher. The purpose of the check, as stated on the request form, was "acquisition of--Loan to DRD re purchase plan". In addition, at the time he made out the check request form Belcher made a notation in the left-hand corner, as follows: "3 lots (crossed out), 1100 (crossed out) shWE," with below it the note "four lots 1200." The request form for the $251.48 check to Moroney Beissner and Company, listed the purpose of the check as "Balance on Dallas R. Davis Loan." Both of these checks were debited to Weco account No. 1822 titled "Purchase Deposits". The supporting documentation for these checks was not filed with the check request and was not requested by respondents and, consequently, was never examined.[26/] This "Purchase Deposit" account was the third largest asset account on the Weco books and as of October 31, 1965, had a balance of $344,552.93 representing the purchase

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26/ McCaskill stated that the accounting distribution "appeared reasonable."

of 33,300 shares of Westec stock on the open market through Moroney Beissner and Company. On December 31, this balance of $344,552.93 was transferred to an account on Westec's books entitled "Accounts Receivable--Other". This transfer was accomplished by first preparing a journal voucher transferring the $344,552.93 to an Inter-company Investment account, the stated purpose of the entry being, "to record the transfer of Dallas R. Davis A/R to Corp." Another journal entry was prepared as of December 31, 1965 crediting the Inter-company Investment account and debiting Westec's Accounts Receivable--Other. Ray Thompson, the Westec accountant who prepared these entries, was aware that what he was classifying as a receivable was actually the total purchase price of shares of Westec stock. He testified that these entries were false. A third journal voucher debited Westec's Camerina investment account in the amount of $459,860.00, and credited notes payable in the amount of $115,307.07 and accounts receivable for $344,552.93, the stated purpose being to "record the purchase of 183,944 shares of Camerina Petroleum stock at $2.50 per share from M. Baker." These vouchers and entries left the Weco Purchase Deposit account with a zero balance as of December 31, 1965. They also eliminated the Davis receivable from Westec's books.

M. Baker was Malcolm Baker, an administrative assistant who worked for Hall and Williams. In a memo concerning contingent liabilities of Westec Corporation dated 8/31/66, Isensee said:

> "inquired of Belcher, during the course of the 12/31/65 audit, of the source of a note payable to Malcolm Baker at 12/31/65, was told that it was the balance due on acquisition of Camerina stock from Baker, after Baker's taking over a loan or advance balance due from Dallas R. Davis as partial consideration for such stock."

Isensee testified that he made this inquiry because "Baker was an employee of the company and when you have payables or receivables [presumably to an employee] you normally make some inquiry as to the reason why they happen to be there". Isensee did not recall who brought the Baker account to his attention or what he discussed with Belcher about the Dallas R. Davis account receivable. He did not recall discussing this account receivable with Maurer. Maurer, who supervised and participated in the Weco audit, was also aware of the Westec transaction with Baker. Although Maurer knew that Baker was an employee of Westec and that he was receiving some sort of an account receivable totaling $344,000.00 he made no inquiry into the unusual nature of this transaction.

Respondents contend that the entries described above were designed to conceal the stock purchases during the time the audit was in progress. They claim this is demonstrated by management's response to the closing instructions submitted to the various Westec entities and which required completion of a schedule listing investments during the year in the securities of affiliates. The Weco schedule requesting the information was returned to the respondents with the notation "N/A". (Not Applicable). Respondents urge that the Moroney Beissner confirmations, which were the supporting documentation, were not filed by the Westec accountants with the check requests, but were kept separate from the regular accounting records of the company. However, Belcher testified that they were in an office file next to his desk. Respondents argue that McCaskill's not inquiring for these supporting documents or requesting that they be produced is supported by generally accepted auditing standards. Halvorson testified that it was not necessary to examine independent documentation because the purpose of the cash disbursement, as it appeared on the check request form, was "what is described as being in one way or another someone's account or for the acquisition of a loan." Halvorson also testified as to why E&E had no duty to question the removal of the balance in the account on December 31, 1965 by saying "the point is the account no longer exists, so why check into it."

Isensee testified that in testing transactions involving disbursements of goods and services, the auditor will ordinarily examine invoices or statements. Halvorson testified that the supporting documentation for other kinds of disbursements, however, will necessarily vary according to the nature of the disbursements. Both Maurer and Isensee testified that confirmations from Moroney Beissner were not comparable to invoices from vendors of goods and services. The disbursements were ostensibly made in connection with a "loan", something "which would not be evidenced by an invoice." Therefore, according to Halvorson, a properly authorized check request would be adequate support and there was therefore no need for McCaskill to have examined anything more than the check request in the testing of these transactions.

Respondents argument that generally accepted auditing standards did not require them to do more than they did in connection with examining the check documentation is not acceptable in view of all of the circumstances. Also, in view of the fact that August was selected as a test month, it would appear that they could have at least requested the backup for the checks in question. Be that as it may, however, the failure to explore the closing out of the account at the end of the year and the transfer of some $344,000.00 is not satisfactorily answered by Halvorson's testimony that "the point is the account no longer exists, so why check into it". The point is that Isensee and Maurer should have been alerted when they learned that Westec was transferring a $344,000.00 "loan or balance due" to an administrative assistant of Hall and Williams. This is particularly true in view of the fact that respondents admit that by October 1965, they had learned of the misrepresentation made to them by Westec Management in connection with the Beco contingency contract. As the Commission stated in Accounting Series Release No. 19, In the Matter Of McKesson & Robbins Inc.--Summary of Findings and Conclusions (1940):

> "The record indicates that it is not enough for auditors to reconcile intercompany balances and that valuable insight into the company's manner of doing business may be gained by review of the transactions passed through such accounts during the year. Best practice we believe requires the latter procedure."

Unaudited Interim Financial Statements

The order and statement of matters charges that respondents aided and abetted Westec management in the preparation and dissemination of unaudited interim financial statements for the nine months ended September 30, 1965, which were false and misleading because *inter alia* they included income from purported sales of oil properties by Weco. It is alleged that respondents knew or should have known that these interim financial statements were false.

Although the sales of oil properties by Weco to McGregor did not go through (p. 87, supra) the gain was recorded on the books of Weco and included in interim financial statements of Westec during 1965. The gain on the June 30, 1965 transaction ($489,171.11) was included by Belcher (as $490,000) under the one line heading "Sales", in the unaudited consolidated statement of earnings of Westec for the six-month period ended June 30, 1965, which statement is included in the Westec interim report for the second quarter of 1965, in the Westec Form 9-K for the six-month period ending June 30, 1965, which was filed by Westec with the Commission on August 16, 1965, and (as $489,171.11) in the unaudited consolidated financial statements of Westec for the nine month period ended September 30, 1965.

Sometime in September of 1965, Hall reported to Belcher that Weco had made another sale of Weco Oil properties for $650,000. No document of conveyance concerning this transaction was ever prepared. The gain recorded on the books of Weco for this transaction ($626,000) was included by Belcher in the unaudited consolidated financial statements of Westec; $650,000 was included under the one-line heading "Sales", and $24,000 was included under the subheading "Cost of Goods Sold", for the three-month and nine-month periods ended September 30, 1965.

From February 2, 1966, through February 5, 1966, Maurer spent 23 hours on a task which he described in his "Statistical Time Report" as "Assistance in preparing without audit financials and notes for 9-30-65 to be used in listing" application concerning Metric. He did not inquire whether any income from the earlier Weco oil sales was included in the reported earnings of Westec as shown on these financial statements although he then knew that those sales had fallen through, and although the reported gross sales and net earnings shown on these financial statements were unchanged from the figures given in the printed Westec Interim Report to shareholders dated November 13, 1965, covering the nine months ended September 30, 1965. 27/ On March 22, and 23, 1966, Maurer participated in a conference with Newman T. Halvorson, of the Ernst & Ernst national office, in which the Westec 1965 financial statements were discussed. (p. 49 supra). For purposes of this conference Belcher had prepared a schedule entitled "Analysis of Earnings Decline - WE Inc. & Subs & Acq." which shows that the "Last Reported Figures" for Weco as of November 30, 1965, reflected earnings of $1,043,547.

27/ Maurer testified that his participation in the preparation of the September 30, 1965, financial statements was limited to work on the statement of additional paid-in capital and did not include any work on the income statement or the notes to these financial statements. However, his "Statistical Time Report " specifically mentions the notes and also shows that he was aware that these statements were being prepared for filing with the American Stock Exchange in connection with a listing application.

Maurer's review of the interim financial statements was in connection with the filing for the Metric acquisition of a listing application with the American Stock Exchange and an exemption application with the SEC. Maurer's review occurred approximately three months after the interim reports involved were released to shareholders. At the time, as stated above, he was aware that the purported "sales" had fallen through but made no inquiry as to what effect this may have had on the nine months statements he was reviewing. This was another instance where the application of proper auditing procedures or the exercise of a modicum of curiosity would have revealed the falsity of the interim statements.

Under all the circumstances it becomes apparent that while an adequate examination by respondents would have revealed the falsity of the unaudited September 30, 1965, financial statements and thereby prevented their further dissemination, the record does not support the allegation that respondents aided and abetted in their preparation.

<u>Form of Income Statements</u>

The statement of matters alleges that respondents improperly certified financial statements in which the income statement for 1965 reflected both income from operations and non-recurring income instead of segregating extraordinary and nonrecurring items so that the financial statements would present fairly the results of operations and in a manner consistent with the 1964 financial statements.

The items in question are the sales of the Weco properties and the Camerina carved-out production payment. Both of these items, totaling $5,204,628, are included in current operating income. The OGC argues that these are nonrecurring items and should have been set out as extraordinary income so that the material contribution of these two items to the income for 1965 would be properly understood.

An indication of the fact that respondents were aware that the form of presentation in the 1965 financials was unacceptable is illustrated by the fact that the 1965 statement of earnings was changed three months after the report was issued. In July 1966, Westec's 1965 financial statements were filed with the Commission in preliminary proxy material prepared in connection with its proposed acquisition of Independent Coal & Coke Company, previously mentioned. E&E assisted with the preparation of the statement of earnings contained in those financial statements, which separates the "Gain on sale of carved-out production payment" and "Gain on sale of oil and gas properties" from the current operations of Westec and places these items under the heading "Other income (expense)" below current operating income. In addition, the gain from each item is shown separately so that the material contribution to net income is readily apparent without any computation.

Several experts called by respondents testified that in their opinion, the form of reporting these items in the 1965 Westec financials was not misleading. They pointed out that both items were separately shown in the income section and that the corresponding expense for each item was shown under operating cost and expenses so that the reader of the financial statement could readily compute the contribution made to net earnings by these two transactions. Respondents concede that these sales were not "normal recurring" items but argue that Westec was in the business of developing oil and mineral interests so in that sense the sale was not extraordinary. One of the experts testified "it clearly showed in the way they set it out that it was something that was not regular". Further, all the experts made it clear that in view of the degree of disclosure the form of reporting was acceptable whether the sale was considered to be "recurring" or "nonrecurring".

E&E's Guide for Report Writing states, under the heading, Determination of Net Income and Extraordinary items:

> "Net income or loss shall include all items of income and expense recognized during the period except for material items and adjustments which can be identified specifically with, and directly related to, business activities of prior periods. Material items which are extraordinary in nature, that is, not typical of the customary business activities of the business enterprise, should be segregated from the results of ordinary operations and shown separately in the income statement. The income statement should disclose the following elements:

Income before extraordinary items	$6,850,000
Extraordinary items, less applicable income tax--Note C	975,000
Net income	$7,825,000

One of the major problems in reporting on the results of operations will be the recognition of extraordinary items. To be adjudged extraordinary, the item should be material, should not be expected to recur frequently and should not be considered as a recurring factor in evaluating the operating processes of the business. (See APB Opinion, Reporting the Results of Operations for criteria identifying extraordinary items and specific exclusions therefrom)."

The APB opinion referred to is No. 9, issued in December 1966, which sets forth in paragraph 21 the criteria for extraordinary items related to the current period:

"The segregation in the income statement of the effects of events and transactions which have occurred during the current period, which are of an extraordinary nature and whose effects are material requires the exercise of judgment."

Based on E&E's own guidelines, and APB No. 9 referred to therein, it becomes apparent that respondents did not present the results of the Camerina and Weco transactions in an acceptable form. The subsequent presentation in the proxy material indicates that respondents were fully cognizant of the proper disclosure but chose to ignore it, thereby rendering the financial statements, as included in Westec's 1965 Annual Report, materially misleading.[28/]

28/ Columbia Baking Company, et al., 38 SEC 213, 217 (1958).

Summary and Conclusions Concerning 1965 Audit

Any summary of the 1965 audit must be viewed in the light of the 1964 audit and subsequent events, particularly the discovery of the Beco transaction. Respondents were now aware of management's duplicity which should have alerted them to be "on guard". Any notions as to managements' reliability should have been dispelled by this time. The Beco contingency had been discovered, Doliver hadn't produced any business, contrary to Belcher's representations upon which Isensee had depended, and the Trak acquisition, which the SEC staff had questioned had, also, drawn comment in a memorandum of 3-2-65 from Hogan to Isensee, as follows:

> "It seemed obvious that the intent of the parties was to obtain a pooling treatment on the present statements and convert to a cash transaction this summer."

In addition to the warning signals triggered by the 1964 audit, the meeting on March 22 and 23, 1966, for the express purpose of discussing Westec's earnings decline, at which top echelon E&E personnel were present, should have indicated management's poor earnings situation and its desire to improve them through any available means. At that conference the discussion centered on accounting for proceeds from sales of carved-out production payments and oil properties. Immediately after the conference the pooling of interests transactions occurred. As Isensee testified concerning Westec's interest in acquisitions:

> "They were looking to every source they could and Mr. Heinen apparently indicated to them that we did have some listings, some information on companies that might be available."

Isensee was referring to an arrangement in E&E offices around the country to provide interested clients with information as to companies that were available for acquisition.

Without the Camarina and Weco transactions, which were discussed at the March 22-23 conference, and the subsequent pooling Westec would have had no income for 1965. (P. 50 supra). Therefore, the tremendous profits that were brought into income from these sources should have aroused some interest as to their bona fides. Weco was a patent fabrication and its appraisal value of approximately $400,000 should have raised questions in view of the $2,250,000 sale price. The weaving into ordinary income of the profits from Weco and Camarina indicatesan intent to conceal the serious lack of other income. Add to this the structured Seacat and EFCO acquisitions and more than the $4,868,913 of reported net income is accounted for. The reappearance of McGregor in two,or possibly three, more transactions was allowed to go unquestioned. Not only did he figure prominently in EFCO and two recorded oil property sales during 1965 but the sales of shares in his name to pay off the $1,125,000 down payment on the Weco sale to Irving remains unexplored and unexplained, (P. 83 supra).

All of these circumstances should have been inquired into by respondents. As the Commission said in McKesson & Robbins (P. 48 supra):

> "The time has long passed, if it ever existed, when the basis of an audit was restricted to the material appearing in the books and records."

OTHER MATTERS

Expert Testimony

Respondents contend that the issues presented in this proceeding are questions requiring expert guidance to resolve and in support of their position introduced the testimony of a number of members of other firms who testified as experts. Respondents lay great emphasis on this testimony and point out, that with the exception of some limited rebuttal, no expert testimony to the contrary was introduced by the OCA. However, as the Commission has previously stated, while the opinions of qualified expert accountants may be helpful, the Commission must in the last analysis weigh the value of expert testimony against its own judgment of what is sound accounting practice.[29/]

Careful consideration has been given to the testimony of the experts but it has not been deemed necessary to discuss it at length since the views they expressed were substantially the same as those of respondents.[30/]

Generally Accepted Accounting Principles

Much of the testimony adduced from the expert witnesses called by respondents was concerned with supporting respondents in their basic contention that in their audits of Westec they did not violate generally accepted accounting and reporting principles and auditing standards.

29/ Interstate Hosiery Mills, Inc., 4 SEC 706, 715 (1939).

30/ In the Matter of Haskins & Sells and Andrew Stewart ASR 73 (10-30-52).

However, when the occasion arises respondents are willing to follow alleged erosions of the pooling of interests criteria laid down in ARB No. 48, citing instances where the OCA allowed some deviation depending on the circumstances in a particular case. Then they turn around and reject Commission policy as it concerns the reporting of income from carved-out production payments on the ground that it was not officially published. Neither was the action in pooling of interests cases. In other words, while depending on exceptions to pooling criteria accepted by the staff, respondents deny Commission authority in connection with reporting of income for carved-out production payments.

The Commission long ago expressed its opinion in this area when it said:

> "We think, moreover, that too much attention to the question whether the financial statements formally complied with principles, practices and conventions accepted at the time should not be permitted to blind us to the basic question whether the financial statements performed the function of enlightenment which is their only reason for existence. 31/

That the emphasis of the Commission is on adequate disclosure rather than form or purported following of announced accounting principles and policies is evidenced by a letter, dated December 11, 1947, from the Chief Accountant to the Director of Research of the American Institute of Accountants ("AIA") which states, in part:

> "Under these circumstances the Commission has authorized the staff to take exception to financial statements which appear to be misleading, even though they reflect the application of APB No. 32." 32/

31/ Associated Gas & Electric Company, 11 SEC 975, 1058 (1942).

32/ 85 Journal of Accounting 25 (1948).

Independence

The order and statement of matters alleges that respondents were not independent in their performance of the Westec audit in 1964 and 1965.

One cornerstone of proper professional conduct is that the accountant shall be independent of the client whose financial statements he certifies.33/

Rule 2-01(b) of Regulation S-X, promulgated by the Commission under the respective statutes which it administers and enforces, provides in part: "The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent...." Rule 2-01(c) of Regulation S-X provides: "In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission."

The public accountant must report fairly on the facts as he finds them whether favorable or unfavorable to his client. His duty is to safeguard the public interest, not that of his client. As this Commission pointed out in an early decision:34/

33/ SEC 10th Annual Report, 205 (1945).

34/ In the Matter of Cornucopina Gold Mines, 1 SEC 364, 367 (1963).

> ". . . The insistence of the Act [Securities Act of 1933] 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. . . . Accordingly, the certification gives a minimum of protection against untruths and half-truths which otherwise would more easily creep into financial statements. . . . It [the certificate] is a material fact, for it gives meaning and reliability to financial data and makes less likely misleading or untrue financial statements. . ."

The evidence in this case, as detailed heretofore, leaves no doubt as to respondents lack of independence in conducting their examination and expressing their report thereon. The record is replete with examples of unverified dependency on management. Indeed, respondents' brief repeatedly cites instances of reliance on Belcher, Hall, Williams or simply "management". Perhaps the most striking concession is the one concerning Belcher, which as stated in their brief has previously been referred to herein on page 47 but which bears repeating in the present context; respondents did "accept as factual certain representations made to them by Belcher <u>who was of course more than a representative of management. He had been an associate of respondents for most of the preceding 12 years"</u> (Underscoring supplied).

Another indication of a lack of independence alleged in the statement of matters is that respondents delayed their reports on the 1964 and 1965 financial statements in order to permit the inclusion of earnings of companies which were acquired after the close of the year and were pooled retroactively back into the financial statements of the past year.

With respect to the 1964 financials respondents met with management on 3-12-65 at which time they had financial statements prepared to certify as of 3-15-65. However, management made three acquisitions after those dates, on March 25, 29 and 31, respectively. Respondents report was dated March 26, 1965, but not approved for printing until April 2 or 3, 1965.

As regards the 1965 financials respondents met with management on March 22 and 23, 1966. As far back as March 8, 1966, Heinen had estimated that E&E's report would be out about April 1, 1966. However, two acquisitions were made on April 18 and 27, respectively, and E&E's report was dated April 28, 1966.

The record in this proceeding discloses that the only adjustments made to the financial statements for both 1964 and 1965 were for the purpose of including the pooling of interests transactions described above. This strongly indicates that respondents had completed the audit for 1964 on or before March 15, 1965 and for 1965 on or before April 1, 1966, and that the issuance of the reports for both years was delayed so that these later transactions could be included.

E&E's Guide to Audit Procedure states that the date of the audit report is usually the date of completion of the field work. Applying that standard the evidence supports the conclusion that the field work was completed on or before March 15, 1965 and on or before April 1, 1966 for the years 1964 and 1965, respectively. Therefore, any extension beyond those dates was for purposes other than completing the field work.

Upon careful consideration of all relevant circumstances it is concluded that respondents were not independent within the meaning of the Federal securities acts or the Commission's Rules and Regulations promulgated thereunder. Accordingly, the reports filed by Westec for 1964 and 1965 are further deficient in that the financial statements included therein have not been certified, as required by the appropriate regulations, by an independent public accountant.[35/]

Supervision

The responsibility for the certification of these financial statements rests with E&E. As the Commission has said:[36/]

> ". . . where a firm of public accountants permits a report or certificate to be executed in its name the Commission will hold such firm fully accountable."

It becomes evident upon a review of the record that E&E had established procedures for the conduct of audits and the presentation of results but that such procedures were not followed. Also, there were consultations by telephone between the Houston branch office and the Cleveland home office and meetings with the client at which E&E partners were present. In addition, many of the E&E partners had considerable SEC experience. In light of all these guidelines it becomes apparent that lack of supervision at all levels was largely responsible for their not being followed.

Some indication of the problem is contained in a Memo to File from Erwin Heinen, dated 11-5-64, which recaps a lengthy discussion between Heinen and Belcher on 11-4-64 concerning the need of information for the

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35/ A. Hollander & Son, Inc., 8 SEC 586, 617 (1941).

36/ ASR No. 67 (April 18, 1949).

audit and concludes: "I repeated all this information to Mr. Johnson and Mr. Maurer, <u>since there seems to be such a lack of communication</u>, as to why we need the tax returns, what we are going to do with them after we get them, and when we are going to finish up our projects" (Underscoring supplied).

Copies of this Memo went to Maurer, Isensee and Hogan and Isensee initialled it.

The initiation of guidelines and instructions serves no useful purpose if they are not implemented. In its own way it is another example of form over substance and steps should be taken by E&E to enforce its own procedures.

Public Interest

As heretofore indicated in the respective Summary and Conclusions for 1964 and 1965, it is found that the financial statements certified to by E&E for the years ending December 31, 1964 and December 31, 1965, were materially false and misleading.

It is concluded, also, that in certifying such financial statements the respondents failed to comply with generally accepted auditing standards and rules and regulations of the Commission, and failed to fulfill their responsibilities as independent accountants by their reliance upon the unsupported and unverified representations of management, and by delaying their reports for management's benefit.

Under these circumstances it is concluded that the E&E firm and the individual respondents, Maurer and Isensee, engaged in improper professional conduct within the meaning of Rule 2(e). Accordingly, it is necessary to consider what disciplinary action is appropriate.

Careful consideration has been given to all pertinent factors, including those stressed by respondents. However, these are serious charges and Maurer and Isensee are skilled professionals and E&E is a firm with a favorable reputation in the accounting field. The failure of the respondents, individuals and firm, were not entirely the result of negligence although on many occasions they were negligent. Rather, it is found that respondents were aware of facts which they chose to ignore, generally accepted auditing standards and principles which they disregarded, and independent courses of conduct which they were persuaded not to follow.

Respondent Maurer was audit manager on the engagement. He was responsible for the field work and reported to Isensee. This was Maurer's first large audit of a public company with a national stock exchange listing, required to file with this Commission. Although he was responsible for the audit program and the day to day routine examination he did not make the policy decisions on pooling of interests, carved-out production payments or other matters. He did have constant contact with management, particularly Belcher, and came to depend on information supplied from those sources. He was negligent in seeking outside verification of management supplied information. However, if his work and that performed under his direction had been properly coordinated and reviewed many of the errors should have been eliminated. Upon consideration of all factors concerning his role it is believed that he should be denied the privilege of practicing before this Commission for the period of one year.

Respondent Isensee has been with E&E since 1941 and was certified in 1948. He is a skilled professional and was the partner in charge of this engagement.

Isensee's actions reflect his accounting background. He took the correct accounting positions in many situations but abandoned them in the face of management persuasion or other pressures not disclosed. At the outset he insisted on correct accounting procedures in the BFI warrant and Arizona property matters and refused to compromise. In the ICF Florida property transaction he made inquiries about McGregor but failed to follow up. In Doliver he relied on information from Belcher as to future business intent and allowed a pooling. In Seacat he raised questions which threatened the pooling, i.e., continuity of management, leasing arrangement, but then structured the transaction to management's wishes. In Weco he had schedules prepared which contained leads that would have uncovered the fraud but did not follow them. He testified that he did not read the PW report on Beco but the evidence does not support him. He did discuss the Beco contingency with Hall but then succumbed to Hall's assurances. In the Weco purchases of Westec stock he inquired about Baker because he was an employee, but then let it drop. He made all of the pooling decisions and was responsible for the complex structuring of the Seacat transaction and was aware of the facts behind the EFCO pooling. He consulted Halvorson on some poolings, but the record indicates, he did not fully apprise Halvorson of all matters necessary for an adequate consideration.

There can be no doubt that what Isensee did, or neglected to do, was knowingly and deliberately done or not done. By his conduct and acquiescence he was fully culpable for the improper audits which resulted in false and misleading financial statements being contained in Westec's Annual Reports for 1964 and 1965 and which were filed with this Commission.

Upon consideration of all aspects of his participation in the 1964 and 1965 audit engagements it is believed that he should not be permitted to practice before this Commission for a period of three years.

Concerning the E&E firm it is concluded that it should be held responsible for failure to properly supervise the activities of its

Houston office. Therefore, it is believed that E&E should institute stringent measures to insure that the violations and inadequacies enumerated herein will not occur again.

Under all the circumstances it is concluded that E&E should be barred from Commission practice as to new business, with provision made that at the end of six months E&E upon proper showing, may make application to be restored to full practice before this Commission.

ORDER

Accordingly, IT IS ORDERED, pursuant to Rule 2(e) of the Rules of Practice, that respondents John F. Maurer and Clarence T. Isensee be denied the privilege of practicing before this Commission for the periods of one year and three years, respectively, from the effective date of this order.

IT IS FURTHER ORDERED that Ernst & Ernst be barred from certifying to any financial statements filed with this Commission for any new client 37/ or participating in any other filing (with the Commission) of a new client, except that after a period of six months from the effective date of this order upon proper showing being made that E&E has adopted acceptable procedures for assuring adequate internal supervision in the preparation of financial statements so as to preclude recurrence of similar violations, the privilege of practicing before this Commission without restriction may be restored.

37/ A "new client" shall be defined as any prospective client for whom E&E has not previously prepared a financial statement as of 45 days following the effective date of this decision.

This order shall become effective in accordance with and subject to Rule 17(f) of the Commission's Rules of Practice.

Pursuant to Rule 17(f), this initial decision shall become the final decision of the Commission as to each party who has not within fifteen days after service of this initial decision upon him, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission, pursuant to Rule 17(c) determines on its own initiative to review this initial decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.[38/]

Ralph Hunter Tracy
Hearing Examiner

Washington, D.C.
July 19, 1972

38/ To the extent that the proposed findings and conclusions submitted by the parties, and the arguments made by them, are in accordance with the views herein they are accepted, and to the extent they are inconsistent therewith they are rejected.