

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

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In the Matter of  
ERNST & ERNST  
CLARENCE T. ISENSEE  
JOHN F. MAURER  
Rule 2(e) of the Rules of Practice

INITIAL DECISION  
(Private Proceeding)

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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 Commission.

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







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").



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."<sup>6/</sup> 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.<sup>7/</sup>

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

<sup>7/</sup> 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).<sup>8/</sup> 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<sup>9/</sup> 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.<sup>10/</sup>

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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<sup>10/</sup> The instructions to Form 10-K under Part II, item 11 calls for the disclosure of any person known or 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

U/ \$230,000, 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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U/ 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 dis-

closure. 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.<sup>12/</sup> 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.

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<sup>12/</sup> 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 consummated 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<sup>12a/</sup> 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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<sup>12a/</sup> 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 Isensæ 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.<sup>13/</sup>

#### 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% cumulative 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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<sup>13/</sup> 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 occurred 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







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 consummated" 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





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 acquirer 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.





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.











### 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



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."

#### 1965 Pooling of Interests Transactions

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







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 pur-





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



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. <sup>17/</sup> The important thing for an accountant to con-

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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









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, whichever 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.,



Moreover, there was a complete change in the power to control management, if not management itself, which also violated the pooling standards.<sup>19/</sup>

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

"6. Other attendant 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



Sale of Carved Out Oil Production Payment

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



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 than 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





mend 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.



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.

































































